Tharaa Financial Center

PSU-1998

Pre-Budget 2023

October 2022

Sustaining momentum

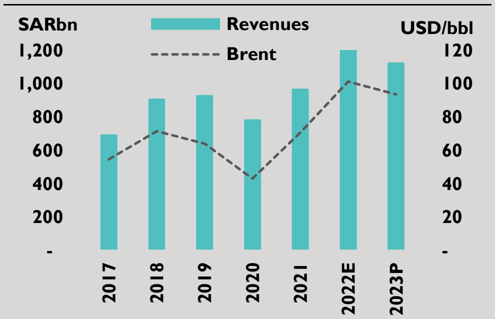
KSA's Fiscal Budget 2023 Snapshot

SARbn	2022E	2023P	YoY
Total Revenue	1,222	1,123	-8.1%
Total Expenditure	1,132	1,114	-1.6%
Budget Surplus	**90**	**9**	**-90%**
Budget Surplus (% of GDP)	**2.3%**	**0.2%**	**-210bps**
Public Debt	967*	967*	_
Public Debt (% of GDP)	24.5*	24.9%	

*1H22

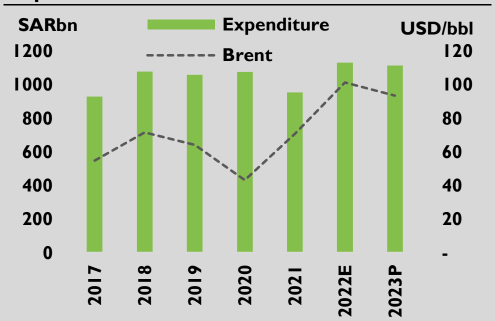
Source: Budget Statement 2023

Revenue Trend



Source: Ministry of Finance, Bloomberg

Expenditure Trend



Source: Pre-Budget Statement 2022, Bloomberg

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Pre-Budget 2023: From turnaround to sustaining momentum

The Preliminary Budget for 2023 unveiled by the Ministry of Finance on 30th Sep seeks to further build on the strong economic momentum and fiscal consolidation achieved in 2022 to accelerate the progress towards targets under Vision 2030. Despite incorporating apparently conservative estimates, authorities have pencilled; (i) continuation of fiscal surplus to sustain in future to further strengthen fiscal sustainability, (ii) inflation (regulated prices + commodity price drop) and GDP growth (high base-effect+ post COVID-19 normalization of economic activity) to normalize and (iii) higher medium-term expenditure ceiling (likely driven by higher allocation for capital expenditure and subsidy benefits). The room for further fine tuning of estimates at the time of approval of the budget by the Council of Ministers for both 2022 and 2023 remains in view of performance in 1H2022 and favourable oil price environment.

GDP: Major revision in 2024 estimate, no major change in 2023

While the MoF has left the GDP (8/3.1%) and CPI estimate (2.6/2.1%) unchanged for 2022/23, medium-term projections show significant revisions in 2024/25 GDP estimates to 6/4.5% from previous 3.6/3.3% respectively. The revisions are partially explained by; (i) ramp-up in investment as a result of a number of structural reforms and initiatives, and (ii) higher consumption. Private sector will likely remain a major driver of future growth. Meanwhile, the role of Public Investment Fund (PIF) remains important in spurring investment in strategic sectors crucial for delivery of objectives under Vision 2030. CPI estimates for the medium-term (2/2.1%) are broadly unchanged. Regulated prices, stable currency regime and no major flare-up in food prices likely underpin normalization of CPI.

Fiscal Targets: Surplus seen despite higher expenditure ceiling

Concurrent to revision in the medium-term estimates for GDP, estimates for total budget outlay and revenues build in significant revisions. More importantly, the MoF now projects recurring fiscal surplus over medium-term with more visibility on non-oil revenue as a result of past efforts on diversifying revenue base, and favourable oil dynamics. MoF has proposed upward revision in expenditure ceiling by 17/18% over 2023/2024. Expenditure over medium-term is expected to range 26-29% of GDP (SAR1.1trn). Greater focus on social benefit and protection and support for strategic initiatives (Capex: ~4% of GDP) likely account for the revision. Projections for fiscal Revenues have also been revised up in tandem by 15-16% (28-29% of GDP). We estimate the Pre-Budget 2023 incorporates USD70-75/bbl oil prices for 2023 (USD60-65/bbl in 2022, see details inside). To us, total revenue forecasts leaves possible room for upside risks in both 2022/23 from three sources; (i) higher oil prices, (ii) revision in Aramco dividend, & (iii) preponing of major oil projects.

Fiscal surplus to be used for higher fiscal sustainability

The three key areas for utilizing projected fiscal surplus are; (i) rebuilding further fiscal cushion (reserves 30-month import cover in July vs an average of 38-month) in order to enhance fiscal sustainability, strengthening public funds and accelerating projects of strategic importance. The MoF has proposed sticking to its strategy of repaying the debt principals from fresh borrowing. Overall debt in 1H is quoted at SAR967bn (24.5% of GDP), up 4% from Dec-21 levels. Despite fiscal surplus (3.4% of GDP in 1H), the MoF has raised additional financing in 1H22, over and above debt repayment, ahead of interest rate hikes. Assuming MoF sticks to its strategy of maintaining debt level, Public debt/GDP is expected to drop to 22.7% by 2025.

Key risks ahead

The four key risks to MoF projections stems from; (i) any risk to global economic growth as major economies deal with record inflation and reversal of COVID-era monetary stimulus (ii) dynamics of oil markets, (iii) any regional or global COVID-like challenge, and (iv) delays in major projects or non-materialization of anticipated benefits.

From turnaround to sustaining momentum

The draft budget demonstrates government's aspirations to further build on the strong momentum of economic activity and fiscal consolidation achieved in 2022

The Ministry of Finance (MoF) unveiled Pre-Budget document on 30th Sep-2022. The draft budget clearly demonstrates government's aspirations to further build on the strong momentum of economic activity in the aftermath of COVID-19 and fiscal consolidation in order to accelerate progress towards achievement of goals set under Vision 2030.

Despite incorporating what we believe conservative estimates on revenues, authorities have pencilled;

(i) Continuation of fiscal surplus to sustain over the medium term which will further strengthen fiscal sustainability,

(ii) GDP growth (high base-effect+COVID-19 normalization of economic activity already achieved) and CPI (high-base + commodity price drop) to normalize,

and (iii) upward revision in medium-term expenditure ceiling (likely driven by higher allocation for capital expenditure and subsidy benefits)

Overall, the room for further fine tuning of estimates at the time of approval of the budget by the Council of Ministers (likely by Dec-22) for both 2022 and 2023 remain in view of performance in 1H2022 and favourable oil price environment.

GDP: from acceleration to consolidation

Latest medium-term projections carry significant revisions in 2024/25 GDP estimates to 6/4.5% from previous 3.6/3.3% respectively

While the MoF has left the GDP (8/3.1%) and CPI estimates (2.6/2.1%) unchanged for 2022/23, medium-term projections show significant revisions in 2024/25 GDP estimates to 6/4.5% from previous 3.6/3.3% respectively. For 2022, 8% GDP growth for KSA is expected to be highest among major economies as per IMF estimates as both engines of economy i.e. oil (high oil production) and non-oil (wholesale & retail, restaurants & hotel) sectors are on fire. On nominal basis, a sharp recovery in oil and commodity prices, coupled with higher underlying real activity will provide the final push for the Kingdom to achieve a much-coveted landmark of USD1trn economy in 2022. KSA's projected GDP growth of 3.1% for 2023 is still quite respectable and one of the highest among G20 countries as per IMF estimates.

The revisions are made despite higher-base effect from 2022 are partially explained by;

(i) **Ramp up in investment as a result of a number of structural reforms and initiatives.** Private sector will likely remain a major driver of future growth as the government implements a multi-prong strategy which encompasses tapping of existing potential in key industries, opening-up new sectors and enhancing the role of private sector via privatization and PPP

(ii) **Higher consumption (total contribution of 55% in GDP):** Both government (higher expenditure ceiling) and private sector consumption (purchasing power+higher employment) are likely to contribute to higher GDP growth. The complete recovery in tourism and travel segment following removal of COVID-19 related restrictions will also contribute to overall economic activity.

(iii) The role of Public Investment Fund (PIF) remains crucial in spurring investment in strategic new sectors crucial for delivery of objectives under vision 2030.

KSA has made significant contribution towards achieving oil market stability by increasing its production by 13% since Dec-21

(iv) **Improved trade balance in light of more favourable environment for oil:** KSA has made significant contribution towards achieving oil market stability by increasing its production by 13% since Dec-21. The average production for 2022 is likely to remain between 10.7-10.8mmbpd vs Kingdom's current production ceiling of 11.5mmbpd under OPEC+ arrangement. While the risk of global recession have grown and may reflect in low global energy demand, the geopolitical conflicts, the need for rebuilding of the U.S strategic oil reserves and production constraint faced by many OPEC+ members will likely keep dependence on oil from the Kingdom high and hence may cushion KSA from potential drop in global oil demand.

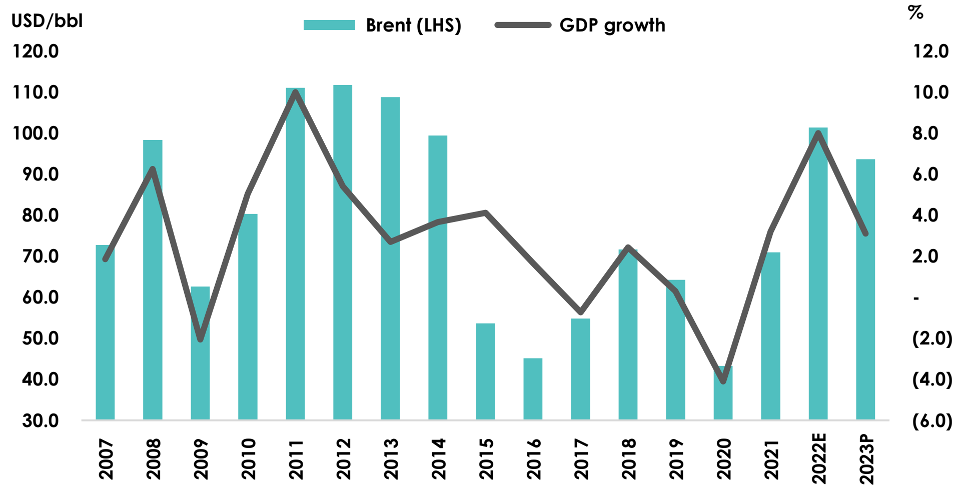
Key Economic Indicators in Medium-Term

%	2020	2021	2022E	2023P	2024P	2025P
Real GDP growth	-4.1%	3.2%	8.0%	3.1%	6.0%	4.5%
Nominal GDP (SARbn)	2,625	3,126	3,927	3,897	3,966	4,247
Nominal GDP Growth	-11.7%	19.1%	25.6%	-0.8%	1.8%	7.1%
Inflation	3.4%	3.1%	2.6%	2.1%	2.1%	2.0%

Source: Pre-Budget 2023, Tharaa

GDP growth is expected to normalize in 2023 (3.1%) after a sharp increase in 2022 (8%).

GDP growth set to normalize in 2023 post a steep rise in 2022



Source: Pre-Budget Statement 2023, Bloomberg

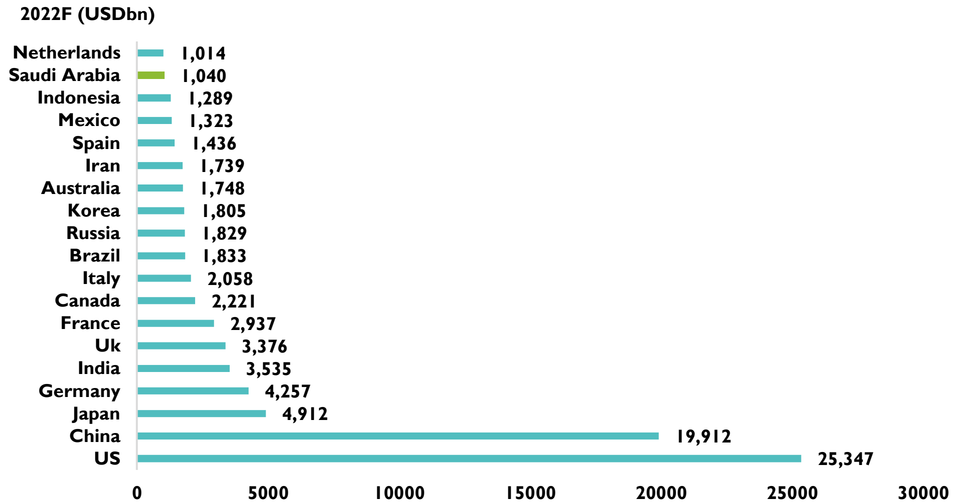
In 2022, Saudi Arabia's GDP is expected to grow at the fastest rate (7.6%) among G20 countries as per IMF estimates

GDP set to grow at the fastest pace among G20 countries in 2022

Source: IMF Estimates

KSA is set to achieve a much-coveted landmark of USD1trn economy in 2022

KSA is poised to achieve a much-coveted landmark of USD1trn economy in 2022



Source: IMF Estimates

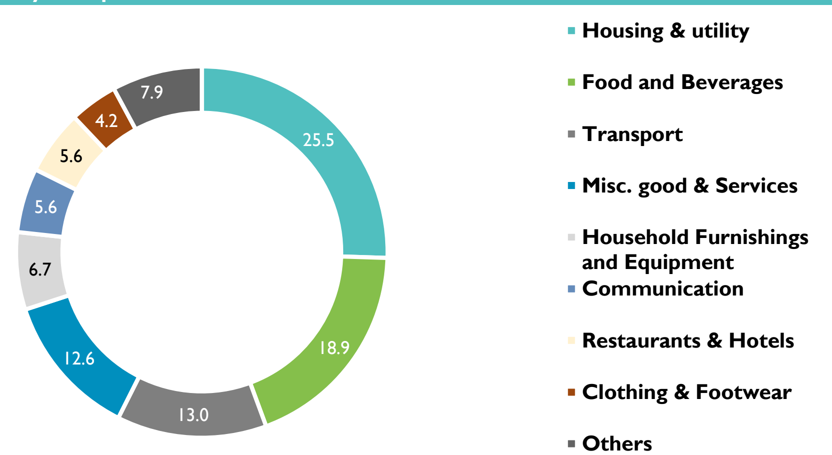
CPI to normalize; big positive real interest on the cards

CPI estimates for 2023 (2.1%) and mid-term (2/2.1%) are largely unchanged from estimates carried in the medium-year projections published in 2022.

CPI estimates for 2023 (2.1%) and mid-term (2/2.1%) are largely unchanged from estimates carried in the medium-year projections published in 2022. Regulated energy and utilities prices, stable currency regime, expectation of no major flare-up in food prices and relief on supply chain challenges, particularly in food items, likely underpin normalization of CPI over the medium-term, in our view. The key risk to projection primarily stems from abnormal flare up in housing rent index (21% weight in CPI basket).

That said, it is worth highlighting a major corollary of a benign inflation environment in KSA vis a vis the U.S, base currency for SAR currency peg, is the persistence of positive real interest in the Kingdom for an extended period given; (i) current outlook of inflation and interest rates in the U.S, and (ii) expectations of mirroring the movement in interest rate in the U.S by the central bank in the Kingdom in order to avoid complication with the arbitrage opportunities. Current consensus estimates build in Fed Fund Rate of 4.25-4.5% by end of 2023, suggesting at least further 100-125bps hike in interest rate from current levels of 3.25% (upper bound). This implies positive real interest rate of 2-2.15% in KSA over 2023.

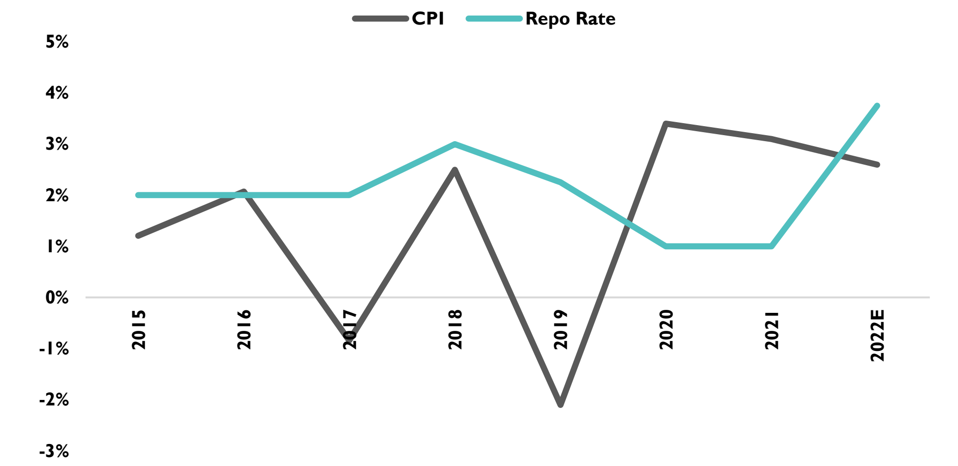
Weights of Key Components in CPI Basket



Source: Pre-Budget Statement 2023, Bloomberg

The persistence of positive real interest rate in the Kingdom (2 - 2.15%) for an extended period beyond 2023 is a major corollary of a benign inflation environment in KSA relative to the US and currency peg

Significant positive interest rates in KSA are likely over 2022-2023



Source: Pre-Budget Statement 2023, Bloomberg

Higher real interest rates in KSA, coupled with effective currency appreciation, could have implications for trade, investment, and consumption.

Higher real interest rates in KSA, coupled with effective currency appreciation under the pegged regime may have multiple implications for KSA's trade (export competitive particularly for non-oil exports), investment (cost of capital) and consumption (higher rate encourages more saving and deters consumption). On their part, the authorities have already rolled out a number of programs to encourage investment via subsidized cost of capital and other support measures. Easing of export tariff for products with heavy energy use could be other policy measure to support exports of non-oil segment.

Fiscal Account: Surplus seen despite higher expenditure ceiling

Concurrent to revision in medium-term estimates for GDP, estimates for total budget outlay and revenues build in significant revision.

KSA's Fiscal Budget 2021 Summary & Medium-Term Fiscal Projections

SARbn	2020	2021	2022E	2023P	2024P	2025P
Total Revenue	782	965	1,222	1,123	1,146	1,205
Total Expenditure	1,076	1,039	1,132	1,114	1,125	1,134
Budget Deficit	-294	-73	90	9	21	71
Budget Deficit (as % of GDP)	-11.2%	-2.3%	2.3%	0.2%	0.5%	1.7%
Nominal GDP (SARbn)	2,625	3,126	3,927	3,897	3,966	4,247
Public Debt	678	854	967*	967*	967*	967*
Public debt (as % of GDP)	22.8%	32.5%	24.5%	24.9%	24.3%	22.7%

*1H22 stock, Source: Pre-Budget Statement 2023
2022: Government Estimate, P: Projected

MoF now projects recurring fiscal surplus over medium-term with more visibility on non-oil revenue as a result of past efforts on diversifying revenue base.

More importantly, the MoF now projects recurring fiscal surplus over medium-term with more visibility on non-oil revenue as a result of past efforts on diversifying revenue base (imposition of VAT, custom duty, expat levy), and favourable oil dynamics (primarily due to underinvestment and issues with other producers). Under the base-case scenario, the projections suggest fiscal surplus of 2.3% in 2022, 0.2% in 2023 and 0.5/1.7% for 2024/2025 respectively. Following observations are noteworthy on the projections

- Under the projected numbers, KSA is set to go a sustained period of fiscal surplus similar to periods seen over 2010 to 2013 (average surplus of 8.4% of GDP, average oil prices of USD100/bbl), average GDP growth of 6% and over 2003 to 2008 (average surplus of 12.4% of GDP, average oil prices of USD56/bbl, average GDP growth of 6%)

Comparison of economic indicators during periods of sustained fiscal surplus since 2000

	2003-2008	2010-2013	2022-2025
GDP (Real)	5.9%	5.9%	5.4%
Fiscal Surplus (% of GDP)	17.6%	8.6%	1.2%
Oil Prices (USD/bbl)	59	101	70-75
Revenues (% of GDP)	46%	42%	29%
Oil	41%	39%	18%
Non-Oil	6%	4%	11%
Expenditure (% of GDP)	29%	34%	28%

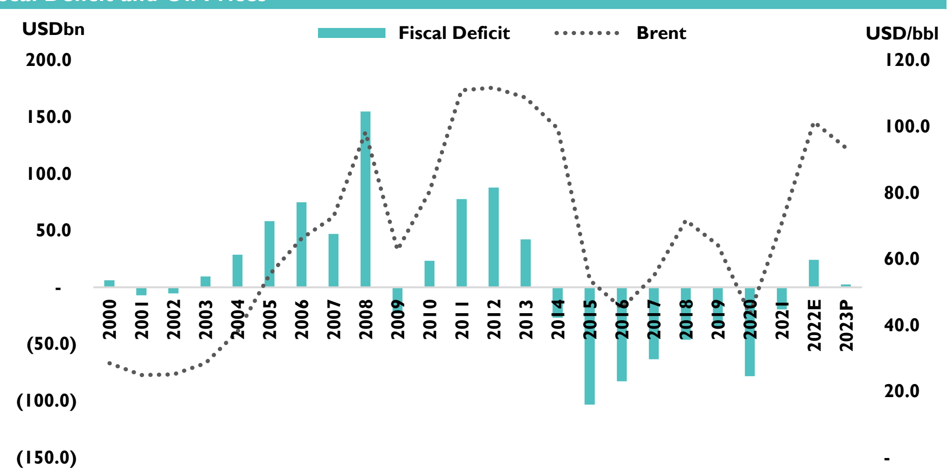
Source: Annual Statistical Bulletin, Pre-Budget Statement 2023, Tharaa

Fiscal surplus in 1H22 has come in at 3.5%, higher than the current estimates for the full year.

- For 2022 projection, MoF estimates are based on mid-term review. Fiscal surplus in 1H22 has come in at 3.5%, higher than the current estimates of 2.3% for the full year. The average oil prices for 3Q22 of USD99/bbl (Brent) and 4Q22 outlook suggest fiscal surplus may persist in 2H despite expected ramp up in expenditure in 2H22. KSA is set to make first full year fiscal surplus in 2022 since 2013, at least two year ahead of estimates rolled out in 2021.
- For 2023, estimate of fiscal surplus of SAR9bn faces upside risk from higher oil revenues (see discussion below on 2023 revenue forecast).
- For 2024/25, the projection appears to have built in higher GDP growth and better oil dynamics

With revenue diversification achieved since 2016, KSA can enjoy a sustained period of fiscal surplus even with relatively low oil prices

Fiscal Deficit and Oil Prices



Source: Pre-Budget Statement 2023, Bloomberg

Expenditure over medium-term is expected to average 27-28% of GDP (SAR1.1trn)

Expenditure: The MoF has proposed upward expenditure ceiling by 17/18% over 2023/2024. Expenditure over medium-term is expected to average 27-28% of GDP (SAR1.1trn). Greater focus on social benefit and protection and support for strategic initiatives (Capex: ~4% of GDP) likely account for the revisions.

Projections for fiscal revenues for 2022 and 2023 have been revised up by 15-16% (28-29% of GDP).

Revenues: Projections for fiscal Revenues have also been revised up in tandem by 15-16% (28-29% of GDP). The revisions largely reflect;

Higher oil revenues (oil prices used for current base-case forecasts are estimated at USD70-75/bbl relative to previous projections USD60-65/bbl) and

Non-oil revenues as a result of increased private sector activity, higher nominal GDP and continuation of measures on revenue diversification undertaken over 2017-2020 (VAT, sugar tax, levy, custom duty etc.)

Interestingly, the draft budget builds in an 8% reduction in total revenue in 2023 relative to 2022 while revenue estimates for 2022 of SAR1.2trn from mid-year review has been retained. On the first look, government estimates of total revenues for both 2022 and 2023 appear conservative, given +USD99/bbl oil price average in 3Q22, positive outlook of oil prices for both 4Q21 and beyond, and expected step-up in oil production in 2023 and 2024 toward production ceiling. Three possible areas of non-trend revenue contributions in 2H21 and 2022 are;

(i) Dividend income from Aramco for the majority shareholders: In the latest investors call, the management hinted at possible review of company's dividend policy with year-end results

(ii) Changes in VAT rate (unlikely given MoF's CPI forecast for 2023 plus emphasis on achieving higher contribution of non-oil revenue and ensuing upward revision in medium-term expenditure ceiling)

(iii) Other non-oil, non-tax revenues

(iv) Preponing of oil projects currently slated to come online by 2027-28

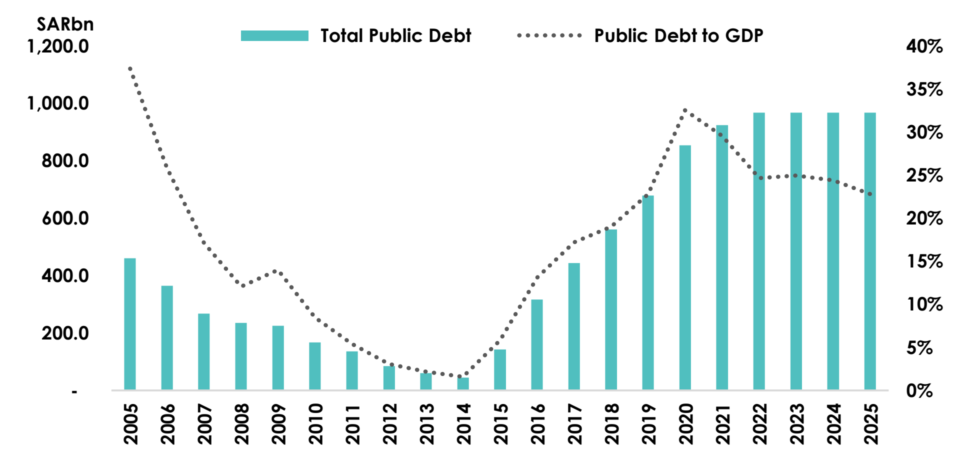
Fiscal Financing: Rebuilding reserve cushion

Overall debt in 1H is quoted at SAR967bn (24.5% of GDP) up 4% from Dec-21 levels, according to MoF figures

MoF has highlighted three key areas for utilizing projected fiscal surplus; (i) rebuilding further fiscal cushion (reserves 30-month import cover in July vs an average of 38-month) in order to enhance fiscal sustainability and address any external macro shock via countercyclical measures, (ii) strengthening public funds and (iii)accelerating projects of strategic importance. The MoF has proposed sticking to its strategy of repaying the debt principals from fresh borrowing while looking for any opportunity for borrowing for future debt repayment, financing of strategic initiative and alternative financing. Overall debt in 1H is quoted at SAR967bn (24.5% of GDP) up 4% from Dec-21 levels. Despite fiscal surplus (3.5% of GDP in 1H22), the MoF has raised additional financing, over and above debt repayment, ahead of interest rate hikes. Assuming MoF sticks to its strategy of maintaining debt level, Public debt/GDP is expected to drop to 22.7% by 2025. Given interest rate environment and expectation of likely pivot to easing cycle by the global central sometime in 2H 2023 or 2024, possibility of MoF using fiscal surplus to make early payment/repayment is high.

Public debt/GDP is anticipated to fall to 22.7% by 2025, assuming MoF sticks to its plan of maintaining debt levels

Debt to GDP is set to trend down even on 1H22 debt levels given rising Nominal GDP



Source: Pre-Budget Statement 2023, Tharaa, Bloomberg

Key risk factors

The four key risks to MoF projections stems from; (i) any risk to global economic growth as major economies deal with record inflation and reversal COVID-era monetary stimulus (ii) dynamics of oil markets, particularly with reference to geopolitical tension and nuclear talks with Iran (iii) any regional or global COVID-like challenge, and (iv) delays in major projects or non-materialization of anticipated benefits.

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