Saudi Arabia: Fiscal Financing Outlook, 2016-2020

Executive Summary

- In this note we examine the Saudi government’s fiscal financing outlook, with a view to quantifying the size of the fiscal “hole” over the next five years and the likely sources of financing.

- This exercise begins with our oil price outlook, since this will largely determine the size of the requirement. Our view is that the oil market is now finally beginning to rebalance. Saudi Arabia’s own production has been quietly trimmed and, crucially, US shale oil output is finally beginning to sag in the face of sustained low oil prices—which has seen investment collapse—and a tighter financing environment. Meanwhile, demand from key EMs, such as China and India, has held up better than many had expected, while gasoline consumption in the US is also set to gather pace.

- Prices have yet to respond meaningfully, reflecting the outsize overhang of stocks that have been built up in the past couple of years. With the changing supply and demand dynamics we expect stocks to begin to be worked down in the second half of this year. This trend should become more entrenched in the medium term as the lack of investment by international oil companies begins to have an impact. Prices will no doubt remain volatile, especially given the elasticity of US shale supply, but we expect Brent to climb to an average of $60/b in 2017 from $40/b this year, reaching almost $80/b by 2020.

- Even as prices recover, we doubt that the Saudi government will loosen its fiscal stance significantly. The days of excessive budget overruns are gone, and as the recently-released Vision 2030 plan makes clear, the priority is to reduce the government’s share of the economy and allow a greater role for the private sector. That said, neither the oil price recovery nor the tighter fiscal stance will be enough to forestall sizeable fiscal deficits over the next five years. We put the aggregate fiscal deficit at SR1 trillion for the 2016-20 period.

- Financing this position is not straightforward, but it is do-able. The main tool will be domestic debt issuance, with local banks and government institutions such as GOSI and PIF likely to take most of the offering. The banks are liquid and would be keen to take on government debt given that it can be repoed with SAMA (and will offer a decent yield). GOSI and PIF are also understood to have deep pockets, though the true state of their balance sheets is a matter of conjecture. Another source of finance will be foreign debt. This is something that the government has historically shied away from, but its recent $10bn syndicated loan is understood to have achieved very competitive pricing.

- The government will also continue to draw on its savings to finance its position. Years of fiscal surpluses have contributed to a sizeable war-chest. The drawdown will be significant, but we still expect that the government will remain a net domestic creditor at end 2020.
Saudi Fiscal Financing Outlook

In this note we examine the Saudi government’s fiscal financing outlook. We seek to establish how much the government will need to find to plug its fiscal hole over the next five years and how these funds might be raised.

Oil Market Outlook

The oil price outlook is the starting point for any fiscal projection.

The starting point for any Saudi fiscal outlook is our price projection. Oil prices remain depressed, with Brent unwilling to climb much above $40/b. The reason for this is that stocks of crude oil remain elevated. This time last year, crude stocks in the US appeared to have peaked and were on a gentle downward path. However, this trajectory was short-lived, and by August 2015, stocks were on the rise again so that by early April of this year stocks had put on an additional 80 million barrels.

Last year’s build-up of crude oil stocks has more to do with OPEC output that US shale oil

This sharp reversal of trend was not primarily due to US tight oil (“shale”) production; in fact, the driver was a pronounced increase in OPEC output—primarily from the Middle East and North Africa. Saudi Arabia, along with Iran, Iraq and Libya raised output by almost 1 million b/d in the twelve months from March 2015. While much focus has been on US shale output, this additional OPEC crude was enough to keep the market firmly in oversupply. Put another way, if these states had kept production flat, then the global oil market would have begun to rebalance last year, with demand outpacing output and—all else being equal—stocks beginning to fall.

Now there are signs that the tide is turning as Saudi output cools...

This year, there are already signs that the situation will be different. Looking at production, the most notable change is Saudi Arabia: the dramatic ramping up of output witnessed in the first half of 2015 has now reversed, with production drifting back down under 10.2 m b/d from over 10.5 m b/d. Granted, there is some seasonality in this trend, but there is also likely a recognition that further dramatic increases in output could not be digested by the market without seeing prices shift even lower, thereby inviting further pressure on the Kingdom’s exchange rate peg. Libya and Iraq have also seen production cool. For Libya, this is not so much policy-related as a product of its chaotic political situation. There is a similar situation in Iraq, where infrastructure constraints and chronic political problems have seen output level off, albeit with a good deal of volatility.

...shale oil turns down...

The defining feature of US shale output has been its resilience. Shale output kept rising long after prices went into freefall, demonstrating both the adaptability of US producers and the financial necessity of keeping wells running to recover capital costs. But this gravity-defiance appears, finally, to
have run its course. Department of Energy (DOE) data show total US output falling by some 500,000 b/d over the past 12 months. This was presaged by a fall in the rig count (a proxy for investment in the sector) and has also been catalysed by a more recent tightening in liquidity as banks and other potential investors take a more sceptical view of the sector’s longer-term prospects.

...and IOCs shelve investments

The resilience of shale output partly reflects the fact that wells can be quickly drilled (or capped) in response to price changes. This is not true of most oil production, especially that from International Oil Companies (IOCs), which is often extracted from challenging terrain, be it onshore or offshore. When prices collapsed in mid-2014 it was not long before IOCs began to announce major cut-backs in both planned and current investment. To date, projects with some 20 billion barrels of oil equivalent reserves have been shelved by IOCs. Unlike shale, they are unlikely to be revived if oil prices lurch upwards again: projects of this sort take many months (if not years) of planning and involve substantial upfront capital costs. To revive them, IOCs will need to see a sustained rise in oil prices that will generate enough revenue to exceed the full cycle costs of any project.

Oil demand is also stronger than one would assume given the gloomy prognosis for China

What of demand? The first quarter of this year has been marked by excessive gloominess about the health of the global economy, with concerns extending from China to the US via Emerging Markets. But at least where demand for oil is concerned, the situation does not appear too bad. In China, the focus of most concern, February’s oil imports were some 24 percent higher than in February 2015. Part of this reflects the lifting of restrictions on private refiners’ imports, along with some strategic restocking, but also demand from Chinese motorists, with gasoline demand rising by 9.3 percent year-on-year in February.

India and the US are also important engines of demand

The other large Emerging Market consumer of oil is India. Here too demand remains brisk, with imports of crude oil and products up by 28 percent in February, year on year, reflecting the revival in India’s economic activity over the past year or so. The US remains the largest consumer of oil, and while the larger base means that the percentage changes are not so striking, consumption appears set on an upward path, with gasoline demand supported by both lower prices and a decent outlook for jobs and income growth.

The market is therefore rebalancing, though it will take time for stocks to be worked down

Bringing these dynamics together, we think that demand will outstrip supply this year for the first time since 2013. This does not mean that prices will suddenly shoot up; it will take some time for the large overhang of stocks to...
be worked down. Moreover, prices are unlikely to rise in a steady trajectory: US shale output is likely to pick up again as prices rise, so the price ascent is likely to be volatile. Yet, the simple fact is that prices at $40/b or below are too low to encourage investment among IOCs. Prices will need to rise significantly in order to provide the supply to match future demand. Thus we expect Brent to average $40/b this year, before climbing to an average $60/b in 2017 (helped by an expected weakening of the US dollar). The outlook for 2018-20 is obviously hazy, but with a good deal of IOC oil still “locked in”, prices should continue to shift higher. From 2020 onwards prices should get a further lift as the depletion of US tight oil reserves becomes more of an issue.

The Fiscal Outlook

Despite the better oil price outlook Saudi Arabia is facing double-digit fiscal deficits

Oil prices might be set to recover, but that does not mean that Saudi Arabia’s fiscal outlook is comfortable. Oil revenue in 2016 is set to be SR340bn, just 30 percent of the 2012 figure, which was the peak year for oil earnings. We expect oil revenue to recover steadily, helped by the winding down of subsidies, which will free up more oil for export. But even so, oil earnings in 2020 are set to reach just SR725 bn, still less than two-thirds of the 2012 figure.

Nonoil revenue should grow, and privatisation offers considerable potential

The recently-released National Transformation Plan emphasises the need to increase non-oil revenue and reduce the state’s role in the economy. Privatisation offers the obvious route to achieve these goals, though we remain cautious about the proposed Aramco sale, pending further details.

The late April announcement of the National Transformation Plan (“Vision 2030”) placed the enhancement of nonoil revenue high on the government’s agenda. We expect VAT to be introduced next year, at 5 percent, which should raise 1-2 percent of GDP. Other fees and charges are also likely to be expanded and deepened. Expansion of religious tourism is also being promoted, and we think that this will provide a useful source of government revenue in the years ahead. In addition, the proposed deregulation of various sectors suggests that foreign direct investment inflows should pick up, providing a valuable stream of foreign exchange as well as a growth impetus.

Privatisation has also been heavily trailed in the NTP. Clearly, this represents a significant untapped resource, but we are bound to be more cautious here. The privatisation of Saudi Aramco is in some ways the “centrepiece” of the NTP, but the mechanics of any such sale—as well as the company’s value—are at this stage vague (further details are expected in the next few months). For the moment we therefore have not included any part-sale of Aramco in our fiscal projections. Clearly, though, the possibility of a sale represents significant upside risk to the fiscal projections contained in this report (note that we would treat any such revenue as a fiscal financing item).

Privatisation need not be confined to the sale of state assets. It can also mean a greater role for the private sector in the provision of services. In the Kingdom’s case, obvious candidates are health, utilities and municipal
services. The NTP puts great emphasis on enhancing the private sector’s role, and we expect this to be energetically pursued, thereby helping to ease the state’s financial burden in the years ahead.

**Spending stance set to loosen only gradually**

The government’s spending stance is likely to remain tight this year, and loosen only slightly in 2017. A more significant easing is likely in 2018-20, but we doubt that there will be any return to the free-spending of the boom years, even as oil prices pick up. Inevitably, capital spending will be targeted, though all areas of government spending will continue to be rationalised, with particular focus on those that create a draw on foreign reserves.

Given these parameters, we expect that the fiscal deficit will narrow over the next five years, though they will remain substantial, at least until 2020. The average deficit is expected to be around 8 percent of average GDP over this period. The cumulative shortfall in revenue will amount to a little over SR1 trillion, or some $280bn. How can this be financed?

**The Fiscal Financing Outlook**

*Much of the SR1 trillion fiscal shortfall for 2016-20 will be met through domestic debt...*

There are essentially four sources: issuing Saudi riyal debt to domestic banks, issuing SR debt to public sector financial institutions (GOSI, PIF), issuing hard currency denominated sovereign bonds /syndicated loans, and a drawdown of savings. (Privatisation revenue represents a further potential source, but because of the uncertainties noted above, we have not made any projections on this front.)

*...and Saudi banks will take up much of this issuance*

We expect the authorities to use a combination of these, but in what proportions? Much of course depends on capacity. Starting with the **commercial banks**: the sector had total liquid assets (cash, repos, Sama bills, foreign assets etc) of some SR615 billion at end-2015. We have not included existing holdings of government debt as “liquid” assets, though this is a moot point: currently there is no meaningful secondary market in Saudi government debt. Thus, if there were a system-wide liquidity crisis, the debt would be
difficult to convert into cash “at little or no loss of value” (albeit at some nominal cost)—one of the key criteria for a High Quality Liquid Asset (HQLA) as defined by the Basel Committee. However, the debt can be repoed with the central bank for cash—a feature that the Basel Committee feels essentially overrides the problems of an illiquid secondary market.

Thus, one might say that a) the banks’ existing holdings of government debt should be included in liquid assets and b) therefore future investments in government debt offerings would simply be a case of realigning their liquid assets, not a shift from liquid into illiquid assets.

That said, we are inclined to take a conservative view of this conundrum. The lack of secondary market cannot be ignored: while Saudi government can be repoed with SAMA, a US T-bill, for example, can be repoed with practically any financial institution precisely because there is a deep, liquid market attached to it. Thus, selling a US T-bill and buying a Saudi government bond cannot be seen simply as a realignment of HQLAs: there is a qualitative difference and we anticipate that the banks would be reluctant to convert more than 60 percent of their liquid asset pool into government debt. Obviously these assets would be redeployed towards government debt over the five-year period, not all at once. We assume also that the asset base continues to grow by 3.5 percent a year. Given these parameters, we think that banks would be willing to buy a cumulative SR311 billion, or 30 percent of the aggregate financing requirement.

**GOSI and the PIF represent another major source of funding**

There are scant data on the accounts of GOSI and the PIF (the two main public sector financial institutions). SAMA data show that these and similar agencies have some $100bn in foreign assets, though other reports suggest that GOSI alone has some $400bn in foreign assets. Clearly, as quasi government entities they would likely be amenable to buying large amounts of government debt, and as a pension fund, GOSI would presumably be more than happy to take on long-term government paper. Again, we take a conservative view and anticipate that these institutions would take some SR355bn of government debt over the five years. This would be just over a third of the offering.

**Hard currency syndicated loans will form a smaller piece of the financing jigsaw**

The Saudi government has historically been reluctant to take on much foreign currency debt. However, with last year’s pronounced NFA drawdown in mind, the Ministry of Finance is tapping the international syndicated loan market this year, using its relationships with large international banks to secure a five-year syndicated loan deal worth $10bn at very keen pricing. There is also the possibility of a fc sovereign bond issuance, but a further syndicated loan is just as likely given the competitive pricing achieved—probably more competitive than a bond given recent ratings downgrades. We have therefore pencilled in an additional $10bn loan in 2017, while accepting that there is also room for a bond issue. We doubt that authorities will tap the market in 2018 and
Beyond given that the fiscal deficit should have narrowed towards 6 percent of GDP by then.

The yield on the syndicated loan might have been low, but it was enough to generate a lot of interest from banks, who were probably mindful of the chance of further arrangement and advisory fees down the road. But even without this, in a world of negative interest rates and persistent fears of deflation, future offerings with even smaller nominal yields from a government with no external debt, a very small domestic debt stock, and the world’s largest oil reserves are likely to be compelling.

The government will also continue to draw on its own savings

The final source of financing is the government’s own savings. These were drawn down by a substantial SR400 billion last year. Savings will continue to be drawn upon, but not at last year’s rate. We project that the aggregate draw on savings over the next five years will be SR294 billion, with almost two thirds of that occurring this year, when the deficit is set to be at its biggest. By 2020, when the fiscal deficit is set to narrow to just 3.5 percent of GDP, the call on government savings is likely to be just SR2bn.

By 2020, the government’s stock of domestic savings is forecast to have been drawn down to just SR127bn, or 3.7 percent of GDP. In net terms, i.e. subtracting domestic debt, these savings would be negative 21 percent of GDP. However, there is a very important caveat: there is a large stock of liabilities in the monetary system listed as “other items”. This amounted to over SR1 trillion at end-February. It is not clear precisely what is included in this figure, but it is almost certain that the vast majority of this represents public sector savings of one form or another (in fact, only by classifying these as public sector savings can we reconcile the domestic and foreign exchange accounts). If one assumes that this amount is stable and we include it in the
2020 net savings calculation, then the government remains a net domestic creditor with SR331 billion worth of savings, equivalent to 10 percent of 2020 GDP.

When thinking about the interplay between domestic savings and foreign exchange, it is worth remembering that the draw on government savings is not—as is sometime described—simply the obverse of the draw on SAMA’s NFA. The government will pay domestic creditors with domestic currency; it will only use foreign currency where it has a specific foreign currency cost or liability. Those domestic creditors might choose to spend some (or all) of these riyals on imports or make foreign investments. Only when they do so, will there be a call on SAMA’s NFA. Because Saudi Arabia is highly import-dependent and because there are limited domestic investment opportunities, the drawdown of government savings tends to result in a drawdown of SAMA’s NFA, but the process is not automatic.

While the drawdown of government savings is likely to be substantial, we still expect the government to be a net domestic creditor in 2020.

Clearly the fiscal financing situation is a challenging one, but we think the country has the capacity to fill the hole without too much stress. That said, this conclusion presupposes that oil prices will recover.
But Saudi Arabia starts from a strong position. The government has no external debt, and its domestic debt stock was just 8 percent of GDP at the end of last year. Local banks are liquid and well capitalised, and as the economy cools will be happy to take on more government debt, especially as it can be classified as high quality and liquid. The exact state of GOSI and PIF’s balance sheets is a matter of conjecture, but after a decade-long oil boom, there is every reason to think that their foreign and domestic assets are substantial. Foreign investors too will likely find the Saudi investment case more compelling as oil prices recover and the government unveils more investment opportunities. Finally, compared to similarly-rated peers, Saudi Arabia has significant fiscal buffers in the form of savings that were worth SR2,186bn at end-February, some 96 percent of our forecast for GDP. Thus, while the fiscal profile does at first sight appear alarming, our view is that—assuming oil prices do post a steady recovery—the financing outlook remains manageable.
James Reeve
Deputy Chief Economist
James.Reeve@samba.com

Andrew Gilmour
Deputy Chief Economist
Andrew.Gilmour@samba.com

Thomas Simmons
Economist
Thomas.Simmons@samba.com

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Samba Financial Group
P.O. Box 833, Riyadh 11421
Saudi Arabia