Saudi Fiscal Developments - Tracking Inflation

Faisal AlJasir
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Later this month, the Saudi Arabian Ministry of Finance will issue the government final budget statement that would typically cover key fiscal events during the year 2020, and broader economic developments concerning next year's budget and its main economic targets.

The unprecedented economic shock of the COVID-19 pandemic has had its significant repercussion on global economic activities. It will undeniably take its toll as well on the Kingdom's economic growth this year. This can be seen by the unanticipated increase in the budget deficit to 12% of GDP compared to 4.5% last year. In the case of Saudi, the adverse effect was further pronounced given the decline in global oil demand and prices. According to the IMF for June 2020, it is estimated that the global economy will shrink by 4.9% in 2020. While in the Kingdom, it is projected that real GDP will record a decline of 3.8% this year. A contraction that was initially expected to be even worse should some of the implemented stimulus measures and liquidity support programs were not employed earlier this year.

Apart from this exceptional year, the government has been reporting a declining budget deficit, yet a persistent increase in the level of public debts since 2014. Apparently, some will be eyeing these fiscal developments to the extent they relate to the expected level of inflation and interest rates.

UNDERSTANDING INFLATION

Inflation refers to the rise in prices of a set of goods and services over a certain period. It exists when prices rise, but purchasing power falls, impacting the cost of living in a country. Inflation can also be looked at as a function of the supply and demand for money. Due to its different meanings in different contexts, Inflation is and has been a highly debated phenomenon in economics.

Anyways, this brings us to a well-established theory in macroeconomics that says fiscally dominant governments running persistent deficits have sooner or later to finance those deficits with money creation (Increase in the money supply), hence producing inflation. Nonetheless, empirical data reveals that the relationship between fiscal deficits and inflation is one that cannot be inferred casually nor measured easily. Different research suggests that current deficits need not to cause inflation in the short run, rather over a long period of time. The literature around this topic shows a great degree of nonlinearity among both variables and depend largely on various factors. The analysis of such should consider aspects such as the country's level of financial developments – deeper financial markets, its central bank commitment to a targeted inflation level, monetary and exchange rate policy flexibility, and its ability to facilitate continues rolling over of its debt. Hence, at its core, the relationship between both variables is dynamic.

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In Saudi Arabia, inflation is measured by the growth rate of the Consumer Price Indexes (CPIs) released by the General Authority for Statistics (GaStat). The CPI basket is composed of 12 different segments with varying weights. According to data from the World Bank, it can be observed that higher inflation levels in Saudi have been closely associated with factors such as fiscal spending and oil prices rather than explicitly with the level of the money supply. In the years 2010-2013, inflation rates have maintained a range of 5%-3% per annum, which was primarily the result of the expansionary policy at the time in conjunction with the factors just stated. Moreover, external influences, such as currency devaluation and the increase in imported goods prices, are primary domestic inflation sources. The latter factor is a natural result of the Saudi Riyal peg to the Dollar and is believed, at times, to cause what is referred to as imported inflation that has been the cause of several inflationary periods in recent history.

When analyzing the years 2014-2019, it can be safely assumed that the economy has embarked into a semi deflationary phase. Save for the short-term effect of introducing VAT, levels of inflation have averaged for the period at around 0.90% per annum (ranging from -2%-2.5%). This observation can be linked to the collective effect stemming from the drop of oil prices, government reforms and spending cuts, and the impact caused by an appreciating U.S Dollar against major trading partners on the kingdom import bill. This year's inflation is estimated at 3.7%, a surge that can be explained by the short-term impact of the increase in the VAT rate and certain customs duties. Such fluctuations in inflation rates are expected to persist, at least for a while, given current global developments and domestic fiscal reforms that are still in play. That, in turn, makes the task of predicting the future path of inflation over the short to medium term a troublesome one.

FISCAL VS MONETARY POLICY

Now factoring public debt into our storyline would require more than one article. But in short, there is plenty of practical evidence supporting the hypothesis, which argues that an increase in debt to GDP ratio in developing countries is associated with a rise in inflation over the long run and can very well be traced to levels of local liquidity. Public debt has been building up since 2015 and is estimated to reach around 35% of GDP by end of this year and decrease gradually thereafter.

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It is imperative to understand that one of the key roles of a monetary policy is to manage the level of inflation. Yet, in a fixed exchange rate regime, such a policy becomes, to a certain extent, constrained in tackling inflation and fiscal policy instead develops to be the major tool for macroeconomic stabilization. Many would argue that the positive economic effects of maintaining the peg with the US Dollar would far outweigh the benefits of having a fully flexible monetary policy, and they might be right. But in this case, targeting optimal levels of interest rates loses its traditional appeal as one of those effective monetary tools to manage inflation and deflation alike. Available tools to do so come to be more fiscally tilted.

Thus, the current fiscal reforms under vision 2030 become more crucial now than ever and may possibly be the major steps towards macroeconomic stability. Hopefully, the aim would be to reach a consistent and healthy level of inflation, one that is typically associated with a sustainable and growing economy.

For more information, please contact Faisal AlJasir, Co-Managing Partner at Ehata Financial, ***faisal.aljasir@ehata.com.sa***

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