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WHAT YOU SHOULD KNOW

Saudi Arabia announced a series of measures on Monday – including a three-fold hike in VAT from July – to address a sharp deterioration in its financial position. A policy response to the twin crises of lower oil prices and the global coronavirus pandemic was inevitable, but the austerity measures are far-reaching and will hit Saudis at a time when many businesses are already struggling amid severely restricted economic activity.

Previously, some austerity measures have proven short-lived amid resistance from the public. Should the latest moves survive the uptick in oil prices at year end, then the fundamentals of the social contract will change as citizens will want representation for taxation.

WHY THIS MATTERS

FRAGILE FINANCES: Saudi Arabia will increase the rate of VAT to 15% from the 5% currently from July 1 and remove a SR1000 ($267) monthly cost of living allowance for state employees from next month, the finance minister Mohammed Al Jadaan announced. The move comes after Saudi posted a $9bn budget deficit for the first quarter. The world's biggest oil exporter is expected to suffer from a sharp decline in revenues this year after agreeing to cut production amid low oil prices and depressed demand. As a result, forecasts suggest the state's budget deficit will balloon to double digits this year, prompting a mix of increased borrowing, reduced spending and other fiscal adjustment measures to tackle it. The savings from spending cuts and other measures are estimated at SR100bn ($26.6bn). Last month Al Jadaan said the kingdom could borrow up to $58.5bn in both foreign and local currency debt this year as well as take up to SR120bn ($32bn) from its reserves. The central bank's net foreign assets fell nearly $27bn in March already, sparking speculation that the state could need to draw down on more assets than estimated. Moody's downgraded Saudi's rating outlook to negative in early May, citing fiscal weakness, but has stopped short of a credit downgrade for the time being.

ARAMCO REFOCUS: In an interlude from its market share push, Saudi Aramco now appears more focused on revenue maximisation, particularly as it pushes ahead with delivering 2.5m bpd of output cuts per its OPEC+ commitment. Late last week the company unexpectedly raised its June Official Selling Prices (OSPs) for all crude grades. This could signal confidence in early market recovery, but also reflects deteriorating domestic finances. As the government enacts deep spending cuts, Aramco will have to prioritise revenue over market share to help support economic recovery and critical investments. With oil prices expected to remain in the $35-40/bbl range over the next year or so, it will take time for the economy to get back on track and for Aramco to resume some of its previous spending ambitions, especially after having to cut capex targets for the year by 25% or more. In addition, Aramco is now calling for a review of the $69bn price tag on the SABIC deal following a 40% drop in value; this is a staggering expense for the oil company as it has to make significant cuts to its work plan elsewhere.

PUBLIC DISSENT UNLIKELY: Although the move to increase VAT and instil austerity measures will be unpopular, there are very few avenues at present for citizens to express their frustration and press for policy reversal. The old decision-making process characterised by consensus and caution has given way to one whereby the crown prince and his technocratic cohort are ready to impose change and hunker down. The domestic political environment now is far less tolerant of dissent andtalk of tensions and protests are far-fetched.

WHAT’S NEXT

The oil price crash and the need for Gulf governments to implement deep reforms and diversify their economies will inevitably raise questions about the continued need for domestic currencies to be pegged to the US dollar. Only Kuwait is pegged to a basket of currencies. Saudi’s foreign assets remain adequate at around $470bn, according to HSBC estimates, to defend the currency peg against the US dollar. Although the policy independence of the central bank is constrained by the peg, any decision to reconsider it will be seen as a last resort measure because of its political sensitivity.

Pressure on public finances may tempt other Gulf states to impose or raise taxation – always a contentious issue in the region – as a result of the Saudi decision on VAT. The UAE finance minister has said the state does not plan to raise its 5% VAT, but Oman and Kuwait will be assessing their options. Higher tax rates in Saudi will affect its ability to attract businesses and labour – essential to economic growth plans.

Saudi Arabia will remain an extremely competitive oil exporter long term, due to its low development costs. This will protect the attractiveness of its oil exports and help Aramco quickly regain market share once the country emerges from the twin crises and oil prices show sustained recovery. However, this could also mean a choice to double down on more profitable oil and downstream ambitions at the expense of a more diversified fuel mix. Overseas LNG projects, domestic gas projects and renewables all could face setbacks or loss of project funding just at a time when they were beginning to gain real traction in the energy sector.

The new leadership will continue to enjoy the support of its youthful base, even as it tightens its belt. The greater risk to keeping the public on side is introducing new financial measures and, at the same time, failing to deliver on some of Vision 2030's more basic but meaningful goals, such as jobs and housing, rather than loftier projects, such as NEOM. The durability of these measures as a way to restructure the economy will be tested if and when the oil price cycle next turns; previous upsides show a tendency towards the temporary.

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