جدوى للإستثمار
Jadwa Investment

February 2018

Inflation Update

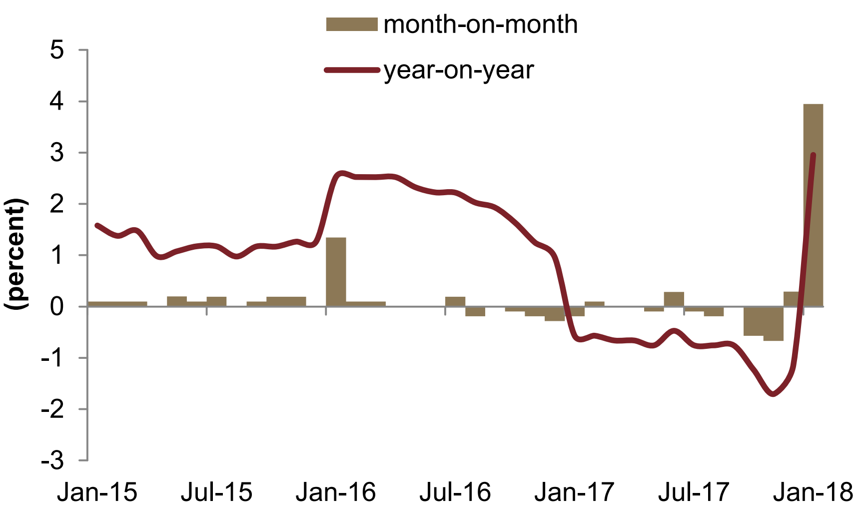
Saudi CPI inflation
(percent)

	Monthly change	Annual change
January 2018	3.9	3.0
December 2017	0.3	-1.1

VAT triggers inflation hike in January

- The latest General Authority for Statistics (GaStat) release for January shows that inflation rose in January 2018 by 3 percent year-on-year, and 3.9 percent month-on-month, largely as a result of the implementation of VAT and utility and fuel price reform during the month.
- A major development in the latest CPI release, is the revised base year and the weights on the subcomponent series, which had an impact on headline and sub-group inflation rates.
- 'Food and beverages' prices increased 5.6 percent month-on-month in January, as the segment is fully entitled to VAT.
- 'Housing and utilities' prices rose only 1.7 percent in January compared to December 2017. This seems to be due to the downward trend in rentals for housing.
- Looking at POS transactions in the Kingdom, a proxy for local consumption, we can notice a hike in consumption prior to VAT implementation in December 2017.
- Looking ahead, we expect sales to marginally decline after the spike in December, driven by an anticipated weaker demand, especially on goods and services with an elastic demand.
- We find three main external challenges that may have an impact on inflation rates in 2018: higher oil prices, higher international food prices, and monetary tightening by the US Fed.

Figure 1: Inflation rates



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Inflation rate rose in January 2018 by 3 percent year-on-year, and 3.9 percent month-on-month.

GaStat revised the CPI base year and the weights on the subcomponent series.

'Food and beverages' prices increased 5.6 percent month-on-month in January, affected by the fiscal reforms.

Meanwhile, 'housing and utilities' prices rose only 1.7 percent month -on-month, affected by the downward trend in rentals for housing.

<u>Prices in January:</u>

As widely anticipated, inflation rate rose in January 2018 by 3 percent year-on-year, and 3.9 percent month-on-month, largely as a result of the implementation of the value-added tax (VAT) and utility and fuel price reform during the month.

A major development in the latest CPI release, is the revised base year and the weights on the subcomponent series, which had an impact on headline and sub-group inflation rates (for more on this, please see Box 1).

The revised inflation rates show that prices were declining in 2017, and January showed the first increase in 13 months (Figure 1). Comparing to prices in December, segments with highest price increase were 'transport', 'tobacco', 'recreation and culture' and 'food and beverages', while 'clothing and footwear' declined month-on-month, despite VAT implementation on the segment (Table 1).

<u>Varied increases among segments:</u>

'Food and beverages' prices increased 5.6 percent month-on-month in January, as the segment is fully entitled to VAT implementation, and many suppliers might have been affected by the recent reforms (fuel and utility price reform and the expat levies). Looking at sub-group data, we find that the main rises came from fish, meat and poultry prices, followed by bread and cereals prices. As both sub-groups contain many imported items, we expect prices to follow international trends. In 2017, the FAO's (Food and Agriculture Organization of the United Nations) meat price index increased 9 percent, and FAO's cereals price index increased 3.3 percent. Meanwhile, despite the large rise in the international prices of dairy products, local prices did not reflect this trend, as dairy products in the Kingdom are mostly locally produced by local companies (Figure 2).

'Housing and utilities' prices rose only 1.7 percent in January compared to December 2017. This seems to be due to the downward trend in rentals for housing, a sub-group with a large weight in the segment, which saw the only decline in January by 0.3 percent month-on-month, whilst all other sub-group items increased.

Table 1: Main highlights of Saudi CPI inflation
(percent)

	Weights	Month-on-month			Year-on-year		
		Dec-17	Jan-18	Contribution, ppt	Dec-17	Jan-18	Contribution, ppt
Food & beverages	18.8	0.0	5.6	1.0	0.5	6.8	1.2
Housing & utilities	25.3	1.5	1.7	0.5	-1.0	1.3	0.4
Tobacco	0.7	0.1	10.1	0.1	40.4	54.5	0.4
Clothing & footwear	6.2	-1.3	-2.3	-0.1	-6.2	-8.0	-0.5
Furnishing & maintenance	8.5	-0.4	5.4	0.4	-5.2	0.5	0.0
Health	2.3	0.0	3.9	0.1	-0.3	3.7	0.1
Transport	9.9	-0.2	12.8	1.3	-2.2	10.5	1.1
Communication	8.5	0.0	2.2	0.2	-0.8	1.1	0.1
Recreation & culture	3.4	-0.8	5.0	0.2	-5.3	-0.7	0.0
Education	4.2	0.0	-0.7	0.0	1.0	0.2	0.0
Restaurants & hotels	6.5	1.2	5.6	0.4	0.9	5.8	0.4
Misc. goods & services	5.7	-0.3	1.9	0.1	-1.6	0.4	0.0
Core inflation*	**55.9**	**-0.2**	**4.6**	**2.5**	**0.8**	**2.4**	**1.3**
General index	**100.0**	**0.3**	**3.9**	**3.9**	**-1.1**	**3.0**	**3.0**

Note: * Core inflation excludes food and housing inflation and is Jadwa Investment's estimate.

Prices in 'Rentals for housing' segment has continued its downward trend since July 2017, as it is exempted from VAT.

We expect to see continued downward trend in the 'rentals for housing' sector prices in the near future.

'Transport' segment prices increased by 13 percent month-on-month, affected by the fuel and utility price reform.

The VAT experience in the Kingdom is consistent with similar cases in other countries.

The largest increase was seen in 'electricity, gas and other fuels' sub-group, rising by 24 percent month-on-month, affected by the electricity and fuel price reform.

Prices in 'rentals for housing' segment has continued its downward trend since July 2017, when annual rates saw the first decline and continued since then, as it is exempted from VAT (Figure 3). We see this trend as largely correlated with the recent reforms in the real estate sector, which aims to make housing prices more affordable to citizens (e.g. Eskan and Sakani). In addition, media reports show that a number of expats are choosing to repatriate their dependents in response to the expat dependent fees which came into effect in July 2017, which might have also reduced demand for housing.

Looking ahead, we expect to see continued downward trend in the 'rentals for housing' prices in the near future, especially since, firstly, the expat dependent fees and expat levies are expected to rise gradually until 2020, all of which will contribute to lower demand for housing. Added to that, we also expect to see more housing programs coming to market, where the Ministry of Housing aims to raise the annual target of its 'Sakani' program to 350 thousand units in 2018, up from 280 thousand units in 2017. Moreover, with around a third of the SR72 billion private sector stimulus being allocated for residential real estate loans, this should also help increasing the housing supply, and therefore help lowering housing rental prices.

Another segment showing high correlation with the fuel and utility price reform is **'transport'**, where prices increased by 13 percent month-on-month, affected by the rise in 'operations of transport equipment' sub-group which includes fuel prices, by 26 percent, month-on-month.

Generally, we find a correlation between sub-group services with more reliance on expats, and higher inflation rates in January. For example, prices in 'services for the maintenance of dwelling' rose 27 percent month-on-month, and prices in 'refuse collection' rose by 58 percent month-on-month.

<u>VAT and consumer spending:</u>

As indicated above, inflation rises in January were correlated with a number of fiscal reforms, whereas VAT implementation might be the most significantly affecting consumer spending. This is consistent with similar cases in other countries. After being limited to less than

Figure 2: Inflation rates in 'food & beverages' and 'housing & utilities'
(year-on-year change)

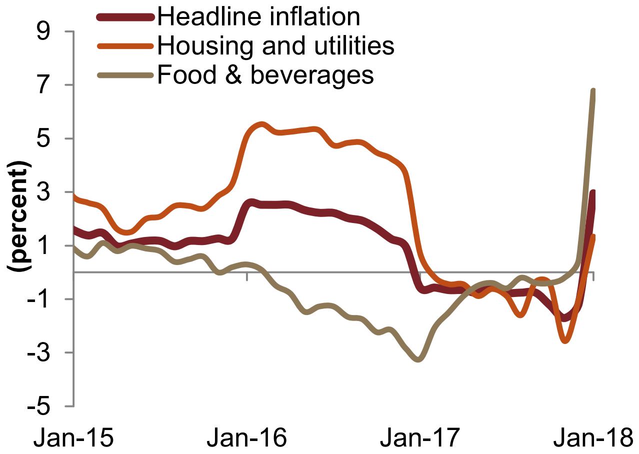
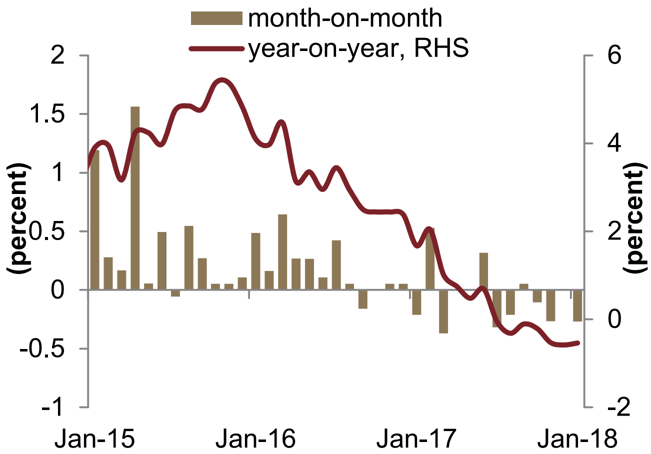


Figure 3: Rentals for housing



A future VAT implementation would encourage households to substitute their consumption over time…

10 countries in the 1960s, the VAT is now implemented in more than 140 countries. A number of examples show that an announced future VAT implementation would encourage households to substitute their consumption over time. Specifically, households have an incentive to increase consumption and purchases of durable goods prior to a VAT implementation when prices are still relatively low, and reduce consumption thereafter.

… as examples from Japan and New Zealand show.

Looking at examples of a rise in VAT in these countries, we can get a better idea of what could occur in the Kingdom following a VAT implementation. For example, the introduction of VAT in New Zealand back in 1985, and raising VAT by 3 percentage points, from 5 to 8 percent in Japan in April 2014, both led to a significant jump in private consumption prior to its implementation, especially on durable goods (Figure 4).

In the Kingdom, POS sales increased by 20 percent month-on-month in December, the highest monthly increase since June 2014, prior to VAT implementation in January.

Based on this example, we had previously expected to see consumption rise quite significantly in the Kingdom towards the end of 2017 (for more on this, please see our report: Macroeconomic Update - June 2017). Looking at a vital measure for consumer spending in the Kingdom, point of sales transaction (POS) sales increased by 20 percent month-on-month in December, the highest monthly increase since June 2014, reaching SR20 billion, its highest monthly figure on record. This rise would help boost economic activity, but potentially at the expense of lower consumption expected in early months of 2018 (Figure 5).

In Japan, consumption rose 8-23 percent in the last two months prior to implementation.

In more details, the above example from Japan shows that consumption in the last two months prior to implementation was 8-23 percent higher than the usual levels. At the time of implementation, consumption fell one-to-one with the income shock of the VAT rise, by almost 5 percent, before going back to its previous levels prior to the implementation. However, there was little change in expenditure on non-durable goods, whether before or after VAT implementation in Japan.

POS sub-group sales in December showed varied outcomes.

Looking at POS transactions in the Kingdom, a proxy for local consumption, we can notice a similar trend in the response to VAT. Whilst total POS sales increased by 28 percent year-on-year in December, the sub-group sales showed varied outcomes. Figure 6 shows the breakdown of these sales.

Figure 4: Japanese private consumption before and after the VAT rise in April 2014

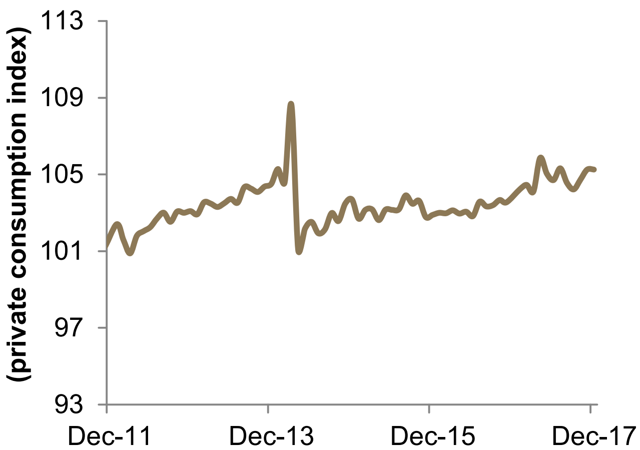
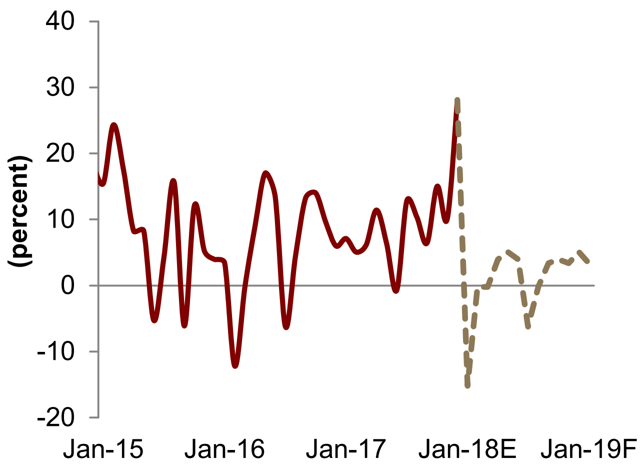


Figure 5: Point of sales transactions (year-on-year change)



POS sales in 'recreation & culture' and 'food & beverages' rose significantly.

POS sales in most sectors followed the significant total hike; where sales in 'recreation and culture' rose 48 percent year-on-year, higher than the total average and its highest annual rise during 2017. As the sector includes a high proportion of durable goods, such as electronics and house appliances, such rise should not be surprising.

Meanwhile, some sectors did not show any unusual trend prior to the VAT.

Meanwhile, sales in 'food and beverages', a sector that usually contains many non-durable goods and an inelastic demand, saw a significant sale hike in December as well, rising by 22 percent year-on-year, its second highest annual sale rise during 2017, coming second after sales in May, where Ramadan began in 2017.

In the same time, a number of other sectors did not show any unusual trend prior to VAT, such as 'health' and 'telecommunication'.

Outlook: stable inflation rates

We revised our inflation rate for the full year of 2018 to average around 3.1 percent.

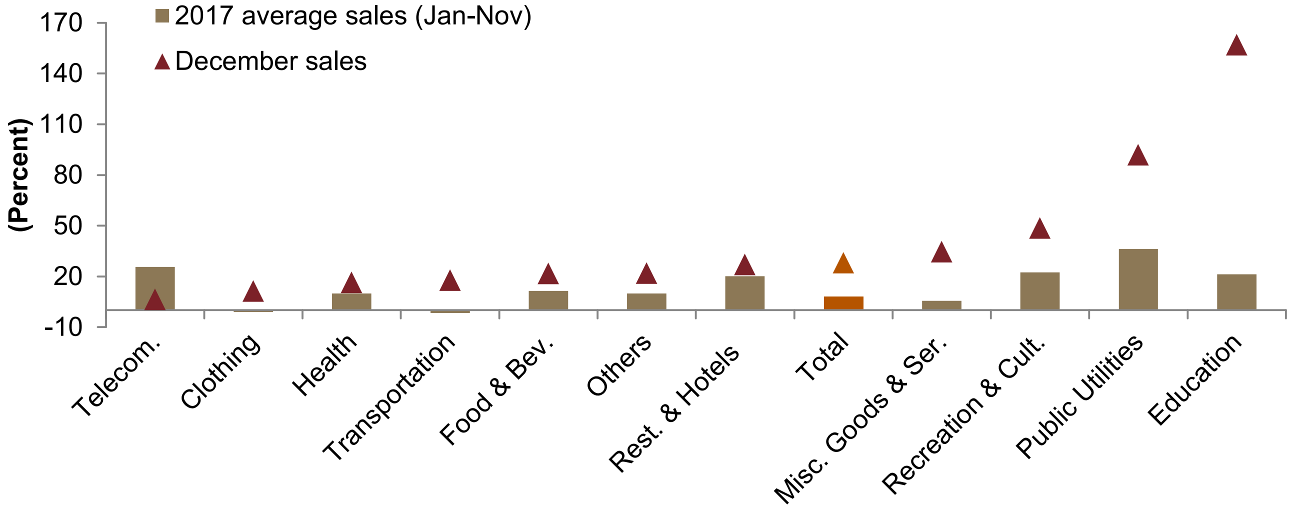
We expect sales to marginally decline after the spike in December, driven by an anticipated weaker demand, especially on goods and services with an elastic demand. Accordingly, suppliers are expected to adjust prices thereafter to meet weaker local demand, leading to stable inflation rates. Additionally, we expect the recent downward trend in the housing sector, specifically in rental prices, to continue. Therefore, we revised our inflation rate for the full year of 2018 to average around 3.1 percent, accounting for the new CPI basket and base year adjustments.

We find three main external challenges that may have an impact on inflation rates in 2018.

That said, we find three main external challenges that may have an impact on inflation rates in 2018. Firstly, current higher oil prices are expected to slightly increase inflation rates in advanced economies, of which many are main trading partners with the Kingdom, raising the probability of imported inflation (Figure 10). However, failure to renew the OPEC agreement could drive prices down by the end of this year, as could increased US shale oil production (for more on this, please see our latest Quarterly Oil Market Update).

Secondly, international food prices are expected to rise, as agricultural commodity prices are seen to edge due to supply shortages during the year, as noted by the World Bank. In the same time, local food prices are also expected to rise, driven by higher

Figure 6: POS sales growth, by sector
(year-on-year change)



Box 1: Revision to CPI data

GaStat updated the base year from 2007 to 2013, and revised the weights on the subcomponent series.

GaStat latest January 2018 inflation data release showed revised consumer price data, as the revision updates the base year from 2007 to 2013, and consequently has revised the weights on the subcomponent series. The main change in the revised CPI basket weights is shown in the 'housing and utilities' segment, increasing from 21 to 25 percent, whilst the weight of 'food and beverages' has been reduced from 22 to 19 percent (Figure 7 and Table 2).

The rebased new series shows lower inflation rates in recent years.

In comparison to the older CPI series, the rebased new series shows lower inflation rates in recent years (Figures 8 and 9), due in part to a lower weight of 'food and beverages' in the overall index, as well as downward revisions to inflation estimates in other categories, such as 'housing and utilities', 'furnishing and household equipment' and 'transport'.

The previous revision was in 2013, when the base year was updated from 1999 to 2007, and the CPI basket weights were also revised.

The current CPI revision comes five years after the previous revision back in 2013, when the base year was updated from 1999 to 2007, and the CPI basket weights were also revised. At that time, the basket had similar weight changes, as the weight on 'food and beverages' was reduced, while that on 'housing and utilities' got increased. Revising the weight of 'housing and utilities' upward for the second time shows how local consumers are increasingly spending on that segment during the past 20 years, to account for a quarter of their expenditure (the segment includes rentals for housing, electricity and fuels, water supply and maintenance services, Figure 12).

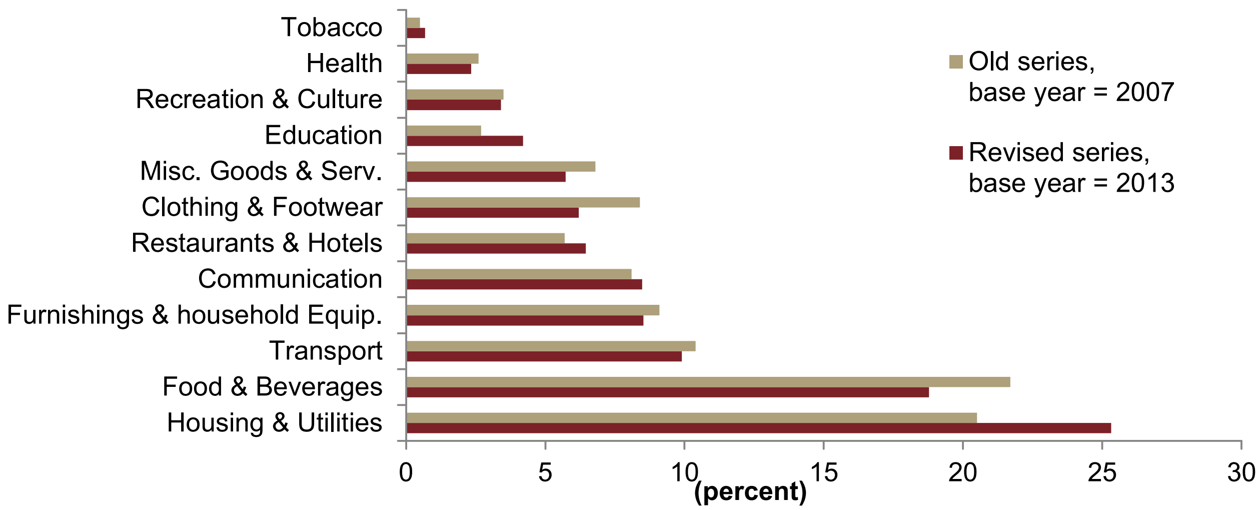
GaStat indicated that the reason behind the new revision is to reflect changing consumer preferences…

GaStat indicated that the reason behind the new revision is to reflect changing consumer preferences, following the findings of its latest household expenditure and income survey of 2013. However, we believe that consumer preferences might have further developed since 2013, as a number of economic reforms and structural changes took place in the past few years.

...therefore, we might see GaStat increasing the frequency of updated the weight basket to every two years.

That being said, we might see that GaStat consider increasing the frequency of updating the weight basket to every two years, in order to keep the CPI current with changing consumer preferences, while keeping the base year unchanged. Many countries keep the CPI base year unchanged for longer periods, while updated the basket weights instead. For example, the US CPI uses a reference period between 1982-1984, while updating the basket weights every two years, and the EU CPI has recently updated its base year from 2005 to 2015.

Figure 7: Segments weights in the CPI basket



The Citizen's Account and the SR1000 cost of living allowance should help citizens cope with inflationary pressures over the course of year.

costs borne by agricultural institutions, including increasing utility prices and expat levies, with Saudization rates in 'agriculture & fishing' sector at only 17 percent in Q3 2017.

The final challenge relates to the monetary tightening by the US Fed, which could have an impact on the US dollar, and therefore the Saudi riyal.

With the challenges coming from the new levels of inflation rates, we believe the commencement of the Citizen's Account, and the recent royal decree ordering a monthly payment of SR1000 to public sector employees during 2018, should help citizens cope with inflationary pressures over the course of year. Assuming no rises in the rate of VAT in 2019, or an adjustment in the number of exemptions/zero tax items, the higher base effects of VAT from 2018 and fewer scheduled energy price hikes is likely to result in limited inflationary pressures in the Kingdom in 2019.

Table 2: CPI basket segments weights, revised and old series

Items	Old weight	New weight	
Housing & Utilities	20.5	25.3	↑
Food & Beverages	21.7	18.8	↓
Transport	10.4	9.9	↓
Furnishings & household Equipment	9.1	8.5	↓
Communication	8.1	8.5	↑
Restaurants & Hotels	5.7	6.5	↑
Clothing & Footwear	8.4	6.2	↓
Misc. Goods & Services	6.8	5.7	↓
Education	2.7	4.2	↑
Recreation & Culture	3.5	3.4	↓
Health	2.6	2.3	↓
Tobacco	0.5	0.7	↑

Figure 8: Revised inflation rates
(year-on-year change)

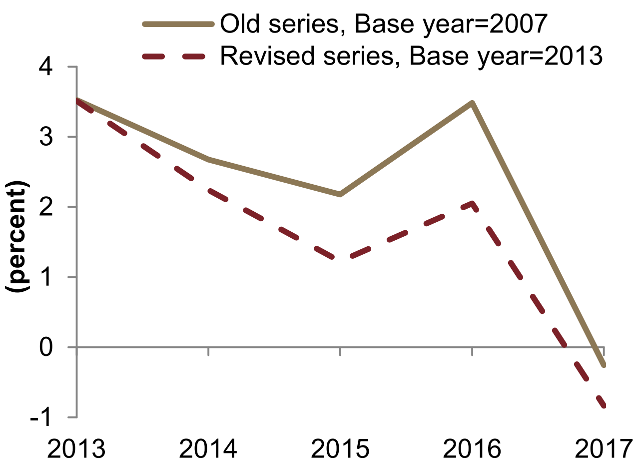


Figure 9: Revised inflation rates
(year-on-year change)

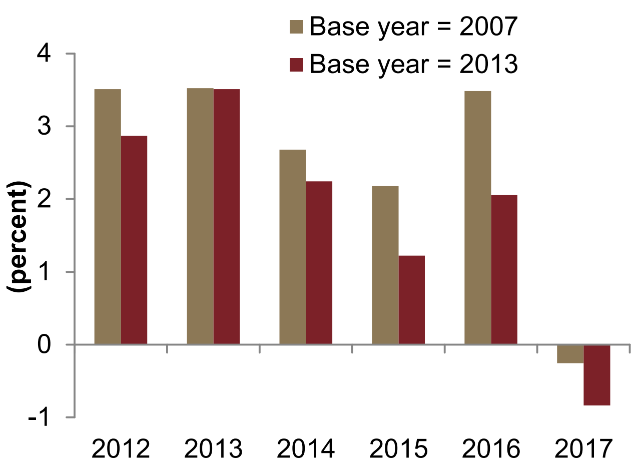


Figure 10: Inflation rates in trading partners and regional countries (latest)

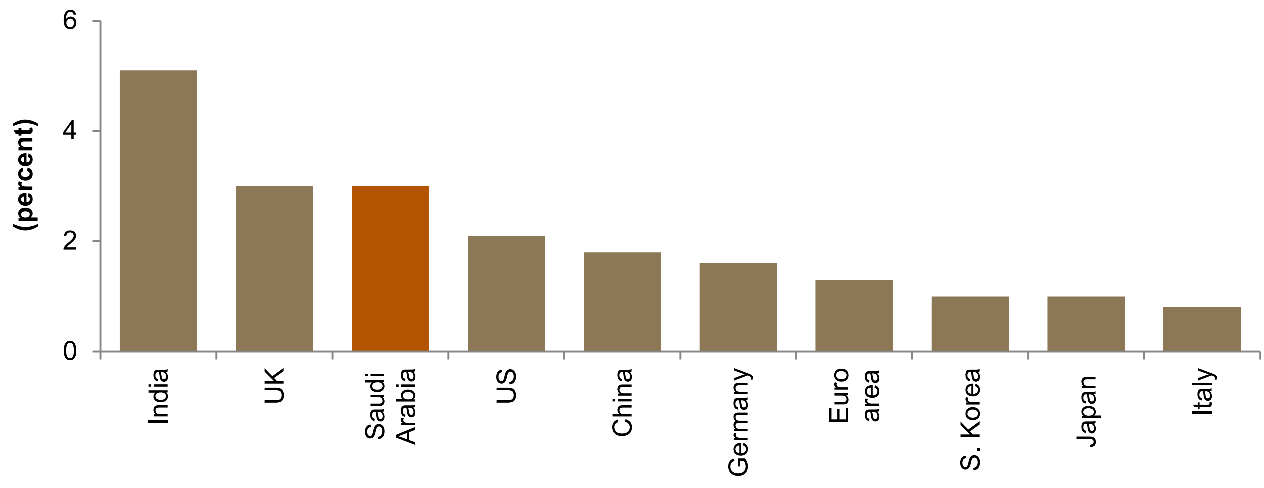


Figure 11: Revised inflation rate, and segment contributions

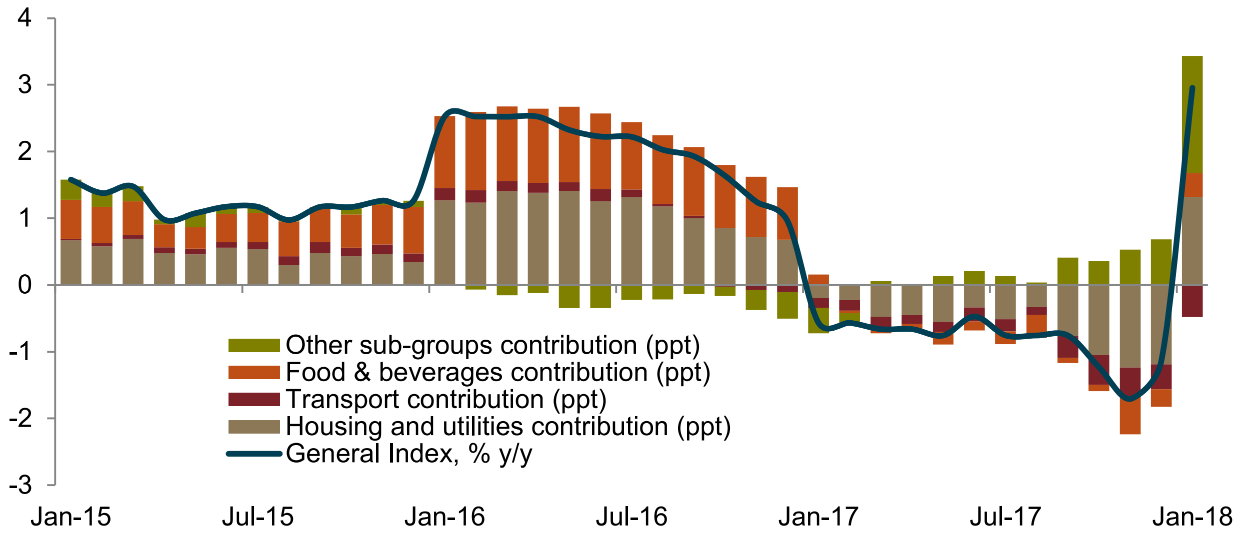


Figure 12: 'Housing & utilities' inflation rates (year-on-year change)

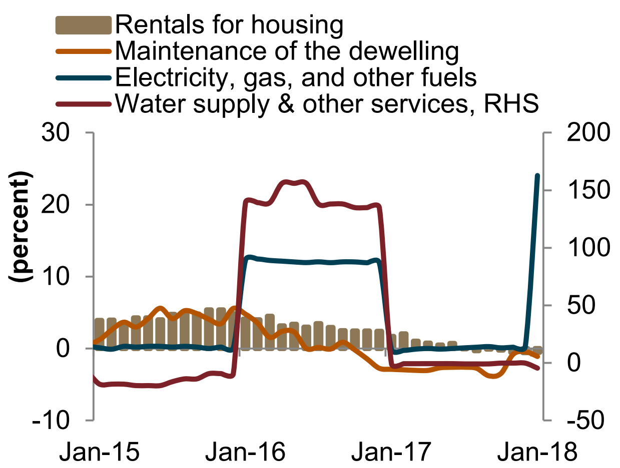
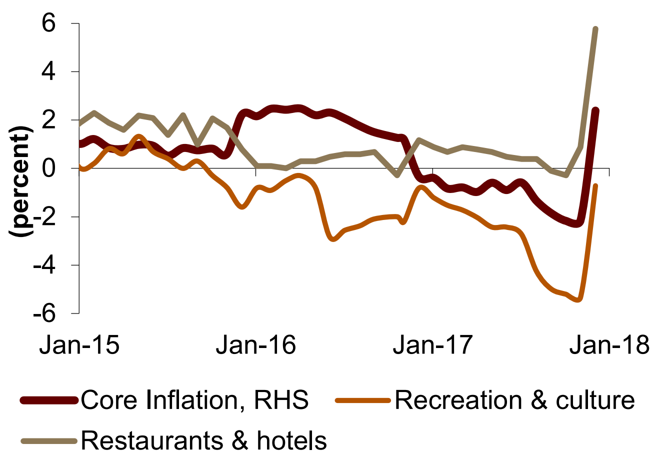


Figure 13: 'Recreation & culture' and 'restaurants & hotels' inflation rates (year-on-year change)



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