Themes from FIM

Debt to revenues and the rise of Saudi Arabia - 20 December 2023

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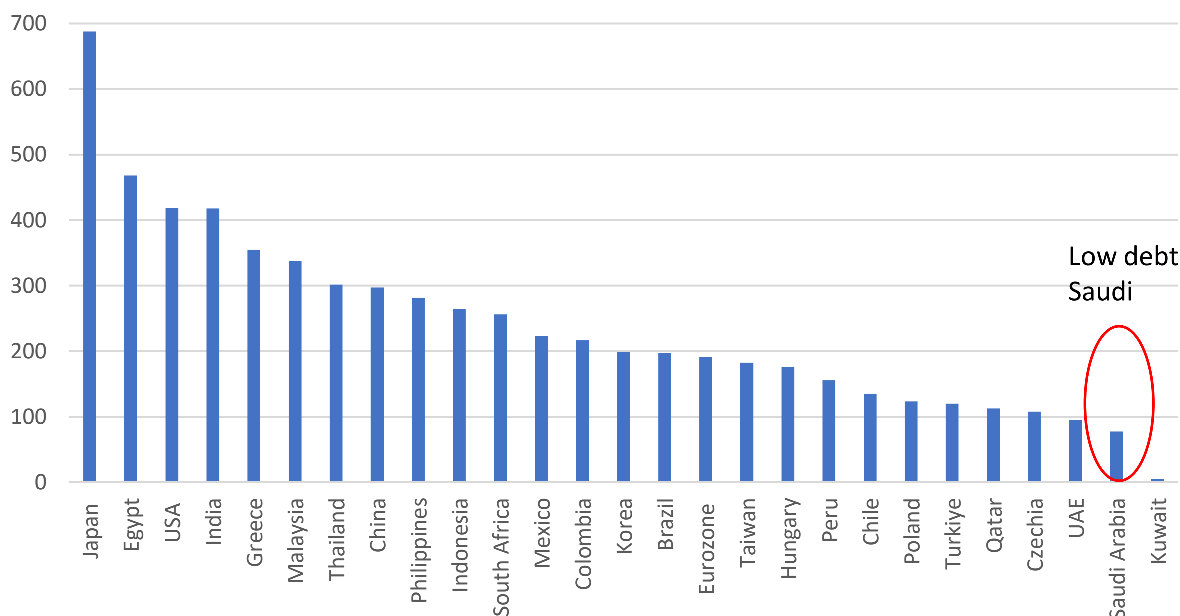
If a picture is worth a thousand words, a good economics chart ought to be worth at least a few million dollars. This month we focus on public debt to revenues and specifically Saudi Arabia.



Source: IMF World Economic Outlook, October 2023

Why do we focus on this chart, rather than the more commonly used debt/GDP ratio? Not every country counts GDP the same way – as investors in 2014 discovered when the UK added illegal activities in their GDP figures and when Nigeria doubled its GDP via new estimates of the informal economy.

Also, implicit in the debt/GDP focus is the idea that revenue generation, and the ability to pay that debt, is similar in all countries. But France's government revenues are 52% of GDP in 2023 (IMF estimates), while Ethiopia's are 8% of GDP

France's debt/GDP ratio of 112% is three times worse than Ethiopia's 38%, yet France's ability to service that mostly domestic currency debt is actually twice as good as Ethiopia's which borrows externally. Differing interest rates makes their relative creditworthiness even more stark.

Focusing on Saudi Arabia

Our main focus this month is the Kingdom of Saudi Arabia (KSA). In 2022, its debt/revenues ratio was the second best (lowest) in MSCI Emerging Markets (EM), only beaten by Kuwait. Saudi and Gulf peers have plenty of room to leverage up their balance sheets. Vision 2030 tells us why Saudi is likely to borrow. Bond issuance data shows the story is well underway.

As recently as 2018, Saudi's weight in the Emerging Market Benchmark Index Global Diversified (EMBIGD) was virtually zero. It is now 5% and the broader GCC is 20%. We expect this to keep growing. KSA investment in tourism, moving up the value-added curve in petro-chemicals, or building NEOM, are big, often huge, projects.

The KSA is not about to run down its sovereign wealth funds to fund this, so borrowing becomes one obvious route to finance this growth. The recently approved 2024 budget with a targeted deficit of 1.9% of GDP sees that gradually increasing to 2.4% of GDP in 2026.

Beyond that, Saudi Arabia has won the competitions to host the Asian Winter Games in 2029, Expo 2030 and then the soccer World Cup in 2034. Each fits with the tourism and sports/fitness focused themes of Vision 2030. Each will require significant investment.

The return from this borrowing, if well spent, will add to the country's productive capacity. One target the KSA aims for is an improved tourism balance. Tourism receipts are on an upward trajectory. They trebled from $5bn in 2005 to $15bn in 2019 (before COVID, UNCTAD data) and reached $23bn in 2022 (2% of GDP), thanks in part to the Haj. The authorities want to encourage Saudis to choose staycations. Since 2007, Saudi travel expenditure abroad has ranged from $15-24bn (an average 3% of GDP) except during COVID, and cutting this to 1-2% of GDP, should have multiplier benefits for the Saudi economy beyond the $10bn or so it would save directly. The state is currently funding investment in tourism, with the goal of privatising the sector as developments are completed.

Spotlights on Capital Markets

Saudi's share in MSCI EM has also surged, from zero in 1H2019 to over 4% in 2023. If an equity fund manager divided up their time by a country's share of MSCI, we calculate they should spend 98 hours a year on Saudi, more than Mexico at 65 hours and not far off Brazil's 128 hours. Raising equity is a second avenue to raise money for Vision 2030 targets, so we expect Saudi's share of EM equity to rise too. Flights to Riyadh are going to get busier.

This is a big deal for both Emerging Market debt and equity investors. Both are gaining access to what is 1) a big market, 2) a growing market and 3) a highly-rated single A credit market, all within a trillion dollars of GDP. It is Saudi/GCC inclusion in the EMBIGD index which has tipped EM into becoming an investment grade asset class (51% of the index), even though historical market memory means EM is most often compared with "risky" high-yield in the US. Equity investors will be aware that Saudi vs bigger equity markets, has a rating advantage over Brazil or India, and a growth advantage over South Korea and Taiwan. The biggest EM equity market China is struggling to maintain both its rating and GDP growth.

What interests us is the scope for Saudi to borrow more for investment in its GDP diversification strategies which benefit equities, while maintaining an attractive credit rating vs other EM states. The ratio of debt/revenues could double from here to 200% and still only be equivalent to Brazil and Vietnam, or highly rated Korea and Taiwan. Our assumption is the KSA will be more conservative and not reach that level, so helping it maintain high credit ratings.

Saudi Arabia's ability to borrow and maintain high credit ratings is strengthened by two factors, a) interest rates which are tied to the US and have probably peaked and b) high savings in its sovereign wealth funds. Rising global rates mean some EM or Frontier markets are forecast by the IMF to spend around 65% of revenues on interest. The figure is closer to 10% for the US and 0% in Japan. It was also 0% in Saudi in 2022, as revenues from offshore savings compensated for rising borrowing costs.

We will look at all of this in more detail in an 11th January webinar for FIM Partner clients.

Conclusions

Both debt and equity investors will be allocating much more money into Saudi Arabia in the 2020s and not just because it's a significant alternative for those seeking an "EM ex-China" theme. Its share in EM equities and debt will very likely keep rising over the decade, warranting more investor time, attention and perhaps a tourist visit too.

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