Title: Little Room to maneuver as Saudi Arabia slows drive to cut deficit
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Saudi Arabia is slowing a drive to cut its huge fiscal deficit in order to revive the economy, but the state budget plan for 2019 suggests it may not have room to boost growth by much.

With unemployment among Saudis at a record 12.9%, creating jobs is becoming increasingly important to justify reforms launched over two years ago by Crown Prince Mohammed bin Salman, who aims to diversify the economy beyond oil exports.

The 2019 budget, released last week, reflected that. It promised a 7% increase in spending, which officials said would lift growth in the non-oil part of the economy and start bringing down unemployment from next year. But even that moderate rise in spending will come at a major cost, the budget plan showed: a dramatic reduction in the pace at which Riyadh shrinks the deficit, which it has pledged to eliminate entirely by 2023.For three years — ever since Riyadh ran an eye-popping deficit of 367 billion riyals ($98 billion) in 2015, or about 15% of gross domestic product, threatening its financial stability — fiscal policy focused to a large extent on reassuring markets by cutting the deficit.

The Finance Ministry said last week the deficit shrank to 136 billion riyals, or an estimated 4.6% of GDP this year, from 230 billion riyals in 2017.The 2019 budget, however, projected that the deficit would shrink only marginally to 131 billion riyals, or 4.2% of GDP, next year. Many private analysts said the budget's spending and revenue numbers implied that the deficit would actually rise.

Bilal Khan, senior regional economist at Standard Chartered, predicted a deficit of 5% in 2019, and Monica Malik, chief economist at Abu Dhabi Commercial Bank, forecast over 7%. Jason Tuvey, senior emerging markets economist at Capital Economics, estimated that if oil prices did not rebound from current levels, the deficit would near 10% in 2019 — a figure that Saudi Arabia could not sustain in the long run.That would leave Riyadh in danger of missing the 2023 target for eliminating the deficit by a wide margin, which could revive markets' concern about the health of Saudi finances, or of being pressured into drastic austerity steps between 2020 and 2023 in order to hit the target.

For these reasons, Saudi Arabia's room to pursue a go-for-growth fiscal policy is limited, and it will not be able to abandon austerity steps entirely next year, economists said. This could keep expansion of the non-oil sector sluggish. "While there may be some fiscal loosening in the first half of next year, we think that austerity will probably resume in the second half of 2019," Tuvey said.

The non-oil part of the economy grew just 2.3% in 2018, far too slowly to have much of an impact in cutting unemployment in a country where the population of Saudi citizens is expanding at an annual rate of close to 2%. Riyadh originally set a 2020 date for balancing its budget, pushing that back to 2023 a year ago as the economy struggled. In recent months, officials have not abandoned the 2023 deadline but they have sought to soften its significance.

In late October, after much planning for the 2019 budget was completed, Finance Minister Mohammed al-Jadaan told Reuters that while Riyadh would balance its budgets over the medium term, it would accept some deficits after 2023 if they were needed to spur the economy.

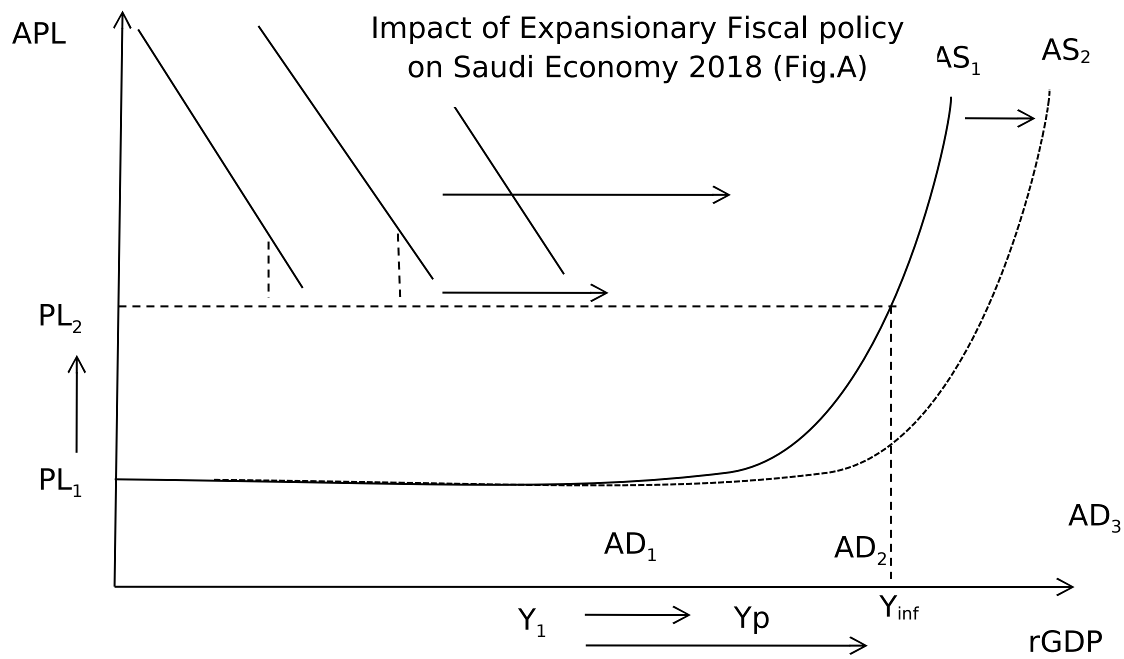
In post-budget news conference last week, senior officials said they remained committed to fiscal balance but did not specifically mention 2023.

Some aspects of the budget indicated that key austerity policies would go ahead, however. Jadaan said Riyadh had no intention of changing policy toward fees that it charges for hiring expatriates and issuing residence permits to their dependents. The fees are due to rise next year, increasing financial pressure on the private sector, which had lobbied for the rises to be delayed. Also, officials declined to rule out last week the possibility of further hikes in domestic fuel prices. Under previously announced policy, domestic prices of fuels including gasoline, diesel and kerosene may be raised in 2019.

Domestic fuel price rises may be the only way Riyadh can achieve a projection in its 2019 budget for oil revenues to rise 9% to 662 billion riyals, as many economists think international oil prices are unlikely to rise much if at all.

This article describes the use of expansionary fiscal policy in Saudi Arabia to combat rising unemployment. Fiscal policy is a demand-side policy that uses government expenditure and taxes to change the level of aggregate demand. Unemployment is the number of individuals who are actively seeking a job, yet are unable to find one.

Fig.A shows the intersection between aggregate demand AD_1 and aggregate supply curve AS at average



price level PL_1 and rGDP Y_1. There is a recessionary gap as cyclical unemployment is present in Saudi Arabia given by the rate of unemployment is 12.9% in paragraph1. Unemployment is greater than the natural rate of unemployment (NRU) and actual output isn't at full employment of resources. The expansionary fiscal policy of "a 7% increase in spending" proposed by Crown Prince Mohammed bin Salman increased aggregate demand towards the potential output. Since government spending is a component of aggregate demand, AD shifts from AD_1 to AD_2 towards potential output at Yp and cyclical unemployment of 12.9% will fall.

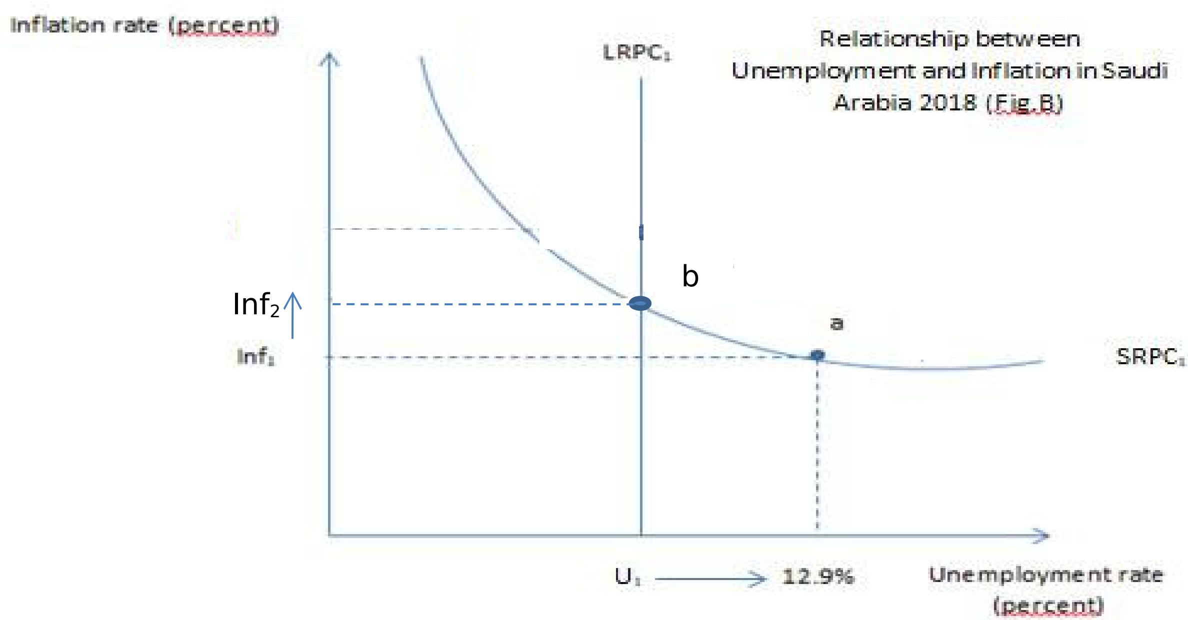


Fig.B depicts the long run and short run Phillip's curve in Saudi Arabia. At point a, the unemployment rate is 12.9 % and inflation is Inf_1. Since the economy is in a deflationary gap, a does not lie on LRPC. In the long run, the economy will return to U_1 on LRPC once the deflationary gap is removed and the economy is at full employment and unemployment is NRU, shown by the movement along $SRPC_1$ from 12.9% $\rightarrow$ U_1 resulting in a higher inflation rate Inf_2 at point b.

One advantage increased spending brings is it decreases cyclical unemployment. It removes the recessionary gap in Fig. A as output increases to full employment where firms hire more workers. The policy will increase actual growth as rGDP increases from Y_1 to Yp and reduces unemployment in the short run. Furthermore, the multiplier effect, or the ratio of rGDP divided by the change in one of the components of AD, is present, thus stimulating the economy further by encouraging spending back into the economy as newly-employed workers have more income to spend. This leads to a greater relative increase in AD than the initial 7% spent on increasing AD. Lastly, the money could be spent on improving infrastructure, healthcare or education, all of which may have the effect of shifting LRAS outward and increasing Saudi Arabia's potential output.

However, this type of policy has its disadvantages. This "go-for-growth" policy proposed by the Crown prince only targets cyclical unemployment and doesn't correct the other types of unemployment, specifically structural unemployment: the main reason behind the 12.9% unemployment. NRU may only decrease if LRAS increases and this may only occur if a supply-side policy was implemented. Structural and seasonal unemployment require additional training of workers to be eliminated and frictional needs better access to information. Inflation may also increase as an expansionary fiscal policy ignores cost-push inflation and may lead to more demand pull inflation. If AD intersects AS at a point greater than Yp as shown in Fig.A-by the shift from AD_1 to AD_3, hyperinflation may occur if the effect of the multiplier is not calculated properly, therefore a supply-side policy to reduce the impact of inflation may be in order like from AS_1 to AS_2 in FigA. This leads to the next disadvantage being that it is very difficult to measure the effect of the multiplier on the economy. The policy may be unnecessary in the long run as the market will return to full employment of resources according to the long run Phillip's curve in Fig.B, thus correcting unemployment. Lastly, the increase in spending goes against the Riyadh's aim of eliminating their budget deficit by 2023, which is "136 billion riyals, or an estimated 4.6% of GDP this year, from 230 billion riyals in 2017." according to paragraph5, as increased spending "could revive markets' concern about the health of Saudi finances, or of being pressured into drastic austerity steps between 2020 and 2023 in order to hit the target." which means lower business confidence. This may cause less investment and a decrease in AD, or crowding out. The-increase in deficits will also lead to larger demand for borrowing and higher interest rates, which may further go against the intentions of the Riyadh.

In conclusion, this policy combats cyclical unemployment and improves growth, but increases inflation and worsens existing budget deficits. It doesn't fully reduce unemployment, but it would be closer to that if it were combined with supply-side policies to combat inflation and NRU.

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