

TABLE OF CONTENTS

Executive Summary	1
Introduction	2
Economic Conditions	4
Real Sector	4
External Sector	6
Public Sector	8
Financial Sector	10
Concluding Remarks	15

A SIGNIFICANT REFORM MOMENTUM DELIVERING NET STRUCTURAL IMPROVEMENTS TO KSA'S ECONOMY

Saudi's real GDP growth at a high of 8.7% in 2022

Saudi Arabia's significant reform momentum in recent years has begun to deliver structural improvements to its economy and fiscal and debt management. Among the reforms are measures to drive non-oil economic growth and widen the non-oil tax base, alongside significant social liberalization, which supports consumer demand. In addition, the economy continues to benefit from Saudi Arabia's leading role as the largest individual oil exporter globally. Within this environment, the year 2022 has been a significantly flourishing year for the Kingdom of Saudi Arabia. Real GDP growth reported 8.7% in 2022 as per IMF, against 3.9% in 2021 and -4.3% in 2020.

Saudi Arabia's external sector performance moderates in 2023

During 2022, amid soaring oil prices and the almost complete return to normalcy following the pandemic, Saudi Arabia's external sector saw a boosted performance. However, a rationalization in the prices of oil as well as a slowdown in global economic activity amid unfavorable conditions, have led to the start of a moderation trend in the sector's performance during 2023. According to the IMF, the current account in the country is expected to be recorded at 6.2% of GDP in 2023, down from 13.8% of GDP in the year prior.

First budget surplus in nearly 10 years on overshooting oil revenues

Saudi Arabia saw in 2022 its first budget surplus in nearly 10 years amid surging oil prices, increased output, and a continuous expansion in non-oil activity within the context of a rebound in consumer and business confidence. This combined with a significant increase in nominal GDP has supported the sharp reduction in the public debt stock to GDP ratio. The Kingdom achieved a fiscal surplus of SR 103.9 billion (US\$ 27.7 billion) in 2022, which is equivalent to 2.5% of GDP. This represents a significant overshoot relative to the budget 2022 (a surplus of SR 90 billion), on the back of energy sector windfall and buoyant non-energy business activity. Saudi Arabia expects a budget surplus of SR 16 billion in 2023, equivalent to 0.4% of GDP.

Contained inflationary pressures in 2023 on strong US dollar and low pass-through of global prices

Saudi monetary conditions were marked by limited inflationary pressures and falling FX buffers early-2023, while the Saudi Central Bank continued to raise its key policy rates in tandem with the US Federal Reserve's policy tightening measures aimed to tame soaring inflation after Russia-Ukraine war. Saudi inflation remained contained so far this year amid a low pass-through of international food and commodity prices due to some subsidies, and as a strong US dollar continued to shield the Kingdom from the global inflationary shock. In fact, Saudi consumer prices increased by 2.7% year-on-year in April 2023, after rising by 2.5% on average in 2022.

A continuously resilient banking industry

At the banking sector level, banks remain liquid, well capitalized, and their profitability—which declined during the COVID-19 pandemic—rebounded strongly in 2021 and 2022 as net interest margins recovered. Credit to the private sector expanded noticeably by 15.3% in 2021 and by 13.1% in 2022, mainly driven by mortgages and SME lending. Despite rapid credit growth, Saudi banks have maintained strong capital levels, as measured by a risk-adjusted capital ratio above 10%.

Activity in Saudi capital markets tilted to upside in first five months of 2023

Saudi equities bounced back by more than 5% over the first five months of 2023, mainly supported by upbeat corporate earnings and continuous expansion in the non-oil private sector economy. Concomitantly, Saudi debt papers saw mostly upward price movements this year, mainly tracking US Treasuries move on mounting global growth concerns in a monetary tightening environment and as recent US banking woes stoked demand for safe-haven assets.

Saudi economy looks on a firmly improving path looking forward

The positive outlooks assigned by rating agencies to Saudi Arabia reflects the increasing likelihood that broad-based structural reforms and investments in a wide range of diversification projects will help reduce significantly the sovereign's economic and fiscal reliance on hydrocarbons over time. The IMF expects Saudi Arabia's economy to grow at 3.1% in 2023 and at an average rate of around 3.0% over the next five years. This is nearly three times the average during 2015-21 (1.0%) but lower than the 4.1% growth rate recorded during 2005-14.

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Saudi Arabia's significant reform momentum in recent years has begun to deliver structural improvements to its economy and fiscal and debt management. Among the reforms are measures to drive non-oil economic growth and widen the non-oil tax base, alongside significant social liberalization, which supports consumer demand. In addition, the economy continues to benefit from Saudi Arabia's leading role as the largest individual oil exporter globally.

Within this environment, the year 2022 has been a significantly flourishing year for the Kingdom of Saudi Arabia. Real GDP growth reported 8.7% in 2022 as per IMF, against 3.9% in 2021 and -4.3% in 2020. Alongside strong oil-sector growth in 2022, the non-oil sector also expanded robustly in 2021 and 2022, and is set to remain reasonably strong through 2026, thanks to services-sector growth, supported by significant ongoing social liberalization and increased female workforce participation. The economy continues to benefit from large investment projects, largely funded by the Public Investment Fund and the National Development Fund (NDF).

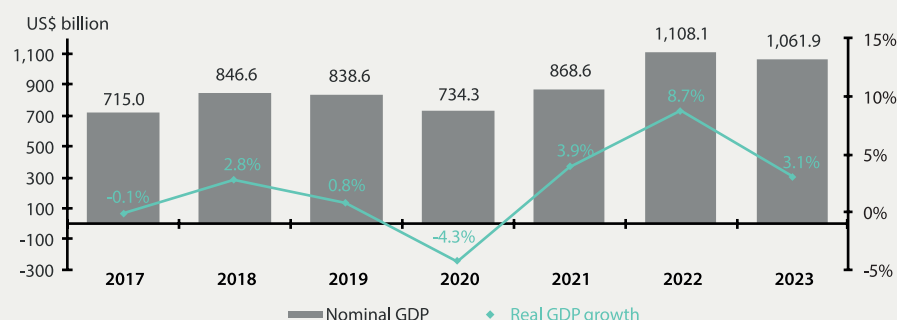
Saudi Arabia's majority State-owned oil producer, Saudi Aramco, posted record-breaking profits in 2022. Net income amounted to US\$ 161 billion for the full year, up 47% on 2021, spurred by higher oil prices, refining margins, and increased volumes. Saudi Aramco's strong financial performance also supports the government's fiscal position through dividend payments of US\$ 75 billion in 2022, alongside taxes and royalties.

At the fiscal level, the overall public finance balance increased by almost 5 percentage points of GDP over the past year to a surplus of 2.5% of GDP in 2022 against a deficit of 2.3% in 2021, mainly reflecting oil revenues and non-oil tax revenues supported by a rebounding economy and the full-year effect of the tripling of the VAT rate to 15 percent.

At the external level, higher oil prices and stepped-up oil production improved the current account by 8.7 percentage points of GDP in 2022, registering a surplus of 13.6% of GDP in 2022 against a surplus of 5.1% in 2021 as strong oil-driven exports surpassed growing imports and large remittance outflows. While reserves increased, net foreign assets declined, although remaining at very comfortable levels at 22 months of imports and are set to increase significantly in the wake of rising oil export revenues over the medium term.

At the banking sector level, banks remain liquid, well capitalized, and their profitability—which declined during the COVID-19 pandemic—rebounded strongly in 2021 and 2022 as net interest margins recovered. Credit to the private sector expanded noticeably by 15.3% in 2021 and by 13.1% in 2022, mainly driven by mortgages and SME lending. Despite rapid credit growth, Saudi banks have maintained strong capital levels, as measured by a risk-adjusted capital ratio above 10%.

NOMINAL AND REAL GDP



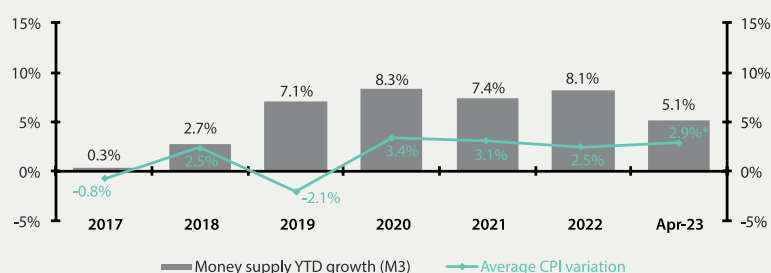
Sources: Saudi Central Bank, IMF, Bank Audi's Group Research Department

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At the capital markets level, activity was at the mirror image of the overall economy. The share price index which contracted by 7.1% in 2022 rose back by 5.1% in the first five months of 2023. Subsequently, market capitalization moved from US\$ 2,669 million at end-2021 to US\$ 2,634 million at end-2022 and to US\$ 2,822 million at end-May 2023. The fluctuation in prices comes within the context of moderating trading activity. Total trading value fell from US\$ 596 million in 2021 to US\$ 455 million in 2022. With respect to fixed income markets, the 5-year CDS spread, a measure of market perception of sovereign risks, moved from 49 basis points at end-2021 to 61 basis points at end-2022 and to 63 basis points at end-May 2023.

The detailed developments in the real sector, external sector, public sector and financial sector are outlined in the sections that follow while the concluding remarks address Saudi Arabia's middle to long term economic outlook looking forward.

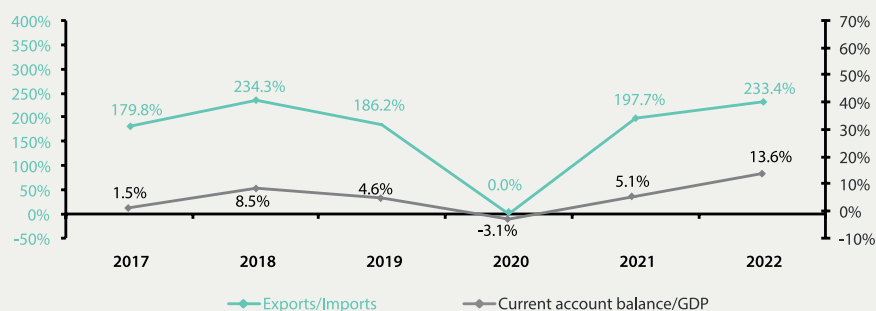
MONEY SUPPLY AND INFLATION



* Yearly average growth in the first 4 months

Sources: Saudi Central Bank, Bank Audi's Group Research Department

FOREIGN SECTOR INDICATORS



Sources: Saudi Central Bank, Bank Audi's Group Research Department

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1. ECONOMIC CONDITIONS

1.1. REAL SECTOR

1.1.1. Hydrocarbon sector

Further expansion in Saudi's hydrocarbon sector on higher oil prices and increased production

Spurred by high global oil prices and increased production, Saudi Arabia's hydrocarbon sector registered further expansion in 2022. Saudi oil revenues surged by 52.5% year-on-year to reach US\$ 228.6 billion in 2022, against US\$ 149.9 billion in the previous year, according to the Ministry of Finance. Accordingly, oil revenues accounted for 67.6% of total revenues in 2022, up from 58.2% in 2021.

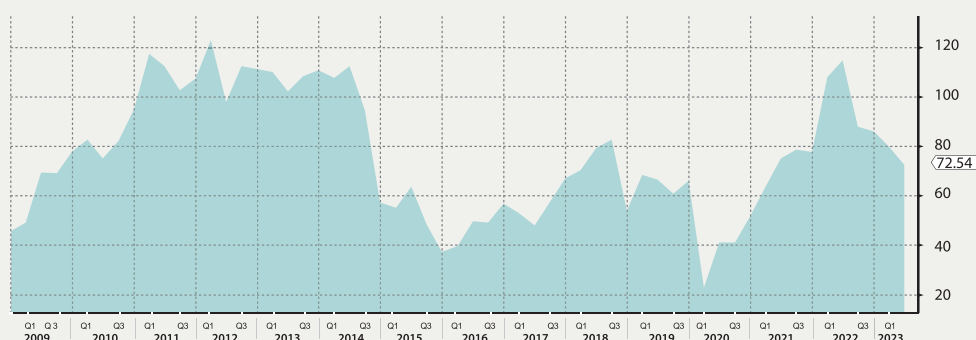
At the level of upstream oil production, data from OPEC showed a 15.5% y-o-y increase in Saudi Arabia's crude oil production in 2022 as the market continues its recovery from the pandemic. Oil output rose to 10.531 million b/d in 2022, up from 9.114 million b/d in 2021, as per Fitch Solutions. However, output growth is currently heavily curtailed by the OPEC+ production cut deal. In fact, OPEC+ decided in October 2022 to implement a 2 million b/d collective cut effective November 2022, of which 526,000 b/d was allocated to Saudi Arabia. Furthermore, the Kingdom announced in June 2023 an additional voluntary oil output cut of one million b/d for July 2023, which could be extended further. This means that Saudi Arabia's production would become 9 million b/d in July 2023, down from around 10 million b/d in May 2023, with voluntary cuts totaling 1.5 million b/d.

Amid surging oil prices in the aftermath of Russia's invasion of Ukraine (37.3% on average y-o-y) and rising Saudi oil production, the division of GDP by kind of economic activity showed that the "mining and quarrying" segment accounted for 33.1% of GDP in 2022, up from 24.6% of GDP in 2021.

In parallel, Saudi's refined products consumption expanded by 7.6% in 2022 to reach 2,329.2 thousands b/d, and is forecast to grow further by 3.7% this year to reach 2,415.5 thousands b/d, as per Fitch Solutions.

At the level of gas production, Fitch Solutions forecasts a growth of 4.0% and 0.9% in 2023 and 2024, respectively. This followed an estimated growth of 5.0% in 2022. The major Hawiyah and Haradh, and Tanajib gas projects are boosting the prospects for hydrocarbons growth over the medium term in Saudi Arabia. In details, Hawiyah gas plant expansion project, which forms part of the Haradh Gas increment program, has progressed with its commissioning activities and is expected to begin operations this year. The project would add around 11.4 billion cubic meters (bcm) annually at peak production, bringing total capacity to around 37.2 bcm, as per Fitch Solutions. In parallel, as part of the Marjan expansion project, Saudi Aramco is investing to add 25.8 bcm of gas processing capacity. The Tanajib gas plant would process gas from the Marjan, Safaniyah and Zuluf fields and is slated for completion in 2025.

CRUDE OIL PRICES



Sources: Bloomberg, Bank Audi's Group Research Department

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All in all, Saudi Arabia is well placed to grow its global oil market share over the long-run as Russian exports stutter in the wake of the country's invasion of Ukraine with sanctions limiting the sale of oil and natural gas in Western markets. Also, the Kingdom's strong pipeline of projects, either awaiting or under development, would offer large opportunities for growth over the long term. In parallel, the natural gas, which is emerging as a strong alternative energy commodity to oil, presents attractive economic prospects for Saudi Arabia.

1.1.2. Non-Hydrocarbon Sector

Optimistic outlook for Saudi Arabia's non-oil sector in 2023 amid diversification efforts

Benefiting from the windfalls brought on by high oil prices in 2022, Saudi Arabia's investment in diversification efforts has increased drastically. This has led to positive indices in all non-oil sectors and an optimistic outlook looking forward as the country's Vision 2030 continues to take effect.

At the level of overall non-oil sector performance, business conditions have continuously improved since September 2020. February 2023 saw an eight-year high Purchasing Managers' Index (PMI) reaching 59.8 with May 2023 standing at 58.5. This comes amid a sharp increase in new business volumes, solid new order growth, increased customer demand and new business opportunities. Additionally, the outlook for the future performance in the sector remains largely optimistic and is set well above the average seen in 2022. This comes amid robust sales pipelines, confidence in domestic business conditions as well as the expected long-term effect of the government's economic policy objectives.

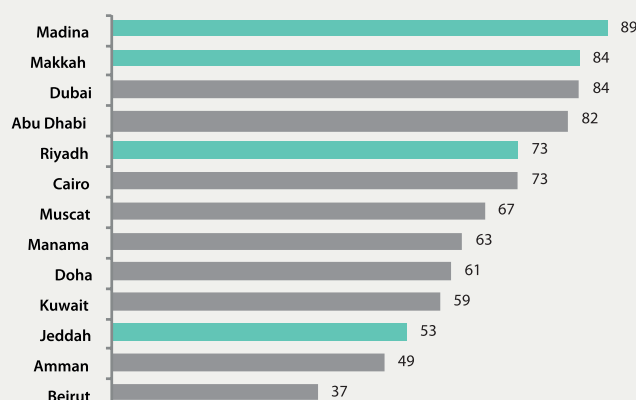
At the level of the population, the upward trend in household (HH) spending is forecasted to continue although at a slower rate with growth rates relatively stagnating. In details, HH spending is forecasted to grow by 4.4% in 2023 to reach US\$ 386.8 billion, up from US\$ 370.5 billion in 2022. The average growth per annum between 2024 and 2027 will somewhat stagnate at 4.9% per year. In addition to this, prices are expected to moderate in 2023 to register 2.2% and remain between 2.2 and 2.3% over the period of 2024-2027, as per BMI.

It is worth noting that following headwinds experienced in 2020 and 2021 and the improvement in economic conditions since then, it is forecasted that spending on non-essential goods and services will notice positive growth in 2023.

At the level of infrastructure and construction, outlook for activity in these sectors remains strongly positive due to the country's economic diversification efforts. These efforts will particularly impact the residential/non-residential buildings and transport infrastructure activities.

In details, Saudi Arabia's megaprojects are crucial to achieve the country's goals which makes their abandonment unlikely, even amid weakened revenues from oil. Additionally, as the Public Investment

COMPARATIVE HOTEL OCCUPANCY RATES (%)*



* First quarter of 2023

Sources: Ernst & Young, Bank Audi's Group Research Department

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Fund aims to increase its investments domestically, this will give a push to the country's megaprojects. This is expected to pose an upside risk towards the financing of projects, especially those that are of significant contribution towards Saudi Arabia's project pipeline.

Looking at the construction industry, a real growth of 2.8% is forecasted in 2023 to reach a value of SR 195.9 billion (US\$ 52.2 billion), up from SR 186.8 billion (US\$ 49.8 billion) in 2022. On the medium term (2024-2028), a yearly real growth of 3.8% is forecasted in the industry's value with a yearly real growth of 4.0% expected on the long term (2024-2031).

In parallel, the infrastructure industry is forecasted to notice a 2.7% growth year-on-year in 2023 to reach SR 111.6 billion (US\$ 29.8 billion). The growth trend is expected to remain on the medium term with a yearly real growth of 3.4%, and in the long term with a yearly real growth of 3.7%, as per BMI.

At the level of tourism, BMI forecasts an upward trend in tourism arrivals to Saudi Arabia in their studied period (2023-2027) with a yearly average growth rate of 14.9%. In 2023, arrivals are expected to grow by 22.0% year-on-year reaching 19.0 million. In turn, this increase will push tourist arrivals above the pre-pandemic levels effectively achieving a full recovery in the sector during the year. As a result of the growth in tourism arrivals, receipts from international tourism is forecasted to also notice an upward trend. In 2023, International Tourism Receipts are forecasted to reach SR 81.3 billion (US\$ 21.7 billion) which denotes a year-on-year growth of 15.6%, up from SR 70.4 billion (US\$ 18.8 billion) in 2022. In the medium term (2024-2027), a yearly average growth rate of 10.4% is expected with receipts reaching SR 120.7 billion (US\$ 32.2 billion) in 2027.

At the level of the hospitality sector, BMI forecasts an increase of 12.5 percentage points in hotel occupancy rate during 2023 to reach 70.3%. It is expected that the occupancy rate will follow an upwards trend, although at a more moderate rate between 2023 and 2026, reaching 77.0% occupancy rate in the latter.

During the first quarter of 2023, Saudi Arabia's 4 and 5 star hotels in the cities of Jeddah, Makkah, Riyadh and Madinah posted a mostly positive performance. In Jeddah, year-on-year increases of 6.0%, 3.0% and 16.1% were recorded in occupancy rate, Average Room Rate (ARR) and Revenue Per Available Room (RevPAR) respectively against figures from the same period of the year prior. Makkah noticed the biggest improvements in performance during Q1 2023 with year-on-year jumps in occupancy rates (26.5%), ARR (94.5%) and RevPAR (184.5%) against the same quarter of the year prior. Riyadh posted increases in ARR (11.7%) and RevPAR (10.0%) and a marginal decrease in occupancy rate of 1.1% in Q1 2023 against figures from Q1 2022. Madinah also posted increases of 12.0%, 61.1% and 86.1% year-on-year in the fields of occupancy rate, ARR and RevPAR during the aforementioned period, according to EY's Hotel Benchmark Survey for March 2023.

1.2. EXTERNAL SECTOR

Saudi Arabia's external sector performance moderates in 2023

During 2022, amid soaring oil prices and the almost complete return to normalcy following the pandemic, Saudi Arabia's external sector saw a boosted performance. However, a rationalization in the prices of oil as well as a slowdown in global economic activity amid unfavorable conditions, have led to the start of a moderation trend in the sector's performance during 2023

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At the level of foreign trade, Saudi Arabia's Balance of Trade (BoT) surplus showed a contraction of 39.2% year-on-year reaching SR 127.1 billion (US\$ 33.9 billion) in the first quarter of 2023, down from SR 209.2 billion (US\$ 55.8 billion) in Q1 2022. This comes following a 204.8% jump year-on-year noticed in the BoT between Q1 2022 and Q1 2021. The main drivers standing behind this moderation in BoT surplus during the first quarter of 2023 are a 14.6% contraction year-on-year in total exports and an 18.1% increase in imports year-on-year between Q1 2023 and Q1 2022, as per data from the Saudi General Authority for Statistics (GASTAT).

In details, total exports were reported at SR 313.6 billion (US\$ 83.6 billion) in Q1 2023, registering a 14.6% decrease from the figures recorded in Q1 2022. The majority of exports (78.3%) were from the oil sector with the non-oil sector accounting for 16.8% of exports.

The breakdown of exports by category shows that exports of mineral products held the biggest share of exports with 78.6% of total exports, followed by exports of the chemical or allied industries representing 6.8% of total exports and exports of plastics and articles thereof with 5.1% of total exports during Q1 2023.

The breakdown of exports by country importing from Saudi Arabia during Q1 2023 indicates that China held the biggest share with 16.4% of total exports followed by Japan with 10.2%, India (9.6%), South Korea (8.6%), UAE (5.3%) and the USA (5.0%), as per data from GASTAT.

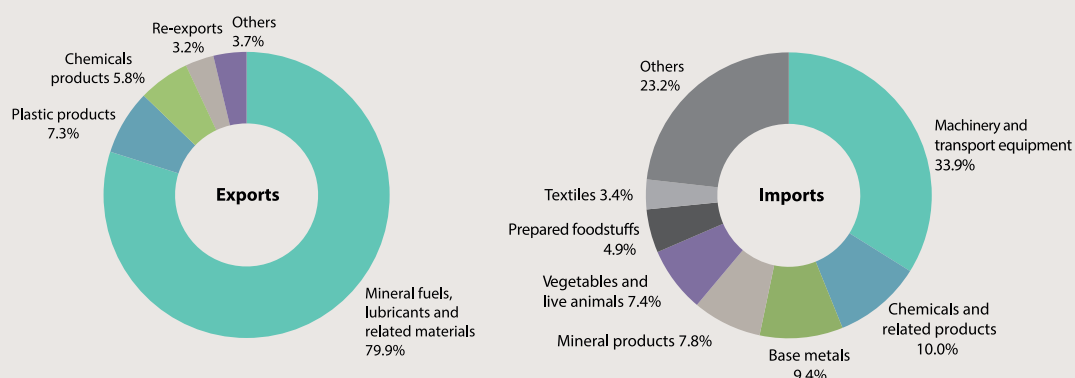
On the other hand, total imports were reported at SR 184.4 billion (US\$ 49.2 billion) in Q1 2023, registering an 18.1% expansion from the figures recorded in Q1 2022.

The breakdown of imports by category shows that imports of machinery and mechanical appliances held the biggest share with 20.9% of total imports, followed by imports of vehicles, aircrafts, vessels and associated transport equipment representing 16.1% of total imports and imports of products of the chemical or allied industries with 9.7% of total imports during Q1 2023.

The breakdown of imports by country exporting to Saudi Arabia during Q1 2023 indicates that China held the biggest share with 21.5% of total imports followed by the USA with 9.2%, UAE (6.5%), India (6.1%), Germany (4.5%) and Japan (4.0%), as per data from GASTAT.

According to the International Monetary Fund (IMF), imports to Saudi Arabia are forecasted to grow by 10.1% in 2023 with an average growth rate of 7.4% per year between 2024 and 2028. In parallel, exports from Saudi Arabia are forecasted to grow by 2.8% in 2023 with an average growth rate of 5.0% per year between 2024 and 2028.

BREAKDOWN OF EXPORTS AND IMPORTS BY COMMODITY 2022



Sources: General Authority for Statistics, Bank Audi's Group Research Department

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On the other side of the external sector, the latest available figures by Saudi Central Bank showed that the current account has recorded a 240% jump year-on-year to reach SR 565.3 billion (US\$ 150.8 billion) in 2022, up from SR 166.2 billion (US\$ 44.3 billion) in the year prior. This comes primarily as the goods and services account marked a year-on-year jump of 150% in 2022 against figures from 2021.

The financial account has also noticed a 236% jump year-on-year in 2022 driven by notable increases in direct investments, reserve assets and other types of investments. In parallel, the capital account has increased its deficit significantly (87%) between 2022 and 2021, as per data from the Central Bank of Saudi Arabia.

Concurrently, in 2022, a decrease of 6.7% year-on-year in Saudi Arabia's public debt is observed to reach SR 1.0 trillion (US\$ 266.7 billion), down from SR 1.1 trillion (US\$ 293.3 billion) in 2021. Additionally, the inflow of Foreign Direct Investment into the country has increased by 3.0% in 2022 to reach SR 1.0 trillion (US\$ 266.7 billion), up from SR 979.0 billion (US\$ 261.1 billion) in the year prior, as per data from the Central Bank of Saudi Arabia.

Looking forward, according to the IMF, the current account in the country is expected to be recorded at 6.2% of GDP in 2023, down from 13.6% of GDP in the year prior. However, when looking at the five year forecast, on average current account will stand at surplus of 1.0% of GDP with a deficit trend for the account forecasted in 2027 and 2028.

1.3. PUBLIC SECTOR

First budget surplus in nearly 10 years on overshooting oil revenues

Saudi Arabia saw in 2022 its first budget surplus in nearly 10 years amid surging oil prices, increased output, and a continuous expansion in non-oil activity within the context of a rebound in consumer and business confidence. This combined with a significant increase in nominal GDP has supported the sharp reduction in the public debt stock to GDP ratio in 2022.

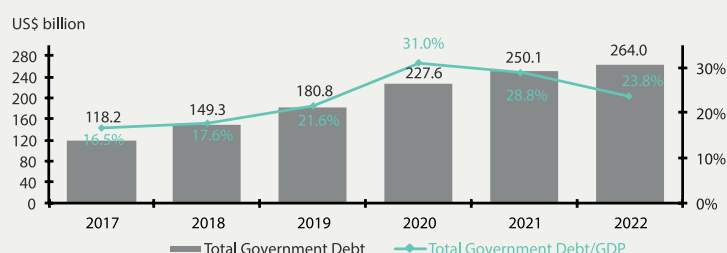
Going further into details, total revenues reached SR 1,268.2 billion in 2022 (US\$ 338.2 billion), which marks a significant expansion of 31.3% relative to the year 2021 and a 21.3% increase relative to the budget 2022. This is mainly explained by a 52.5% surge in oil revenues year-on-year, moving from SR 562.2 billion (US\$ 149.9 billion) in 2021 to SR 857.3 billion (US\$ 228.6 billion) in 2022, on the back of soaring oil prices in the aftermath

SAUDI ARABIA'S PUBLIC FINANCES

(SR billion)	2018A	2019A	2020A	2021A	2022A	2023B
Total revenue	906	927	782	965	1,268	1,130
Oil revenue	611	594	413	562	857	-
Non-oil revenue	294	332	369	403	411	-
Expenditure	1,079	1,059	1,076	1,039	1,164	1,114
Budget balance	-174	-133	-294	-73	104	16
Gross public debt	560	678	854	938	990	951

Sources: Saudi Central Bank, Bank Audi's Group Research Department

PUBLIC INDEBTEDNESS



Sources: Saudi Central Bank, Bank Audi's Group Research Department

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of Russia's invasion of Ukraine, as Brent oil prices rose from US\$ 63 per barrel on average in 2021 to US\$ 87 per barrel on average in 2022, and due to increased oil output as the average production moved from 9.1 mbpd in 2021 to 10.5 mbpd in 2022. On the other hand, non-oil revenues increased slightly by 1.9% in 2022 when compared to the previous year to reach SR 410.9 billion (US\$ 109.6 billion).

On the spending front, total public expenditures reached SR 1,164.3 billion (US\$ 310.5 billion) in 2022, up by 12.1% relative to the previous year, and compared to an originally planned spending of SR 955 billion. The overrun signals in part government initiatives designed to mitigate the impact of high global inflation on the domestic cost of living.

The breakdown of total expenditures shows that current expenditures increased by 10.8% in 2022 when compared to the previous year to reach SR 1,020.8 billion (US\$ 272.2 billion), mainly as a result of an increase in spending on use of goods and services. Concurrently, capital expenditures expanded by 22.4% over the covered period to reach SR 143.5 billion (US\$ 38.3 billion) in 2022, reflecting in part broader rising input costs in relation to public investment and consumption.

That being said, the fiscal balance in Saudi Arabia returned to positive territory for the first time since 2013. The Kingdom achieved a fiscal surplus of SR 103.9 billion (US\$ 27.7 billion) in 2022, which is equivalent to 2.5% of GDP. This represents a significant overshoot relative to the budget 2022 (a surplus of SR 90 billion), on the back of energy sector windfall and buoyant non-energy business activity.

In parallel, the total public debt grew by 5.6% in 2022 or the equivalent of SR 52.1 billion to stand at SR 990 billion at year-end, accounting for 23.8% of GDP, down from 28.8% in 2021. This is mainly explained by a SR 56.2 billion expansion in internal debt to reach SR 615 billion, as internal borrowings (SR 107 billion) outpaced internal debt repayment (SR 50.4 billion) over the year 2022. In contrast, the external debt contracted by 1.1% or the equivalent of SR 4.1 billion in 2022. This is mainly driven by an external debt repayment of SR 22.9 billion, which exceeded external borrowings as Saudi Arabia tapped international debt markets in October 2022 with the sale of US\$ 5 billion (SR 18.8 billion) Islamic and conventional bonds.

On the other hand, planned expenditure for the year 2023 stands at SR 1,114 billion according to the budget 2023, with a continued focus on promoting economic growth and improving spending efficiency. Total public revenues are projected at SR 1,130 billion in 2023, remaining high amid a healthy domestic economic expansion and high international energy prices. Accordingly, Saudi Arabia expects a budget surplus of SR 16 billion in 2023, equivalent to 0.4% of GDP.

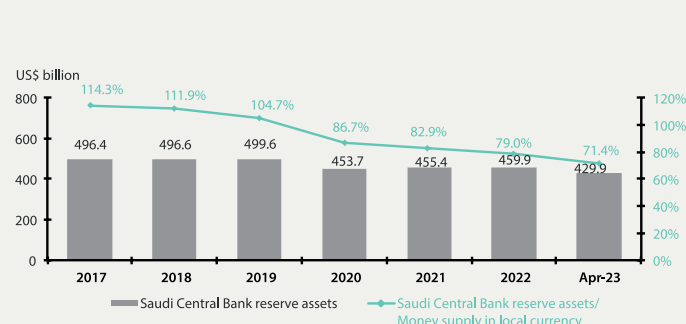
Looking forward, the year 2023 may see a narrowing fiscal surplus or a return to deficit (-1.1% of GDP as per the IMF), mainly on prospects of weakened demand for oil amid a slowing global economy, and as the Saudi authorities have recently stated that they would rely on fiscal loosening to "balance out" the tight monetary policy imposed by the US Federal Reserve.

EVOLUTION OF MONETARY SITUATION

Variations (US\$ million)	2017	2018	2019	2020	2021	2022	Apr-23
Net foreign assets	-38,343	-5,207	-8,977	-45,543	-21,163	16,838	-20,285
Saudi Central Bank	-39,731	670	4,469	-44,882	-10,989	2,301	-30,198
Commercial Banks	1,389	-5,877	-13,446	-661	-10,174	14,537	9,913
Domestic Assets	16,508	24,158	50,044	76,835	87,984	84,755	22,175
Claims on private sector	-3,389	10,678	27,005	57,579	72,439	68,132	19,014
Claims on public sector	20,301	13,496	20,938	14,586	11,301	7,880	2,440
Claims on Nonfinancial							
Public sector Enterprises	-403	-15	2,102	4,670	4,244	8,744	722
Total Money (M3)	1,457	12,926	35,065	43,767	42,547	49,747	33,996
Money Supply (M1)	7,495	12,342	18,004	53,484	20,160	-9,693	6,363
Quasi-Money	-6,038	584	17,061	-9,716	22,388	59,440	27,633
Government Deposits	-36,722	-14,993	-15,613	-10,111	-12,617	15,034	-29,849
Other Items (Net)	13,430	21,018	21,614	-2,364	36,891	36,813	-2,257

Sources: Saudi Central Bank, Bank Audi's Group Research Department

FOREIGN EXCHANGE MARKET INDICATORS



Sources: Saudi Central Bank, Bank Audi's Group Research Department

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1.4. FINANCIAL SECTOR

1.4.1. Monetary Situation

Contained inflationary pressures in 2023 on strong US dollar and low pass-through of global prices

Saudi monetary conditions were marked by limited inflationary pressures and falling FX buffers early-2023, while the Saudi Central Bank continued to raise its key policy rates in tandem with the US Federal Reserve's policy tightening measures aimed to tame soaring inflation after Russia-Ukraine war.

Saudi inflation remained contained so far this year amid a low pass-through of international food and commodity prices due to some subsidies, and as a strong US dollar continued to shield the Kingdom from the global inflationary shock.

In details, Saudi consumer prices increased by 2.7% year-on-year in April 2023, after rising by 2.5% on average in 2022. The breakdown of the Consumer Price Index by segment shows that the housing, water, electricity, gas, and other fuels segment, which has a weight of 25.5% in the Consumer Price Index, registered the largest yearly expansion of 8.1% in April 2023, mainly driven by a strong yearly growth in "actual rents for housing" of 9.6%. This was followed by the restaurants and hotels segment with +6.2%, the recreation and culture segment with +3.1%, the education segment with +3.0%, the transportation segment with +1.1% (weight of 13.1%), the food and beverages segment with +1.0% (with a weight of 18.8%), the health segment with +0.7% and the tobacco segment with +0.1%. In contrast, the clothing and footwear segment registered the largest yearly contraction in April 2023 of 2.1%, followed by the furnishings & household equipment segment with -1.3% and the communication segment with -0.4%, while the miscellaneous goods and services segment reported a nil change in prices year-on-year.

Given the Saudi riyal peg to the US dollar at SR/US\$ 3.75, the Saudi Central Bank's key policy rates remained anchored to the US Federal Reserve. Within this context, the Saudi Central Bank lifted its repo and reverse repo rates three times so far this year by a total 75 bps each to reach 5.75% and 5.25% respectively. This followed seven interest rate hikes totaling 400 bps in 2022 in a global monetary tightening environment aimed to tame soaring inflation.

Although the Kingdom ran a robust current account surplus of US\$ 151 billion in 2022, the largest since 2012, the Saudi Central Bank's reverse assets expanded just by US\$ 4.5 billion over the year to reach US\$ 459.9 billion at end-December 2022. The disconnection between the current account surplus and FX reserves accumulation seen in 2022 is mainly explained by large investment abroad and FX reserves accumulation outside the Saudi Central Bank. Over the first four months of 2023, the Saudi Central Bank's reverse assets contracted significantly by US\$ 30.0 billion to reach US\$ 429.9 billion at end-April. This is mainly attributed to a US\$ 31.7 billion fall in "investment in foreign securities" over the first four months of 2023.

Regarding monetary aggregates, the narrow measure of money supply (M1) grew by 1.6% during the first four months of 2023 (the equivalent of US\$ 6.4 billion), reaching US\$ 414 billion at end-April, given a US\$ 357 billion rise in "demand deposits". This followed a 2.3% contraction in (M1) in 2022. The broader money supply (M2), which grew by 6.0% in 2022, widened further by 3.5% during the first four months of 2023 (the equivalent of US\$ 20.2 billion) to reach US\$ 602 billion amid a US\$ 13.8 billion increase in "time and saving deposits". The money supply in its broadest sense (M3) expanded by 5.1% during the first four months of 2023 (the equivalent of US\$ 34.0 billion), within the context of a significant rise in quasi-money deposits of 16.6%. This followed an 8.1% expansion in (M3) in 2022. Given a lower growth in demand deposits than money supply (M3) during the first four months of 2023, the demand deposits to broader money supply (M3) ratio reached 51.0% at end-April 2023, down from 53.2% at end-December 2022. In parallel, the M1/M3 ratio was quoted at 59.2% at end-April 2023, moving down from 61.2% at end-December 2022.

In the coming period, a strong dollar, subsidies and price caps on certain products and continued labor market slack would help contain pressure from supply-side shocks, while the Saudi Central Bank would continue to follow US Federal Reserve moves, given the currency peg.

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1.4.2. Banking Activity

A continuously resilient banking industry

At the banking sector level, banks remain liquid, well capitalized, and their profitability—which declined during the COVID-19 pandemic—rebounded strongly in 2021 and 2022 as net interest margins recovered. Credit to the private sector expanded noticeably by 15.3% in 2021 and by 13.1% in 2022, mainly driven by mortgages and SME lending. Despite rapid credit growth, Saudi banks have maintained strong capital levels, as measured by a risk-adjusted capital ratio above 10%.

Higher credit demand, better asset yield, and operating efficiencies drove the top Saudi lenders' profitability amidst rising benchmark interest rates. FY'22 witnessed a high credit growth compared with deposits and is seen inching up further given strong economic momentum and investments, pushing the loan-to-deposit ratio to 96.8%. This can largely be attributed to demand in personal loans and real estate activities. The banks' credit growth stood at 13.1% YoY, while deposits grew by 9.1% YoY.

In a recent report by S&P, the rating agency says rapid credit growth has reduced the availability of liquidity in the Saudi banking sector. The government has large deposits with the Saudi Central Bank (SAMA) but is not deploying this liquidity to alleviate pressure on banks. Whether the government will step up its deposits with the banking system in 2023 is unclear. Moody's expects banking sector credit growth will slow to 10%-12% in 2023-2024, owing to a high base effect, higher interest rates, and tighter liquidity. Corporate demand is likely to increasingly drive credit growth as Vision 2030 projects are implemented.

At the profitability level, NIM expanded as asset yield improvement surpassed changes in the funding cost. NIM improved by 15bps YoY to 3.0 percent due to higher spread between yield on credit (YoC) to 5.8% YoY and cost of funds (CoF) to 1.1% in FY'22 according to Alvarez & Marsal. The consolidated net interest income (NII) surged (+15.7%) due to a rise in the SAMA policy rate during the year.

Looking ahead, high rates may result in a portion of deposits migrating to interest-bearing instruments, with downside for banks' margins. In fact, higher interest rates are expected to result in migration of current and savings accounts toward term deposits. S&P expects the sector's return on assets to improve only modestly to 2.0%-2.1% in 2023-2024.

BANKING SECTOR RATIOS

	2017	2018	2019	2020	2021	2022	Apr-23
Banking sector dimension in economy							
Assets/GDP	87.7%	75.5%	83.7%	108.2%	100.6%	87.1%	94.3%
Deposits/GDP	60.9%	52.7%	57.1%	70.6%	64.6%	55.2%	60.5%
Loans to private sector/GDP	50.4%	43.8%	47.4%	61.9%	60.3%	53.5%	57.4%
Loans to public sector/GDP	2.0%	1.7%	2.0%	2.9%	2.9%	3.1%	3.3%
Growth rates (YTD)							
Assets	2.7%	2.0%	9.7%	13.2%	10.0%	10.5%	3.7%
Loans to the private sector	-0.9%	2.8%	7.3%	14.3%	15.3%	13.1%	3.0%
Investments	11.7%	8.4%	18.7%	12.7%	6.1%	8.1%	4.7%
Deposits	0.2%	2.5%	7.3%	8.2%	8.3%	9.1%	4.9%
Capital and reserves	6.3%	-4.3%	13.0%	9.9%	11.3%	4.3%	13.4%
Profit growth (year-on-year)	8.6%	9.8%	4.5%	-23.1%	39.2%	28.6%	-
Financial ratios							
Primary liquidity	367,029	328,993	350,140	392,783	326,334	319,543	354,554
Bonds and shares	458,549	497,085	589,895	664,641	705,077	762,421	798,218
Liquid assets	825,578	826,078	940,035	1,057,424	1,031,411	1,081,964	1,152,772
Primary liquidity/Deposits	22.5%	19.7%	19.5%	20.2%	15.5%	13.9%	14.7%
Liquid assets/Deposits	50.6%	49.4%	52.3%	54.4%	49.0%	47.1%	47.9%
Loans to the private sector/Deposits	82.7%	83.0%	83.0%	87.7%	93.3%	96.8%	95.0%
Loans to the public sector/Deposits	3.3%	3.2%	3.4%	4.1%	4.5%	5.6%	5.4%
Total loans/Deposits	86.0%	86.2%	86.4%	91.7%	97.9%	102.3%	100.4%
Capitalization							
Capital accounts/Assets	15.4%	14.7%	14.9%	14.0%	14.4%	14.0%	13.9%
Profitability							
ROAA	1.89%	2.03%	2.00%	1.38%	1.72%	2.01%	2.02%
ROAE	12.5%	13.5%	13.5%	9.6%	12.1%	14.1%	14.5%

Sources: Saudi Central Bank, Bank Audi's Group Research Department

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Boston Consulting Group (BCG) highlights four avenues emerge as viable options for Saudi banks looking ahead to consider when pursuing strategies to strengthen their position:

- **Manage funding effectively:** Despite healthy loan growth, tighter funding conditions (as a result of higher borrowing costs and government inflows receding following a softening in energy prices) could impact loan volumes and NIM growth. Saudi banks should revisit their deposit-gathering strategy and in parallel, proactively encourage searching for other funding sources such as term deposits and wholesale funding.
- **Revisit and re-balance product strategies:** By taking advantage of favorable interest rates, banks can acquire new customers through a range of savings products. Campaigns to improve financial literacy, as prescribed by Vision 2030 to drive growth in the banking sector, can also help raise the savings rate from 6% to 10% of total household income.
- **Invest for growth:** By leveraging favorable macro conditions and strong sector growth, Saudi banks can pursue strategic investments to grow revenues and optimize costs. Areas with promising investment opportunities include emerging digital initiatives, re-imagined customer journeys, and the upgrade of underlying technology infrastructure.
- **Leverage partnerships:** To counter new digital competitors, banks should consider tapping into growing consumer spending trends to expand their portfolio of partnerships. For instance, by partnering with e-commerce businesses and retailers on agency banking and POS microfinancing solutions, banks can expand their customer base. Banks can also work with nonbanking financial institution partners to extend low-cost financing options to targeted SMEs.

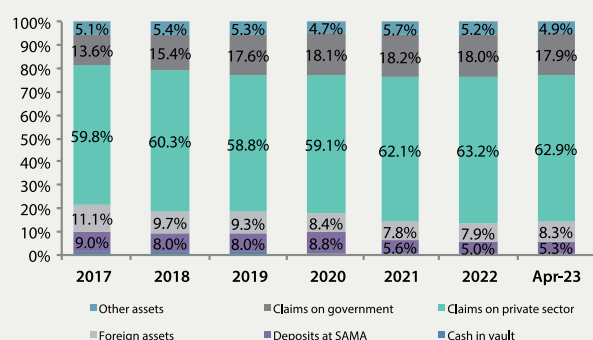
1.4.3. Equity and Bond Markets

Activity in Saudi capital markets tilted to upside in first five months of 2023

Saudi equities bounced back over the first five months of 2023, mainly supported by upbeat corporate earnings and continuous expansion in the non-oil private sector economy. Concomitantly, Saudi debt papers saw mostly upward price movements this year, mainly tracking US Treasuries move on mounting global growth concerns in a monetary tightening environment and as recent US banking woes stoked demand for safe-haven assets.

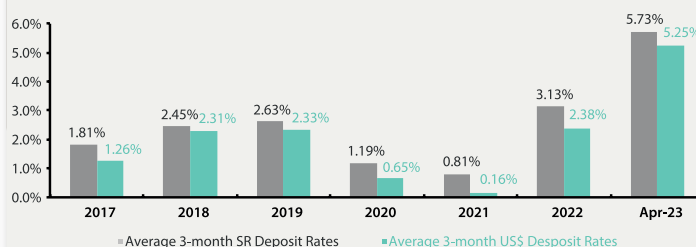
The Saudi Exchange registered price rebounds over the first five months of 2023, as reflected by a 5.1% surge in the Tadawul All-Share Index to reach 11,014.13 at end-May, following price falls of 7.1% in 2022. This is mainly driven by robust corporate earnings, as Saudi-listed companies (excluding Saudi Aramco) registered a 15.0% yearly expansion in aggregate net profits in 2022. When including Saudi Aramco, the yearly growth in aggregate net profits surged to 41.9% in 2022. This came on the top of a continuous growth in non-oil activities, as the seasonally adjusted Riyadh Bank Saudi Arabia Purchasing Managers' Index stood at 58.5 in May 2023, well above

BANKING SECTOR ASSET COMPOSITION



Sources: Saudi Central Bank, Bank Audi's Group Research Department

BANKING SECTOR DEPOSIT RATES



Sources: Saudi Central Bank, Bank Audi's Group Research Department

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the 50 reading separating growth from contraction, amid a continuous progress in the Kingdom's economic diversification strategy.

The breakdown of the TASI by the industry groups during the first five months of 2023 shows that the pharma, biotech and & life science sector registered the highest index expansion of 74.70%, followed by the capital goods sector with +33.43%, the consumer services sector with +33.23%, the software & services sector with +30.89%, the real estate management and development sector with 29.99%, the transportation sector with +29.45%, the insurance sector with +27.29%, the healthcare equipment and services sector with +20.70%, the telecommunication services sector with +20.63%, the consumer durables and apparel sector with +18.99%, the commercial and professional services sector with +18.80%, the food & staples retailing sector with +18.61%, the retailing sector with +17.43%, the food & beverage sector with +15.58%, the energy sector with +8.45%, the media & entertainment sector with +8.36% and the materials sector with +2.32%. In contrast, the banks sector reported the highest index contraction with -4.75%, followed by the REITs sector with -2.28%, the diversified financial sector with -1.87% and the utilities sector with -1.10%.

Concomitantly, the total trading value in the Saudi Exchange contracted by 44.7% year-on-year during the first five months of 2023, reaching US\$ 131.9 billion, as compared to US\$ 238.4 billion during the same period of 2022.

The division of the total turnover by industry groups during the first five months of 2023 showed that four out of 21 sectors captured almost half of total activity (49.7%), namely the materials sector with 19.6%, the banks sector with 16.5%, the telecommunication services sector with 7.5% and energy sector with 6.0%. Given the contraction in total turnover and the rise in market capitalization, the annualized turnover ratio fell to 11.2% on the Saudi Exchange during the first five months of 2023 as compared to 17.2% during the same period of 2022.

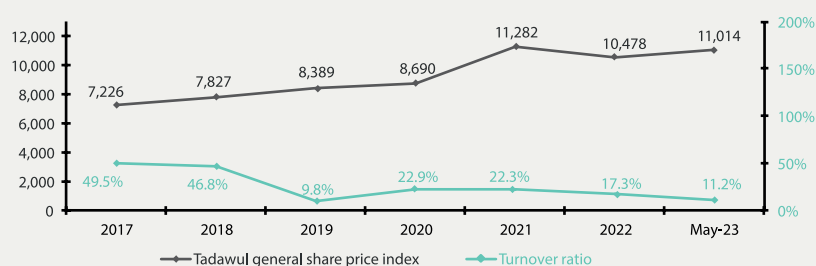
In line with equity price rebounds during the first five months of 2023, the number of listed companies reached 224 at end-May 2023 against 223 at end-2022. Within this context, the Saudi market capitalization increased by 7.1% over the first five months of the year, moving from US\$ 2,634.2 billion at end-2022 to US\$ 2,822.4 billion at end-May 2023. This followed a 1.3% contraction in the Saudi market capitalization in 2022.

SELECTED STOCK MARKET INDICATORS

	2017	2018	2019	2020	2021	2022	May-23
Market capitalization (US\$ billion)	450.6	495.7	2,406.8	2,427.1	2,669.1	2,634.2	2,822.4
Trading value (in US\$ billion)	223.0	232.2	234.7	556.7	596.2	455.5	131.9
Number of transactions (in millions)	21.9	25.0	28.4	76.7	91.9	87.9	35.0
General share price index (base 1999=100)	7,226	7,827	8,389	8,690	11,282	10,478	11,014
Number of listed companies	179	190	199	203	210	223	224
Change in share price index	0.2%	8.3%	7.2%	3.6%	29.8%	-7.1%	5.1%
Price/Earnings ratio	15.2x	15.8x	19.5x	29.2x	20.6x	12.4x	14.3x
Price/Book value ratio	1.7x	1.8x	4.3x	4.4x	4.1x	3.5x	3.5x
5-year CDS spread (bps)	92	105	57	65	49	61	63

Sources: Saudi Exchange, Bank Audi's Group Research Department

STOCK MARKET PERFORMANCE



Sources: Saudi Exchange, Bank Audi's Group Research Department

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In parallel, activity in the Saudi fixed income market was mostly skewed to the upside over the first five months of 2023, mainly tracking US Treasuries move on global recession fears and as US banking woes stoked demand for safety.

In details, Saudi sovereigns maturing in 2025, 2026, 2028 and 2029 registered price expansions of 0.31 pt to 0.88 pt over the first five months of 2023. Saudi Aramco'25 closed up by 0.71 pt. Prices of STC'29 increased by 2.63 pts. SABIC'28 posted price rises of 0.10 pt. SEC'24 traded up by 0.27 pt. This followed across-the-board price contractions in 2022, mainly tracking US Treasuries move as the US Federal Reserve delivered outsized interest rate hikes since March 2022 to fight multi-decades high inflation.

As to new issues, Saudi Arabia tapped international bond markets twice so far this year. In details, the Kingdom raised US\$ 10 billion in January 2023 from the sale of a triple-tranche bond: a five-year US\$ 3.25 billion tranche priced at 110 bps over US Treasuries; a 10.5-year US\$ 3.5 billion tranche priced at 140 bps over UST; and a 30-year US\$3.25 billion tranche offering a yield of 5.5%. Besides, Saudi Arabia returned to international debt markets in May 2023, raising US\$ 6 billion from the sale of a dual-tranche Sukuk: a six-year US\$ 3 billion tranche priced at 80 bps over US Treasuries and a 10-year US\$ 3 billion tranche priced at 100 bps over US Treasuries. This followed the sale of Islamic and conventional bonds in October 2022. In details, the Kingdom sold last October US\$ 2.5 billion in six-year Sukuk at 105 bps over UST and US\$ 2.5 billion in 10-year bonds at 150 bps over UST in October last year.

As to the cost of insuring debt, Saudi Arabia's five-year CDS spreads, which measure the market's perception of sovereign risks, expanded marginally by two basis points over the first five months of 2023 to reach 63 bps at end-May, staying well below the average regional sovereign five-year CDS spreads of 325 bps.

As to credit ratings, Fitch Ratings upgraded in April 2023 Saudi Arabia's long-term foreign currency Issuer Default Rating to "A+" from "A", with a "stable" outlook, citing strong fiscal and external balance sheets, with government debt/GDP and sovereign net foreign assets (SNFA) considerably stronger than both the "A" and "AA" medians, and significant fiscal buffers in the form of deposits and other public sector assets. The upgrade also assumes ongoing, according to Fitch, commitment to gradual progress with fiscal, economic and governance reforms.

S&P Global Ratings raised in March 2023 its unsolicited long-term and short-term foreign and local currency sovereign credit ratings on Saudi Arabia to "A/A-1" from "A-/A-2" on significant reform momentum and economic growth prospects, with a "stable" outlook. The "stable" outlook balances S&P's expectation that the government's reform plans would support the development of the non-oil sector against the cyclicity of a still-hydrocarbon-focused economy, with fiscal and societal pressures tied to rapid population growth.

In parallel, Moody's changed in March 2023 the outlook on the Government of Saudi Arabia to "positive" from "stable" and affirmed its long-term issuer and senior unsecured ratings at "A1". The change of outlook to "positive" reflects, as per Moody's, the increasing likelihood that, through reforms and investment in various non-oil sectors, the sovereign's economic and fiscal reliance on hydrocarbons will, over time, materially decline, thereby reducing its exposure to oil price cycles and a potential acceleration in global carbon transition, while also diminishing the pressure on the government to support the kingdom's implicit social contract through growth in public spending.

In the coming period, many factors would remain in market players' radar screens, namely US Treasuries moves, the US Federal Reserve monetary policy after ten straight interest rate hikes since March 2022, global growth prospects and oil market outlook.

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CONCLUSION

Looking forward, the Saudi economy seems on a firmly improving pace. The positive outlooks assigned by rating agencies to Saudi Arabia reflects the increasing likelihood that broad-based structural reforms and investments in a wide range of diversification projects will help reduce significantly the sovereign's economic and fiscal reliance on hydrocarbons over time. If effectively executed and supported by private-sector investment, government-sponsored diversification projects and initiatives will not only reduce the sovereign's high exposure to oil price cycles and to a potential acceleration in global carbon transition, but also diminish the pressure to support its implicit social contract through growing public spending and employment.

The IMF expects Saudi Arabia's economy to grow at 3.1% in 2023 and at an average rate of around 3.0% over the next five years. This is nearly three times the average during 2015-21 (1.0%) but lower than the 4.1% growth rate recorded during 2005-14.

Medium-term growth projections reflect a combination of factors: The expectation that government fiscal spending will remain restrained, despite high oil prices; and oil production growth will slow after the large adjustment during 2021-22; balanced against expectation that diversification projects will continue to gain traction, with the critical mass moving into the implementation/construction phase in the next several years; and the structural economic, legal and social reforms that the government has been implementing to improve the business environment in Saudi Arabia will begin to bear fruit in the form of higher private-sector investment growth.

It is worth recalling that Saudi Vision 2030, which was announced in 2016, aims to increase the share of the private non-oil sector to 65% of GDP by 2030 from around 50% in 2015 and the share of non-oil exports to 50% from 25% of total merchandise exports. While these shares are very sensitive to fluctuations in oil prices, which makes them less reliable as a measure of progress in diversification, the share of the private non-oil sector was only 42.1% of GDP in 2022 and non-oil exports were only around 19% of total exports.

The key sectors where the government is focusing its diversification efforts include logistics, mining, tourism and entertainment, housing, manufacturing (including petrochemicals, defense, aerospace and renewables technologies), as well as the development of the natural gas sector (mainly for domestic power generation and as a feedstock for the growing petrochemicals industry) and blue and green hydrogen. The kingdom also aims to further expand its retail sector, develop a financial center similar to those already established elsewhere in the region such as Dubai, and expand the small and medium-size enterprise (SME) sector's share to 35% of GDP by 2030 (from around 20% in 2015), while improving the education system to better meet the needs of the growing economy.

The analysis of the Kingdom's short to medium term outlook actually requires a careful examination of strengths and opportunities relative to the threats and challenges. At the level of the former, we mention the moderate government and broader public sector debt burden, the robust fiscal and foreign-currency reserve buffers, the formidable external finances, and prudent banking regulation and the high per-capita income, the large stock of proved oil reserves and low extraction costs, the improving institutions and policy effectiveness, in addition to the non-oil economy gaining traction in recent times.

At the level of risks constraining the outlook, we mention the persistently high economic and fiscal vulnerability to declines in oil demand and prices, the rigid government spending structure and pressures due to high unemployment and rapid population growth, the longer-term risks stemming from the global transition to a lower-carbon economy and the political risks persisting from regional geopolitical tensions although the latter have somehow subsided recently. While risks and challenges are real, we believe strengths and opportunities far outpace threats at the foreseeable horizon.

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Last but not least, in its last Article IV Consultation Mission Report, the IMF commended the Saudi authorities for the significant progress in implementing their ambitious structural reform agenda. They welcomed the impressive pace of labor market reforms, particularly the doubling of female labor force participation, and encouraged continued actions in this area. IMF Directors advised continued efforts to improve the regulatory and business environment, promote private investment, boost productivity, and address corruption. They welcomed the authorities' ambitious climate commitments outlined in the Green Initiative and looked forward to the specific steps to achieve its goals. IMF also reiterated the importance of continuing to improve data quality and availability. Finally, given the increasing role of the Public Investment Fund, they encouraged quick completion of the ongoing work to establish a sovereign-asset liability management framework at large.