SAUDI ARABIA ECONOMIC REPORT

AMID THE CHALLENGES OF AMBITIOUS STRUCTURAL REFORMS AND THE PRESSURES OF PERSISTENTLY LOW OIL PRICES

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- Increasingly tough real sector conditions

  The Saudi authorities deepened fiscal consolidation measures in 2016 and introduced major reform initiatives to counter the growing challenges posed by the new reality of oil markets. With unfolding fiscal consolidation efforts, improvements in medium fiscal outlook were achieved at the expense of growth, which closely relies on public spending. The real GDP growth is estimated to have eased to 1.4% in 2016, its slowest pace since the 2009 recession. Reduced government spending and investment, driven by low oil prices, adversely affected sectors such as government services, construction, trade and tourism, and marketing and communication. One bright spot for the country was manufacturing, albeit heavily reliant on a strong performance in petroleum refining. Looking ahead, the Kingdom's real GDP is forecasted to expand by a mere 0.4% in 2017, despite some recovery in non-oil activity.

- Narrowing current account deficit on the back of a pick-up in trade surplus

  Saudi Arabia's external position has witnessed a relative improvement in 2016 when compared to the previous year's tough performance, as the current account deficit has been cut by more than half, from a deficit of US$ 56.7 billion in 2015 (8.7% of GDP) to a deficit of US$ 24.9 billion in 2016 (3.9% of GDP), on the back of a drop in services account deficit, and a pick-up in trade surplus for the first time since 2012, mainly driven by a significant decline in imports within the context of a sluggish economic activity. In fact, Saudi Arabia's foreign trade figures showed a contraction in exports by 10.7% alongside a 22.1% drop in imports in 2016 compared to 2015, contributing to a 27.7% rise in the foreign trade surplus. In parallel, the Kingdom faced a fiscal deficit of US$ 102.4 billion in 2016, to account for a record high of 16.0% of GDP.

- Increased inflationary pressures along with further declines in SAMA's reserves

  Saudi monetary conditions saw increased inflationary pressures in 2016, a shy growth in broader money supply within the context of tighter domestic liquidity in an era of low oil prices, along with extended declines in SAMA's foreign assets as the Kingdom continued to rely on its built-up buffers to help finance its fiscal deficit. The cost of living index registered an annual growth of 3.5% on average in 2016 as compared to an average growth of 2.2% in 2015. Money supply in its broadest sense (M3) expanded by a shy 0.8% in 2016 and registered a 0.4% decline during the first four months of 2017. SAMA's reserve assets fell by 13.1% and dropped by 6.6% during the first four months of 2017 to reach US$ 500 billion at end-April 2017.

- Solid financial standing buffering banks against notable liquidity constraints

  The Kingdom's banking sector has been witnessing difficult operating conditions in 2016 and so far in 2017, with the low hydrocarbons prices causing a contraction in banks' deposit base - and consequently liquidity and lending appetite - as the public sector's liquidity got drained and the private sector has been struggling with a growth slowdown. Nonetheless, the efficient regulatory framework and banks' conservative practices have built up strong capital adequacy, liquidity, asset quality and profitability buffers that have helped shield the sector at large from adverse operating conditions. Measured by total assets of banks operating in Saudi Arabia, total sector activity grew by a modest 2.2% on a yearly basis in 2016, against a 3.6% increase in 2015 and a much higher 12.6% progression in 2014, mirroring the impact of lower oil prices on the domestic banking sector activity.

- Saudi capital markets benefiting from slightly improved confidence factor

  Saudi capital markets benefited from slightly improved investor sentiment in 2016 following an unprecedented bond sale and after global oil producers agreed on production cuts. Alongside the equity and bond price gains, the cost of insuring debt registered significant contractions in 2016 in a sign of improved market perception of sovereign risks. Saudi Arabia's five-year CDS spreads contracted by 43 bps in 2016 to reach 113 bps at end-December 2016, and reported further contractions during the first five months of 2017 to reach 90 bps at end-May 2017.

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The Saudi authorities deepened fiscal consolidation measures in 2016 and introduced major reform initiatives to counter the growing challenges posed by the new reality of oil markets. With unfolding fiscal consolidation efforts, improvements in medium fiscal outlook were achieved at the expense of growth, which closely relies on public spending. The real GDP growth is estimated to have eased to 1.4% in 2016, its slowest pace since the 2009 recession. Reduced government spending and investment, driven by low oil prices, adversely affected sectors such as government services, construction, trade and tourism, and marketing and communication. One bright spot for the country was manufacturing, albeit heavily reliant on a strong performance in petroleum refining.

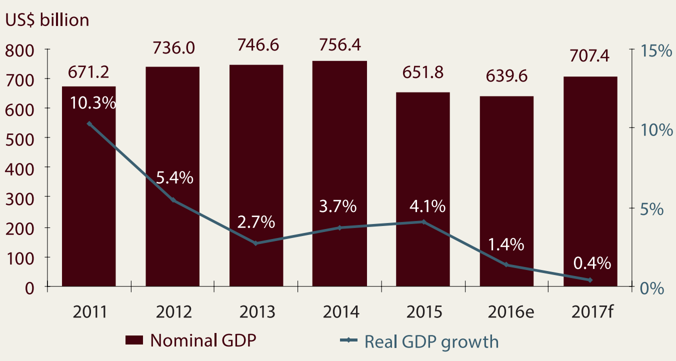
Within this environment, Saudi Arabia has reversed its passive approach to the oil price slump, by agreeing to cut production by 486,000 barrels/day as part of a larger 1.2 million barrel per day OPEC output reduction – to 10.06 million barrels/day in the first half of 2017. It is expected that the Kingdom would push for a similar deal in the second half of the year and continue to exercise considerable production restraint.

At the external level, the current account deficit is estimated at 3.9% of GDP for all of 2016, down from 8.7% of GDP in 2015, reflecting largely the relative rise in oil prices. However, SAMA's net foreign assets fell by US$ 46 billion or 7.2% of GDP between June 2016 and January 2017 to US$ 517 billion. It is worth mentioning that government deposits had declined by US$ 64.5 billion to US$ 224.3 billion between June 2016 and January 2017, only about half the peak of US$ 438.1 billion in August 2014, although this decline partly reflects transfers between the government and the Public Investment Fund. Total government debt rose to 12.4% of GDP, from 5.0% in 2015. This included sales of local currency bonds during the first three quarters of last year and a US$ 17.5 billion Eurobond issued in October.

At the fiscal level, the deterioration in the government balance sheet reflects the large general government budget deficit of US$ 102.4 billion or 16.0% of GDP in 2016, up from US$ 99.4 billion in 2015 and much higher than the budget target. The deterioration was mainly due to the clearance of arrears on capital expenditures that arose in 2015 because payments for many projects were halted while the government was seeking greater visibility on the entirety of outstanding project commitments. More recently, the Saudi Ministry of Finance released its first quarterly report for Q1 2017, whereby revenues were up by 72% year-on-year, while spending was down by 3%, leading to a budget deficit about half that projected by the government in its budget statement for the year. The government has already taken several fiscal consolidation measures, including cuts in civil service allowances and a hike in administered utility prices. The first quarter's fiscal deficit was fully funded using fiscal reserves, with no domestic or external borrowing reported.

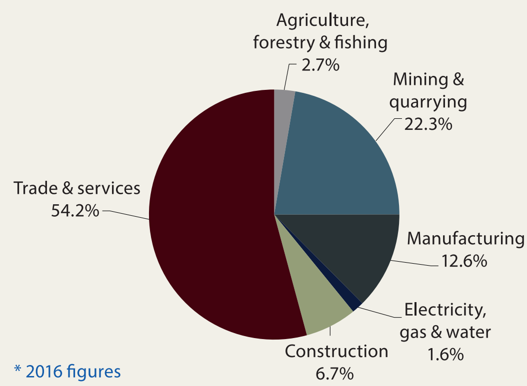
The Kingdom's banking sector contiunues to be strong and stable, with SAMA successfully managing emerging financial sector risks over the past year. The sector is actually driven by good financial

NOMINAL AND REAL GDP



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

GDP BREAKDOWN BY ECONOMIC ACTIVITY*



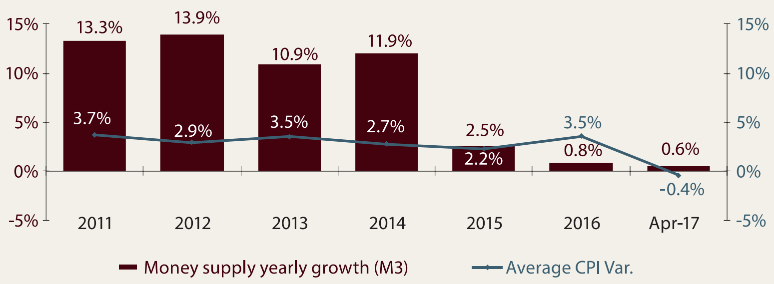
Sources: General Authority for Statistics, Bank Audi's Group Research Department

soundness indicators on the back of strong regulation and supervision. The non-performing loan ratio of a mere 1.4% of total loans and the capital adequacy ratio of 19.5% at end-2016, remain very healthy despite the tougher economic environment, While banking sector liquidity has tightened last year, such pressures eased in the last quarter due to the clearing of government arrears, measures taken by SAMA and increased confidence following the successful Eurobond issuance in October. Nonetheless, private sector credit growth slowed down due to tighter conditions by banks and the weak investment environment at large.

At the capital markets level, equity and bond markets have been performing unevenly. The share price index fell by 4.7% over the first five months of 2017 after having risen by 4.3% in 2016. Value traded continues its descending trend, with the turnover ratio measured by the annual value traded to market capitalization falling from 105.2% in 2015 to 68.8% in 2016 and to 56.4% in the first five months of 2017. In parallel, the 5-year CDS spreads contracted from 156 basis points at end-2015 to 113 basis points at end-2016 and to 90 basis points by end-May 2017, suggesting an overall improvement in market perception of sovereign risks.

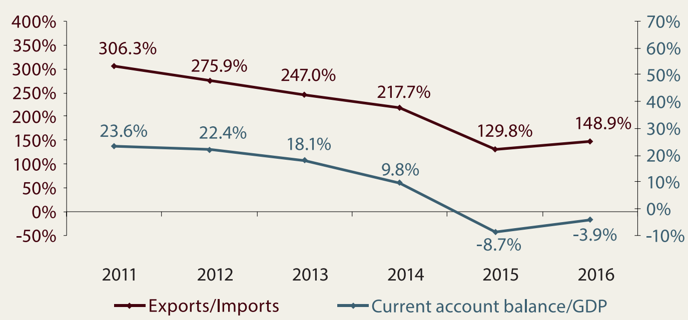
The detailed developments in the real sector, external sector, public sector and financial sector are outlined in the sections that follow while the concluding remarks address the Kingdom's near to medium term economic outlook looking forward.

MONEY SUPPLY AND INFLATION



Sources: Saudi Arabian Monetary Agency, Bank Audi's Group Research Department

FOREIGN SECTOR INDICATORS



Sources: Saudi Arabian Monetary Agency, Bank Audi's Group Research Department

1. ECONOMIC CONDITIONS

1.1. REAL SECTOR

1.1.1. Hydrocarbon Sector

Hydrocarbon sector remaining under pressure amidst lower oil revenues

In an environment of lower oil prices alongside a diversification strategy away from hydrocarbons, Saudi Arabia's hydrocarbon sector came under pressure in 2016 amidst lower oil revenues. The Kingdom pumped higher levels of oil over the past year, but the hydrocarbon sector's share out of total GDP further declined to 22.3%.

In 2016, Saudi Arabia's daily average crude oil output went up by 2.6% from 10,142 thousand barrels per day (b/d) in the previous year to 10,406 thousand b/d in 2016, as per OPEC. The Kingdom's daily production constituted 32.5% of the total OPEC countries' daily crude oil production. In parallel, the country holds nearly one fifth of the world's proven oil reserves, with the figure standing at 266 billion barrels at the end of 2016 (against 267 billion barrels in 2015).

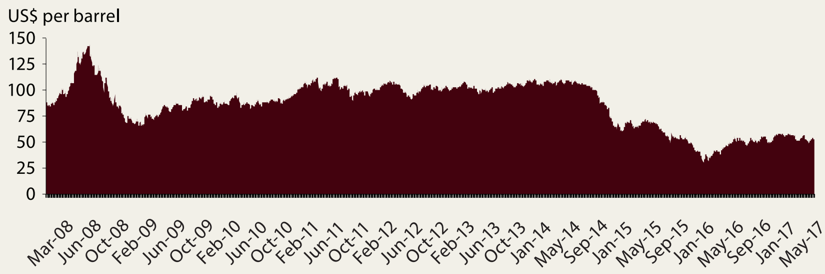
More importantly, the hydrocarbon sector's share out of total GDP amounted to 22.3% in 2016, amidst a 23% annual drop in the price of oil in 2016. Despite still being a major constituent of the Kingdom's GDP, the sector's share fell from 25.4% of GDP in 2015 and 41.8% of GDP in 2014. Furthermore, Saudi Arabia's hydrocarbon sector expanded by a slow 2.4% in 2016, compared to a 4.7% growth rate in 2015.

On the external front, the value of Saudi Arabia's hydrocarbon exports, which are made up of oil exports, decreased by 8.5% to attain US$ 139.9 billion in 2016 against US$ 152.9 billion in 2015. According to Saudi Aramco, the bulk of the Kingdom's crude oil exports was accounted for by countries of Asia and the Far East region, constituting circa 65%. The latter was followed by the US, which claimed 16.6% of crude oil exports. Northwestern Europe and the Mediterranean were tied in third position, where both received 6.4% of crude oil exports.

Moving on to the impact of oil on the Kingdom's public finances, low oil prices took their toll on the latter where actual oil revenues fell by 25% to reach US$ 86 billion over the past year, against US$ 115 billion in 2015. In addition, actual oil revenues' share out of total revenues also fell in 2016, forming only 62% of total revenues in 2016. The figure was down from 72% of total revenues in 2015 and 87% of total revenues in 2014.

Moreover, the consumption of oil in Saudi Arabia remained on an upward trend and posted an increase in 2016. As a matter of fact, consumption of oil in the Kingdom reached 3,435 thousands of barrels per day on average in 2016, up from 3,319 thousands of barrels per day on average in the previous year.
In the gas sector, the Kingdom's gas reserves expanded by 2.0% to 300 trillion standard cubic feet by end-

CRUDE OIL PRICES



Sources: Bloomberg, Bank Audi's Group Research Department

2016, against 294 trillion standard cubic feet by end-2015. Gas production in the country also reached an estimated 131 billion cubic meters (bcm) in 2016, and would rise to 136.1 bcm in 2017, according to BMI Research.

Saudi Arabia is expected to grow its oil production in order to maintain its oil export commitments in the face of growing domestic demand. For instance, the Kingdom through Saudi Aramco, plans to expand the Khurais oilfield, adding 300,000 b/d of additional production capacity. In addition, expansion of the Berri field is expected to add an additional 250,000 b/d production capacity. In the context of sustained lower oil prices, the company is also raising its focus on maximizing recovery rates on existing assets. For example, the company has been investing to improve reservoir characterization and seismic processing techniques.

Last but not least, it is worth noting that the recent OPEC production cut is expected to constrain the Kingdom's output in the short term. However, over the long term, a sharp pullback in global oil capex could open a deficit in the oil market, raising demand on Saudi crude. The former and the latter events would support oil prices, translating into a recovery in the Kingdom's oil sector.

1.1.2. Non-hydrocarbon Sector

Growth in the sector at a very slow pace with mixed performance in its components

Saudi Arabia's non-oil sector contributed to more than 75% of the country's total GDP in 2016, almost maintaining the same share it had in the previous year's GDP, in an environment of a progressing diversification of the country's national economy away from the reliance on hydrocarbons. The sector which spans a number of components including trade and services, manufacturing, construction, agriculture, forestry and fishing and electricity, gas and water grew by nearly 0.2% in 2016, down from a growth of 3.9% registered in 2015, in the context of a deepening fiscal austerity.

In a detailed look, the construction sector contributed by 6.7% to the country's GDP in 2016, an equivalent contribution to that made in 2015. However, the sector revealed signs of weakness with the sharp slowdown in the issuance of new construction contracts, in addition to the decrease in cement production by a yearly 9.0% to 55,945 thousand tons in 2016.

In parallel, manufacturing took over a share of 12.6% of Saudi Arabia's GDP in 2016, slightly up from 12.3% in 2015. Looking at the components of the sector, the number of industrial units increased by a yearly 10.5% from 7,007 in 2015 to 7,746 in 2016. Accordingly, the number of workers in operating industrial units

REAL SECTOR INDICATORS

	2012	2013	2014	2015	2016	Var 16/15
Industrial production						
Number of operating industrial units	6,439	6,670	6,989	7,007	7,746	10.5%
Number of workers in operating industrial units	819,989	868,105	950,024	989,915	1,042,720	5.3%
Power generation capacity (in MW)	44,371	47,414	50,119	51,315	55,718	8.6%
Number of subscribers (in 000s)	6,731	7,143	7,602	8,094	8,589	6.1%
Power sold (in millions of KWh)	240,288	256,688	274,502	286,103	287,442	0.5%
Construction activity						
Cement production (in 000s of tons)	53,332	56,238	57,223	61,492	55,945	-9.0%
Trade and services						
Imports (US$ million)	140,666	152,119	157,195	156,539	121,926	-22.1%
Exports (US$ million)	388,166	375,685	342,225	203,231	181,567	-10.7%
Foreign trade (US$ million)	528,832	527,805	499,421	359,770	303,493	-15.6%
Number of passengers at the airports (all airlines, in millions)	57.8	62.4	71.7	79.0	84.3	6.7%
Number of flights	466,847	489,201	533,237	583,239	643,591	10.3%
Freight at the airports (in 000s of tons)	790.0	782.9	693.2	669.3	901.6	34.7%

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

rose to 1,042,720 in 2016, up by 5.3%. In a similar realm, the electricity, water and gas sector contributed to 1.6% of the country's GDP in 2016, compared to 1.4% in 2015. Industrial production indicators of this sector were favorable as well whereby the country's power generation capacity improved by a yearly 8.6% to 55,718 MW in 2016. The number of subscribers rose by 6.1% year-on-year to 8,589 subscribers, while the power sold stood at 287,442 million KWh registering a yearly increase of 0.5%.

Furthermore, trade and services, highlighting the countries diversification strategy, took over the biggest share of the country's GDP with a contribution of 54.2% in 2016, up from 51.8% in 2015. In this sector, the number of passengers at the airport stood at 84 million in 2016, up by a yearly 6.7%. The number of flights also rose by 10.3% from 583,239 in 2015 to 643,591 in 2016 and the freight handled increased by 34.7% annually to 901.6 thousand tons in 2016.

Regarding the hospitality sector, occupancy rates of four and five star hotels in Riyadh decreased from 66.0% in the first four months of 2016 to 59.9% in the corresponding period of 2017, those of Jeddah declined from 68.7% to 56.4% in the aforementioned period, Madina's occupancy rates fell from 68.9% in the first four months of 2016 to 62.0% in the corresponding period of 2016 and Makkah's occupancy rates fell from 53.7% to 48.1% over the same period. In this context, Riyadh's average room rate fell by a yearly 13.9% from US$ 202 in the first four months of 2016 to US$ 174 in the first four months of this year. Jeddah's average room rate declined by 7.3% year-on-year to US$ 227 in the aforementioned period of 2015, that of Makkah fell by a yearly 11.1%, while that of Madina was on a rising path to stand at US$ 203 in the first four months of 2017. Consequently, rooms' yield declined in Riyadh, Jeddah and Madina, yet rose in Makkah.

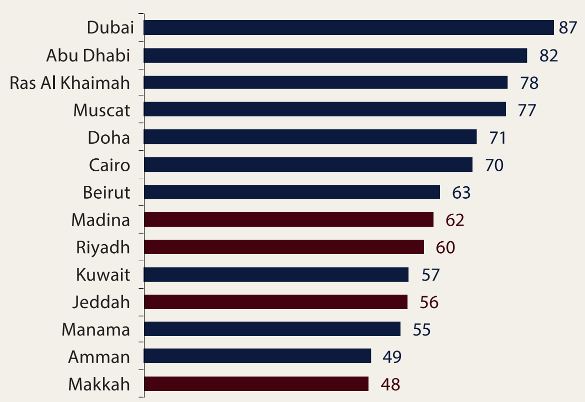
In sum, the country progressed in its diversification strategy despite slower real growth registered in the non-hydrocarbon sector. The sector continues to take over the biggest share of Saudi Arabia's GDP, despite a relatively mixed performance in its indicators at large.

1.2. EXTERNAL SECTOR

Narrowing current account deficit on the back of a pick-up in trade surplus

Saudi Arabia's external position has witnessed a relative improvement in 2016 when compared to the previous year's tough performance, as the current account deficit has been cut by more than half, from a deficit of US$ 56.7 billion in 2015 (8.7% of GDP) to a deficit of US$ 24.9 billion in 2016 (3.9% of GDP), on the back of a drop in services account deficit, and a pick-up in trade surplus for the first time since 2012, mainly driven by a significant decline in imports within the context of a sluggish economic activity.

COMPARATIVE HOTEL OCCUPANCY RATES (%)*



* First 4 months of 2017, four and five star hotels

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

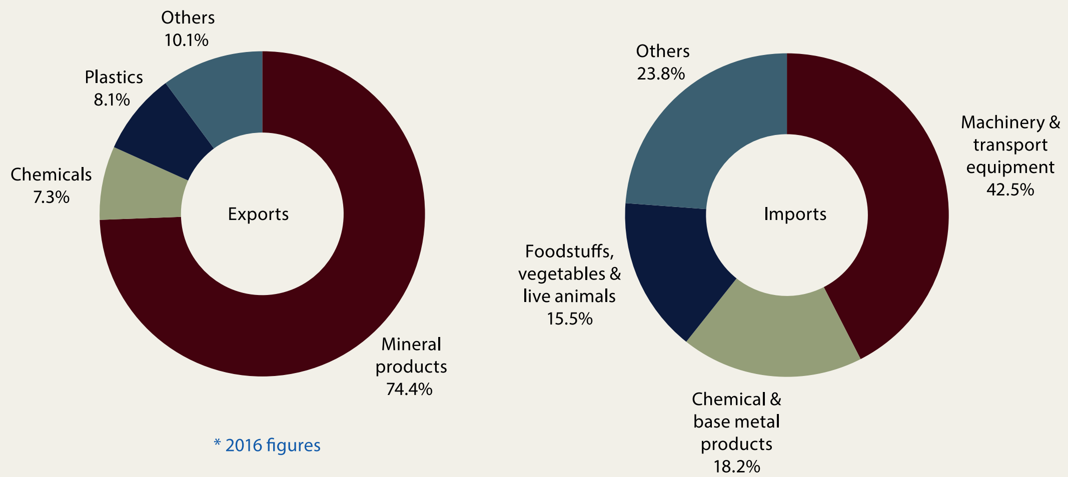
In fact, Saudi Arabia's foreign trade figures showed a contraction in exports by 10.7% alongside a 22.1% drop in imports in 2016 compared to 2015, contributing to a 27.7% rise in the foreign trade surplus, according to the General Authority for Statistics. Saudi's merchandise trade surplus rose from US$ 46.7 billion in 2015 to US$ 59.6 billion in 2016, to reach the equivalent of 9.3% of Saudi's GDP (from 7.2% of GDP in 2015). As such, Saudi's foreign trade activity posted a net contraction in terms of volume, as the sum of exports and imports went down by 15.6% moving from US$ 359.8 billion in 2015 to US$ 303.5 billion in 2016. Accordingly, the exports to imports coverage ratio consequently rose for the first time since 2011, moving from 129.8% in 2015 to 148.9% in 2016.

In details, total exports reached US$ 181.6 billion in 2016, a net decline from US$ 203.2 billion in 2015, continuously dragged by lower oil export revenues yet at a slower pace. The breakdown of exports by category, according to the General Authority for Statistics, suggests that exports of mineral products, grabbing the lion's share of total exports with 74.4%, posted a decline of 10.9% year-on-year, while chemicals registered a drop of 14.3%, followed by vehicles and associated transport equipment with a decline of 9.6%, and base metals with a drop of 6.3%. On the other hand, the main items to have displayed an increase were pearls and precious stones with a rise of 75.0% and live animals and animal products with an increase of 3.6%. The geographic distribution of exports indicates that 11.6% of total exports went to China, followed by Japan with 10.5% of the total, USA with 9.6%, India with 9.3%, South Korea with 8.3% and UAE with 6.6% of total exports.

At the level of imports, a total of US$ 121.9 billion was registered in 2016, compared to US$ 156.5 billion in 2015. The breakdown of imports by category suggests that imports of machinery, mechanical appliances and electrical equipment posted the highest share of 24.6% of total imports, followed by vehicles and associated transport equipment with 17.9%, chemicals with a share of 9.2%, and base metals with 9.0% of total imports. The breakdown of imports by country of origin shows that 14.8% of the inward merchandise in 2016 came from USA, followed by China with 14.4% of the total, Germany with 6.5%, UAE with 5.4%, Japan with 5.3%, and South Korea with 4.4% of total imports.

On the other side of the external sector, the financial account recorded a historical high deficit of US$ 87.3 billion in 2016, from a deficit of US$ 76.1 billion in 2015, as banks and pension funds reverse their foreign investments and buy domestic government debt, and the government borrows externally. Accordingly, the portfolio investment balance posted a deficit of US$ 8.4 billion in 2016, against a surplus of US$ 10.8 billion; and other investment balance reported a tiny surplus of US$ 0.8 billion in 2016, against a larger surplus of US$ 34.8 billion in 2015.

EXPORTS AND IMPORTS*



* 2016 figures

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

Last but not least, Saudi Arabia is expected to post a current account surplus of 1.5% of GDP in 2017 as per the IMF, amid a recovery in oil prices, and driven by a large trade surplus on the back of rising export volumes of aluminum, phosphate and petrochemicals within the context of the Kingdom's efforts to develop the non-oil private sector in order to diversify its economy and reduce its reliance on the oil sector at large.

1.3. PUBLIC SECTOR

Fiscal deficit edges up slightly amidst continued fiscal consolidation measures

Saudi Arabia's fiscal performance in 2016 was underpinned by a fall in public revenues, reaching its lowest level since 2009, and a reduction in public expenditures within the context of fiscal consolidation efforts. Accordingly, the Kingdom's fiscal position deteriorated slightly compared to the previous year registering a record high fiscal deficit in 2016.

In details, despite an increase in oil production and due to the continued fall of oil prices compared to 2015, actual public revenues fell by 13.0% in 2016 to reach US$ 138.5 billion, according to the General Authority of Statistics. Oil revenues that represent 62% of total revenues (down from 72% in 2015) reached US$ 86.21 billion, a decline of 25.2% year-on-year. It is worth mentioning that production was up by 3.6% and prices were down by 16%. At the same time, and as a result of the diversification efforts, non-oil revenues increased by 18.8% in 2016 from a year earlier, to reach an all-time high of US$ 52.4 billion, with the majority of the rise coming from investment income, taxes and customs fees.

In parallel, and in line with the fiscal consolidation efforts, total public expenditures declined by 6.8% in 2016 to attain a total of US$ 240.9 billion, following a fall of 12.6% in 2015. The burden of these adjustments thus fell less on current expenditures which rose by 1.5% to reach US$ 185.2 billion (accounting for 76.9% of total expenditures), and more on capital expenditures which retreated by 26.9% year-on-year to reach US$ 55.6 billion, compared to a decrease of 22.9% in the previous year.

Accordingly, the Kingdom faced a fiscal deficit of US$ 102.4 billion in 2016, edging up by 3.0% from the US$ 99.4 billion registered in 2015. It is worth noting that the deficit registered in 2016 is the equivalent of almost six times the deficit that was attained in 2014 (US$ 17.5 billion), to account for a record high of 16.0% of GDP in 2016, against 15.3% of GDP in 2015, according to the General Authority of Statistics. The deficit was mainly financed by large drawdown of net foreign assets and increased domestic debt issuance, as net government domestic debt issuance amounted to US$ 79.1 billion, bringing total gross public debt to 12.4% of GDP at end-2016, from 5.0% of GDP at end-2015.

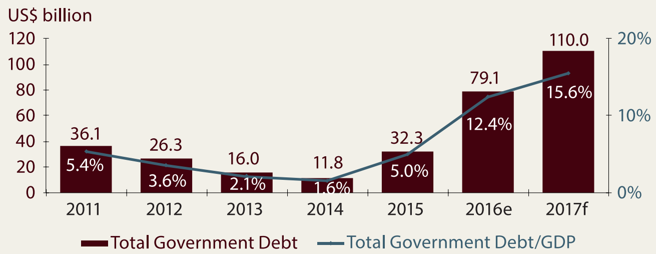
Looking ahead, as indicated in the Vision 2030, the government plans to reduce the Kingdom over-reliance on oil revenues and reduce the country's exposure to oil price volatility. The Council of Ministers announced the National Transformation Program (NTP) in June 2016. The program provides more substance to the Vision 2030 announcement. The NTP provides more detailed targets for the next four years, laying out 178 strategic objectives with more than 340 indicators and targets set for 24 ministries and government entities.

SELECTED PUBLIC FINANCE INDICATORS

US$ billion	2012	2013	2014	2015	2016
General government revenues	332.6	308.4	278.5	159.2	138.5
General government revenues/GDP	45.2%	41.3%	36.8%	24.4%	21.7%
General government expenditures	232.9	260.3	296.0	258.6	240.9
General government expenditures/GDP	31.6%	34.9%	39.1%	39.7%	37.7%
General government fiscal balance	99.8	48.1	-17.5	-99.4	-102.4
General government fiscal balance/GDP	13.6%	6.4%	-2.3%	-15.3%	-16.0%

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

PUBLIC INDEBTEDNESS AND DEBT RATIO



Sources: IMF, Bank Audi's Group Research Department

The National Transformation Program aims to diversify the economy away from oil. Some of the main objectives include creating more than 450,000 jobs in the non-governmental sectors by 2020, increasing the private sector's share of GDP from 40% to 60%, and achieving a balanced budget by 2020. The program also aims to reduce government spending on public sector wages to 40% of total spending by 2020 from about 45%, increase non-oil revenue through taxes on land, the introduction of a value-added tax, excise taxes on tobacco and soft drinks, as well as fees on certain public services.

Until recently, the government had covered its shortfalls by dipping into its massive stock of foreign reserves. However, aware of the need to protect its reserves, the government would continue financing its deficits to a greater degree by issuing debt. As a result, total gross public debt is expected to follow an upward trajectory in 2017, reaching 15.6% of GDP as per the IMF.

1.4. FINANCIAL SECTOR

1.4.1. Monetary Situation

Increased inflationary pressures along with further declines in SAMA's reserves

Saudi monetary conditions saw increased inflationary pressures in 2016, a shy growth in broader money supply within the context of tighter domestic liquidity in an era of low oil prices, along with extended declines in SAMA's foreign assets as the Kingdom continued to rely on its built-up buffers to help finance its fiscal deficit.

The cost of living index registered an annual growth of 3.5% on average in 2016 as compared to an average growth of 2.2% in 2015, mainly driven by fuel and utility subsidy cuts at end-2015 and the doubling of customs fees on tobacco products in March 2016 given the fiscal squeeze from lower oil prices. Yet, inflationary pressures started to ease at the beginning of the year 2017, as the huge rise in fuel, electricity and water bills implemented in December 2015 have fallen out of the yearly comparison. Accordingly, the cost of living index retreated by 0.4% year-on-year during the first four months of 2017.

The breakdown of the cost of living index by category in 2016 shows that the tobacco segment rose by 17.4% on average, followed by the transport segment with +10.0%, the housing, water, electricity, gas, and other fuels segment with +7.3%, the health segment with +6.2%, the education segment with +4.5%, the clothing and footwear segment with +3.8%, the miscellaneous goods and services segment with +2.5%, the furnishings, household equipment & routine household maintenance segment with +2.0%, and the communication segment with +1.4%. However, the restaurants and hotels segment fell by 1.8% on average in 2016, followed by the food and non-alcoholic beverages segment with -0.6% and the recreation and culture segment with -0.3%.

The Saudi riyal peg to the US dollar at SR 3.75/US$ 1, which has been in place since 1986, has been maintained, mainly supported by the Kingdom's strong ability to finance its deficits given its ample foreign reserves and its continued access to international debt markets. Within this context, SAMA continued to track the US Federal Reserve in raising interest rates in December 2016, March 2017 and June 2017, lifting its reverse repurchase rate to reach a current 1.25% as compared to 0.50% at end-2015, noting that June's rate hike marked SAMA's fourth increase since June 2009.

The narrow measure of money supply (M1) reached US$ 305 billion at end-December 2016, with no change relative to end-December 2015, given a 1.1% rise in money in circulation and a 0.2% retreat in demand deposits. This was followed by a 3.3% expansion in (M1) during the first four months of 2017. The broader money supply (M2) registered a growth of 3.6% in 2016 (the equivalent of US$ 15 billion) to reach US$ 436 billion, driven by a healthy growth in time and saving deposits of 13.1%. This was followed by a mere contraction in (M2) of 0.7% during the first four months of 2017 amid a 10.1% fall in time and saving deposits. Money supply in its broadest sense (M3) expanded by a shy 0.8% in 2016 (the equivalent of US$ 3.8 billion), within the context of a 22.0% fall in quasi-money deposits, yet registered a 0.4% decline during the first four months of 2017. Given the shy retreat in demand deposits and the mere expansion in broader money supply (M3) in 2016, the demand deposits to broader money supply (M3) ratio reached 54.5% at end-December 2016, down from 55.1% at end-2015, yet rose to 56.9% at end-April 2017. In parallel, the M1/M3 ratio was quoted at 64.0% at end-December 2016, moving down from 64.6% at end-December 2015, yet bounced back to reach 66.4% at end-April 2017.

The tightening in liquidity caused by low oil prices, subsidy reductions and a series of public sector pay cuts was reflected by an increase in the monthly average 3M SIBOR in 2016, despite the relatively eased liquidity squeeze during the fourth quarter of the year following SAMA's injection of SR 20 billion (the equivalent of US$ 5.3 billion) into the banking system as time deposits and an unprecedented bond sale of US$ 17.5 billion. That being said, the monthly average 3M SIBOR, which reached 1.33% at end-2015, closed the year 2016 at 2.04%, yet slid to 1.75% at end-April 2017.

SAMA's reserve assets continued to follow a downward slope for the second consecutive year, as the Kingdom continued to dip into its massive stock of foreign reserves to cover its shortfalls in an environment of lower oil prices. SAMA's reserve assets fell by 13.1% or the equivalent of US$ 80.6 billion in 2016 to reach US$ 536 billion at end-December, and dropped by 6.6% or the equivalent of US$ 36 billion during the first four months of 2017 to reach US$ 500 billion at end-April 2017 due to capital outflows and external payments. Accordingly, SAMA's reserve assets covered 122.8% of Money Supply in Saudi Riyal at end-2016, down from 146.4% at end-2015, with this ratio reaching 115.5% at end-April 2017.

In the coming period, Saudi rates are set to continue to track movements in US interest rates given the peg to the US dollar. The IMF forecasts inflation to average 3.8% in 2017, given the impact of subsidy cuts and the restoration of bonuses and allowances for State employees that is set to boost liquidity, consumer expenditure and demand for goods and services, while expecting consumer prices to rise further to 5.1% on average in 2018, with the introduction of the value added tax.

1.4.2. Banking Activity

Solid financial standing buffering banks against notable liquidity constraints

The Kingdom's banking sector has been witnessing difficult operating conditions in 2016 and so far in 2017, with the low hydrocarbons prices causing a contraction in banks' deposit base -and consequently liquidity and lending appetite- as the public sector's liquidity got drained and the private sector has been struggling with a growth slowdown. Nonetheless, the efficient regulatory framework and banks' conservative practices have built up strong capital adequacy, liquidity, asset quality and profitability buffers that have helped shield the sector at large from adverse operating conditions.

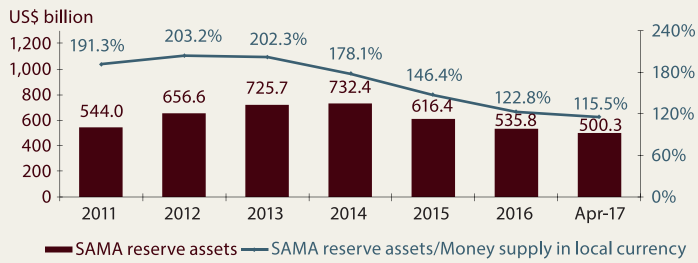
Measured by total assets of banks operating in Saudi Arabia, total sector activity grew by a modest 2.2% on a yearly basis in 2016, against a 3.6% increase in 2015 and a much higher 12.6% progression in 2014, mirroring the impact of lower oil prices on the domestic banking sector activity. Bearing in mind the slight pick-up in oil prices this year, total assets rose by 1.4% in the first four months of 2017 to reach the

EVOLUTION OF MONETARY SITUATION

Variation (US$ million)	2012	2013	2014	2015	2016	4M-17
Net foreign assets	**112,439**	**69,886**	**13,666**	**-97,708**	**-101,564**	**-34,375**
SAMA	112,396	69,126	7,519	-115,362	-80,276	-35,701
Commercial Banks	43	761	6,147	17,654	-21,289	1,326
Domestic Assets	**38,254**	**36,319**	**36,736**	**37,798**	**36,266**	**7,365**
Claims on private sector	37,537	33,205	35,351	30,857	8,946	3,169
Claims on public sector	-1,350	1,903	935	8,806	24,602	4,386
Claims on Non-financial Public Sector Enterprises	2,068	1,211	450	-1,866	2,718	-191
Broad Money (M3)	**45,384**	**40,372**	**49,122**	**11,718**	**3,748**	**-1,790**
Money Supply (M1)	33,635	30,222	38,000	482	-87	10,206
Quasi-Money	11,750	10,150	11,121	11,235	3,835	-11,996
Government Deposits	**87,669**	**33,279**	**-21,556**	**-106,183**	**-76,559**	**-19,857**
Other Items (Net)	**17,639**	**32,555**	**22,836**	**34,555**	**7,513**	**-5,363**

Sources: Saudi Arabian Monetary Agency, Bank Audi's Group Research Department

FOREIGN EXCHANGE MARKET INDICATORS



Sources: Saudi Arabian Monetary Agency, Bank Audi's Group Research Department

equivalent of US$ 610.4 billion at end-April, with the growth in volume over the first four months of 2017 alone representing 69% of the full year 2016 increase. This was mostly due to a continued increase in lending activity albeit at a milder pace than during strong economic growth years.

Total deposits, a traditional activity driver accounting for 70% of total balance sheets of banks, rose by a tiny 0.8% last year, its slowest pace in recent history, and almost stagnated (actually reporting a minimal contraction) in the first four months of this year to reach the equivalent of US$ 429.8 billion at end-April 2017. Banks are maintaining their deposit base by offering lucrative time and savings rates, which is facilitated by the still low interest rate environment on the overall. Besides, Saudi banks continue to rely on domestic funding rather than external funding, with the latter today at less than 5% of total balance sheets.

Last year, it was mostly time and savings deposits (private sector more than public sector) that drove the slight rise in total deposits, helped by the SR 20 billion injection by the public sector in the form of time deposits in September 2016 to support financial stability in the sector. This was offset by declining other quasi-money, which comprises foreign currency deposits of the resident sector, marginal deposits for L/Cs, outstanding remittances, and banks' repo transactions with the private sector. It is worth noting that among other quasi-money, government entities' foreign currency deposits drove the decline in 2016. So far this year, time and savings deposits (private sector more than public sector) drove the slight decline in the total deposit base, offset mostly by rising government entities' demand deposits. Foreign currency deposits now account for less than 8% of total deposits, against 10% at end-2015.

Generally speaking, strains on the government balances at Saudi banks occurred as funds were needed to help plug the fiscal gap, while slowing private sector deposits were due to government spending cuts, payment delays and slowing economic activity growth.

Another major driver of activity, claims on the private sector (including investments in private securities), slowed down sharply last year with a 2.4% growth rate, its slowest pace in recent years, and inched up by 0.8% between December 2016 and April 2017 at the end of which they reached the equivalent of US$ 378.0 billion. The sharp slowdown in economic growth seems to have affected companies' appetite for new loans while prompting banks themselves to be more cautious with regards to new exposure in difficult times.

Claims on the public sector continued to rise over the covered periods, but mostly to finance rising fiscal deficits. While bank credit to public enterprises rose last year before slightly contracting so far in 2017, government bonds rose sharply over the covered periods as banks subscribed to the Kingdom's new sovereign bond issuances.

BANKING SECTOR RATIOS

	2012	2013	2014	2015	2016	Apr-17
Banking sector dimension in economy						
Assets/GDP	62.8%	67.6%	75.2%	90.4%	94.1%	92.2%
Deposits/GDP	45.7%	50.1%	55.6%	65.7%	67.4%	64.9%
Loans to private sector/GDP	34.8%	38.4%	42.5%	54.1%	56.3%	54.8%
Loans to public sector/GDP	1.4%	1.6%	1.6%	1.6%	2.0%	1.9%
Growth rates (YTD)						
Assets	12.3%	9.2%	12.6%	3.6%	2.2%	1.4%
Loans to the private sector	16.4%	12.1%	11.9%	9.8%	2.2%	0.7%
Investments	1.0%	16.9%	21.6%	-8.5%	-11.2%	-0.8%
Deposits	14.2%	11.2%	12.4%	1.9%	0.8%	-0.3%
Capital and reserves	10.2%	7.8%	9.9%	9.2%	10.3%	10.5%
Profit growth (year-on-year)	8.4%	6.5%	12.5%	6.3%	-5.4%	-2.8%
Financial ratios						
Primary liquidity/Deposits	23.5%	19.5%	18.5%	17.1%	19.8%	20.4%
Loans to the private sector/Deposits	76.2%	76.8%	76.5%	82.4%	83.6%	84.4%
Capital accounts/Assets	14.0%	13.8%	13.5%	14.2%	15.0%	15.1%
ROAA	2.04%	1.97%	2.00%	1.97%	1.81%	1.96%
ROAE	14.4%	14.1%	14.6%	14.2%	12.4%	13.0%

Sources: Saudi Arabian Monetary Agency, Bank Audi's Group Research Department

The distribution of bank credit (not including banks' investments in private securities but including loans extended to government agencies) available until Q1 2017 inclusive shows that in each of 2016 and Q1 2017, around half of the sectors witnessed some progression in credit while the other half witnessed some contraction. Over the past 15 months, the biggest beneficiary was the commerce sector while the building and construction sector and the mining and quarrying sector were affected the most. It is worth noting that real estate loans granted by banks pursued their upward trend with both retail and corporate loans growing last year and during Q1 2017. Consumer and credit card loans also rose last year before slightly contracting during Q1 2017.

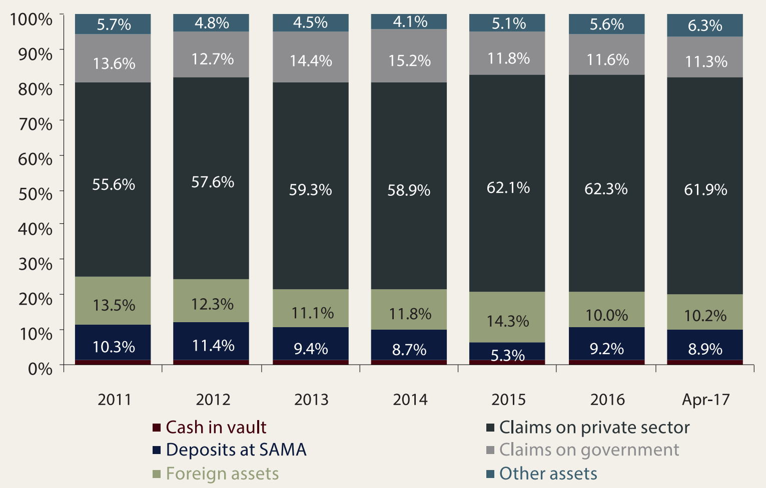
With both deposits and loans slowing down but the former slowing more than the latter, the loans-to-deposits ratio reached 81.5% at end-April 2017, against a slightly lower 80.7% at end-2016 and 80.0% at end-2015. The ratio is calculated by the SAMA as loans minus provisions and commissions to deposits at banks (demand, time and savings, repo agreements and others) plus long-term debt (syndicated loans, bonds and Sukuks), subordinated debt and others. The loans-to-deposits ratio nonetheless remains lower than the 90% ceiling set by the SAMA last year, which was increased from an 85% threshold to support banks in difficult times. Another support measure consists of raising the maximum loan-to-value for real estate lenders (first home ownership) to 85% from 70% and asking banks to reschedule property loans to citizens whose disposable incomes were hit by cuts in public sector staff allowances, without charges.

Liquidity across the domestic banking sector tightened until the third quarter of last year, before pressures were somewhat eased after the successful sovereign Eurobond issuance in October lead to the clearing of government arrears to contractors, increased confidence and allowed the SAMA to support banking liquidity while leading to more corporate deposits at banks.

Another and perhaps more meaningful indicator of liquidity is the core liquidity ratio, which we calculate as the sum of cash in vault, deposits with SAMA, and deposits at banks and branches abroad to total deposits. The core liquidity ratio reached 20.4% at end-April 2017, against 19.8% at end-2016 and 17.1% at end-2015. The gradual increase in the core liquidity ratio is mostly attributed to an increase in bank reserves (i.e. cash and deposits with SAMA) coupled with a slow rise or stagnation in the denominator. This ratio compares rather well with regional, emerging and global averages and reflects the overall satisfactory liquidity buffers that Saudi banks enjoy.

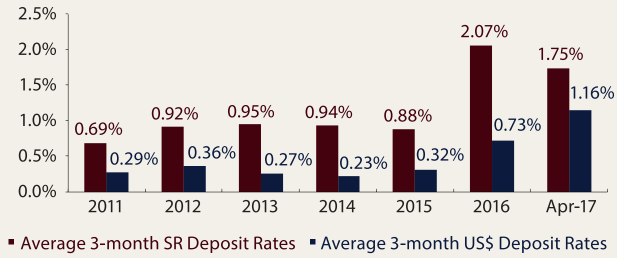
Liquidity constraints across the Kingdom did not come at the expense of a drastic deterioration in banks' asset quality. On the contrary, asset quality ratios remain among the most favorable globally. The NPLs to gross loans ratio increased but very mildly from 1.2% at end-2015 to 1.4% at end-2016 as per the latest SAMA figures. These NPLs remain more than fully covered by provisions as evidenced by the negative

BANKING SECTOR ASSET COMPOSITION



Sources: Saudi Arabian Monetary Agency, Bank Audi's Group Research Department

BANKING SECTOR DEPOSIT RATES



Sources: Saudi Arabian Monetary Agency, Bank Audi's Group Research Department

NPLs net of provisions to capital ratio (-4.7% at end-2016 against -3.7% at end-2015), effectively mitigating risks from the construction and manufacturing sectors which saw some NPL formation lately. While loan concentration remains relatively high in the Kingdom, the SAMA has set stricter rules on single borrower concentrations capping a single exposure at 15% of a bank's capital and reserves by 2019 from a previous 25%.

Even if pressures on their capital base materialize, banks in Saudi Arabia maintain enough capital and loss absorption buffers in absolute terms and relative to peers in the region and across the globe. As per the latest SAMA figures, banks' regulatory capital to risk-weighted assets ratio strengthened further from 18.1% at end-2015 to 19.5% at end-2016, the bulk of which is composed of Tier 1 capital (Tier 1 ratio of 17.5% at end-2016). Saudi banks are thus well in line with Basel III minimum capital requirements, and the regulator is developing a countercyclical capital buffer framework.

Last but not least, the slow economic growth, subdued credit activity, lower equity trading volumes and reduced trade flows and higher funding costs have affected banks' operating income. This, coupled with higher provisioning charges last year as some banks de-risked their contracting sector exposure, lead to a 5.4% fall in the sector's net profits to reach the equivalent of US$ 10.8 billion in 2016. But their cost efficiency helped limit the impact of difficult operating conditions, bearing in mind they posted a relatively low cost-to-income ratio of 38% last year, owing to their low cost base and ability to cover the market with a limited branching due to the high population concentration in few major areas. As such, the return on assets and return on equity ratios remained satisfactory at 1.8% and 12.6% respectively in 2016 (down from 2.0% and 14.5% in the previous year). This year seems to have witnessed an extension of such a performance with aggregated net profits down by 2.8% in the first four months of 2017.

1.4.3. Equity and Bond Markets

Saudi capital markets benefit from increased investor confidence in 2016

Saudi capital markets benefited from improved investor sentiment in 2016 following an unprecedented bond sale and after global oil producers agreed on production cuts. Alongside the equity and bond price gains, the cost of insuring debt registered significant contractions in 2016 in a sign of improved market perception of sovereign risks.

In details, the Saudi Tadawul bounced back in 2016 following two consecutive years of price declines, mainly supported by improved investor sentiment during the fourth quarter of the year, on eased concerns about tight banking system liquidity following the Saudi government's US$ 17.5 billion international bond issue in October 2016 and following the Kingdom's pledge to pay private sector arrears, and after OPEC and non-OPEC oil producers agreed in November and December 2016 on oil production cuts, spurring an oil price recovery, and the Capital Market Authority start easing restrictions on foreign investment in September 2016 in an effort to attract more institutional money into the bourse. This favourable mood triggered a price rebound, with the Tadawul All-Share Index (TASI) closing at 7,210 at end-2016 as compared to 6,912 at end-2015, up by 4.3%. This was yet followed by a 4.7% decrease in prices during the first five months of 2017, mainly driven by some unfavourable financial results and as some market players sought to reshuffle their positions ahead of the Holy month of Ramadan.

The breakdown of the TASI by sector in 2016 shows that the energy and utilities sector reported the highest index surge with +41.0%, followed by the petrochemical industries sector with +25.0%, amid an oil price recovery, the real estate development sector with +21.5%, the REITs sector -which was listed on November 13, 2016- with +11.0%, the insurance sector with +9.2%, the transport sector with +2.3% and the banks and financial services sector with +1.9%. In contrast, the hotel & tourism sector registered a fall in its index of 44.0%, followed by the media and publishing sector with -23.5%, the retail sector with -18.5%, the multi–investment sector with -16.3%, the building and construction sector with -10.8%, the agriculture and food industries sector with -7.0%, the cement sector with -4.9%, the telecommunication and information technology sector with -1.8%, and the industrial investment sector with -0.6%.

Alongside a rise in equity prices in 2016, the number of listed companies increased from 171 companies at end-2015 to 176 companies at end-2016. That being said, the market capitalization increased by 6.5%, moving from US$ 421.1 billion at end-2015 to US$ 448.5 billion at end-2016, yet declined to US$ 432.7 billion at end-May 2017 given declines in equity prices during the first five months of the year and a reduction in the number of listed companies to 174 companies. That being said, the market capitalization-to-GDP ratio rose from 64.6% at end-2015 to 70.1% at end-2016, yet slid to 64.8% at end-May 2017.

The total trading value in the Saudi Tadawul amounted to US$ 308.5 billion in 2016, falling by 30.3% relative to the previous year. The division of the total turnover by category in 2016 showed that the banks & financial services sector captured 19.0% of activity, followed by the petrochemical industries sector with 18.5%, the insurance sector with 13.8%, the real estate development sector with 9.4%, the industrial investment sector and the agriculture and food industries sector with 5.8% each, the retail sector with 5.6%, the building & construction sector with 4.4%, the transport sector with 3.7%, the hotel & tourism sector with 3.1%, the media & publishing sector with 3.0%, the cement sector with 2.9%, the telecommunication & information technology sector with 2.8%, the multi-investment sector with 1.4%, the energy & utilities sector with 1.0%, and the REITs sector with 0.04%. Given a drop in the total trading value and a rise in the market capitalization in 2016, the annualized turnover ratio stood at 68.8% in 2016 as compared to 105.2% in 2015.

In parallel, the total turnover reached US$ 101.7 million during the first five months of 2017 as compared to US$ 161.0 million during the corresponding period of 2016, down by 36.8%. The market capitalization reached US$ 432.7 billion at end-May 2017 as compared to US$ 396.9 billion at end-May 2016, up by 9.0%. Accordingly, the annualized turnover ratio stood at 56.4% during the first five months of 2017 as compared to 97.4% during the corresponding period of 2016.

As to fixed income markets, Saudi debt papers bounced back in 2016, posting mostly upward price movements, on increased investor confidence after the Kingdom issued in October the biggest ever bond in emerging markets and on global oil production cuts deals. In details, Saudi Arabia raised US$ 17.5 billion in October 2016 through the sale of a US$ 5.5 billion five-year bond at a yield of 135 basis points over US Treasuries, US$ 5.5 billion 10-year bonds at a spread of 165 basis points and US$ 6.5 billion 30-year bonds at a spread of 210 basis points. The demand was so strong that the issuance was easily absorbed by the market, with the total order book size reaching US$ 67 billion.

Supported by this relatively improved investor confidence, Saudi debt papers closed the year 2016 on a positive note, and extended their upward trajectory during the first five months of 2017, tracking US Treasuries move. SABIC'20 was up by 2.75 pts in 2016 and posted further price gains of 0.75 pt during the first five months of 2017. Prices of SECO papers maturing in 2022, 2023, 2024, 2043 and 2044 registered price gains hovering between 2.88 pts and 10.50 pts in 2016, and recorded price increases of up to 6.38 pts during the first five months of 2017. Prices of Dar Al Arkan'18 and '19 rose by 4.25 pts and 4.13 pts respectively in 2016, and registered further gains of 2.25 pts each during the first five months of 2017.

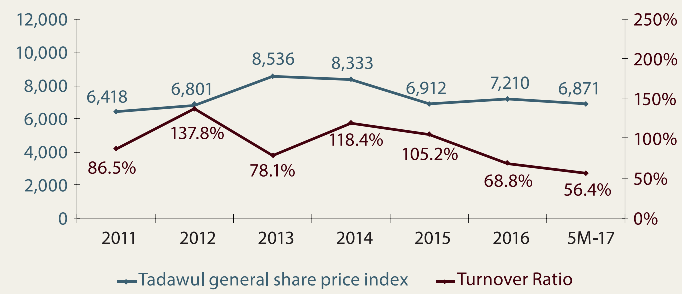
As to sovereigns, Saudi'21, '26 and '46 registered price declines of 2.95 pts, 5.10 pts and 3.63 pts over the October-to-December 2016 period, yet saw a price rebound over the first five months of 2017, registering price rises of up to 5.13 pts.

SELECTED STOCK MARKET INDICATORS

	2012	2013	2014	2015	2016	May-17
Market capitalization (US$ billion)	373.3	467.5	483.4	421.1	448.5	432.7
Market capitalization/GDP	50.7%	62.6%	63.9%	64.6%	70.1%	64.8%
Trading value (in US$ billion)	514.5	365.2	572.4	442.8	308.5	101.7
Number of transactions (in millions)	42.1	29.0	35.8	30.4	27.3	10.2
Number of listed companies	158	163	169	171	176	174
Change in share price index	6.0%	25.5%	-2.4%	-17.1%	4.3%	-4.7%
Price/Earnings ratio	12.8x	15.5x	14.0x	13.8x	15.7x	14.5x
Price/Book value ratio	1.8x	2.2x	2.0x	1.7x	1.7x	1.6x
5-year CDS spreads (bps)	72	55	67	156	113	90

Sources: Tadawul, Bank Audi's Group Research Department

CAPITAL MARKETS PERFORMANCE



Sources: Tadawul, Bank Audi's Group Research Department

Regarding other new bond issues, Saudi Arabia raised US$ 9 billion on April 12, 2017 through the sale of its first dollar-denominated Islamic bond. The government sold a US$ 4.5 billion five-year Sukuk tranche at 100 basis points over the mid-swap rate and an equally sized ten-year tranche at a spread of 140 basis points to the benchmark. Saudi Sukuk'22 and '27 registered price gains of 0.12 pt and 1.50 pt respectively till end-May 2017. As to other new bond issues, Dar Al Arkan issued in April 2017 a five-year US$ 500 million bond at a coupon of 6.875%.

As to the cost of insuring debt, Saudi Arabia's five-year CDS spreads contracted by 43 bps in 2016 to reach 113 bps at end-December 2016, and reported further contractions during the first five months of 2017 to reach 90 bps at end-May 2017, in a sign of improved market perception of sovereign risks, noting that it is one of the lowest CDS levels in the MENA region.

As to credit ratings changes, Fitch downgraded in March 2017 Saudi Arabia's long-term foreign and local currency IDRs to "A+" from "AA-", with "stable" outlook. This reflects, according to Fitch, the continued deterioration of public and external balance sheets, the significantly wider than expected fiscal deficit in 2016, and continued doubts about the extent to which the government's ambitious reform program can be implemented.

Also, Moody's noted in March 2017 that Saudi Arabia's ("A1/stable") credit strengths include a strong, albeit deteriorating, fiscal position; high external liquidity; and prudent financial system regulation. The "stable" outlook reflects Moody's view that risks to Saudi Arabia's credit profile is broadly balanced. However, the rating agency noted that the following developments would be credit-negative: loosening fiscal consolidation, such as fiscal deficits staying wide and government debt ratios rising faster than in the baseline scenario; renewed pressure on the exchange rate and a faster depletion of foreign exchange reserves; difficulties to fund large fiscal and current account deficits; an escalation of regional geopolitical risks and/or signs of deteriorating domestic political and social stability.

Looking forward, the Saudi government, aware of its need to protect its international reserves, would continue to finance its deficits by issuing debt, both to domestic banks and on the international debt markets. Issuance of government debt can help develop a domestic yield curve, and a liquid secondary market in government securities would help support the private debt market that is currently underdeveloped in Saudi Arabia. Within this context, the IMF said that the government's debt issuance policy and instrument mix should reflect a decision to develop local debt markets over the medium to long term, instead of purely being geared towards raising resources.

2. CONCLUDING REMARKS

The most significant 2017 development is the signing between Saudi Arabia and the United States of investment agreements across various sectors worth US$ 380 billion during the US President's visit to the Kingdom in May 2017. The investment agreements are aimed at making progress in achieving key performance objectives set under the 2020 National Transformation Program and Saudi Vision 2030, including diversification of the economy, increasing private sector contribution and creating employment opportunities in Saudi Arabia.

Still, the Kingdom's real GDP is forecasted to expand by a mere 0.4% in 2017, despite some recovery in non-oil activity gradually, with oil production gains remaining muted following the last two years of high output. The further slowdown in 2017 is tied to the Kingdom's OPEC coordinated oil production cut. The public sector's push to attract greater investment through public-private partnerships (PPPs) to finance development projects should provide more impetus for sectors traditionally dependent on public spending and investment, like construction. The main contributor to growth will be the recovery in the non-oil economy, which should more than offset the oil sector's contraction as the public sector begins to clear its enormous payment arrears to building contractors, leading to a revival of the ailing construction sector.

Despite some progress on economic diversification, the impact of fiscal austerity, oil production cuts in 2017 and weakness in the construction sector will keep GDP growth depressed, at an average of 1.4% a year for the next five years. What growth there is will be driven by progress on several huge infrastructure projects, which will provide growing opportunities for the private sector. Within this environment, the Kingdom looks to address oil dependence to foster more favorable longer term prospects. The ambitious National Transformation Program 2020 faces well-known challenges for the Kingdom, such as channeling Saudi nationals into the private sector and away from preferred public sector jobs.

Within the context of low oil prices, the government has pressed ahead with fiscal consolidation and reforms to address internal and external imbalances from reduced oil income. The government has moved to reduce fuel and utility subsidies and should also see some savings from reduced costs of goods and services. Having said that, financing the fiscal deficit should remain manageable. The National Transformation Program envisages a sharp increase in the public debt to 30% of GDP by 2020, which would still be low by international comparisons and would purportedly save Saudi Arabia's foreign assets from a steeper drawdown.

At the monetary level, it is widely expected that the authorities would maintain the riyal's current dollar peg, with no changes envisaged for the current dollar peg of 3.75 looking ahead. While the peg might come under downward pressure, reflecting the likelihood of persistently weak oil prices, it is still expected to remain in place over the next few years, given the country's ample foreign reserves and access to international debt markets. Subsequently, SAMA is expected to follow the US Federal Reserve in raising interest rates over the coming couple of years. Consumer inflation should remain high, averaging 3.8% in 2017, given the impact of subsidy cuts and as global commodity prices begin to recover. Inflation in 2018 and beyond would be partly driven by the introduction of a value added tax in the Kingdom.

At the external level, it is expected that the current account would remain fairly close to balance in the next five years as a gradual recovery in oil prices offsets lower oil production and as returns on the PIF's foreign asset holdings rise. The external account will be further reinforced by rising export volumes of aluminum, phosphate and petrochemicals, which should ensure that the trade balance continues to post large surpluses through the forecast period. The large trade surplus would be coupled with a strengthening of the non-merchandise account, while the current account might move back into surplus, supported by expanding oil production and rising non-oil exports.

According to the 2017 IMF Article IV Consultation Mission report, the Kingdom's structural reforms are ambitious, bearing in mind that further efforts on effective prioritization, sequencing, coordination and communication will be needed to maximize the chances of their successful implementation. Creating more jobs for Saudi nationals in the private sector is essential. Consideration needs to be given to how to increase the competitiveness of Saudi workers in the private sector. Allowing greater mobility of expatriate workers in the economy would help close the wage gap between Saudi nationals and expatriates at large.

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