

SAUDI ARABIA ECONOMIC REPORT

AN ERA OF CHANGE BRINGING BOTH KEY OPPORTUNITIES AND ARISING RISKS

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- Improving economic prospects supported by fiscal stimulus and higher oil prices**
While the Kingdom's real GDP growth has reported a net contraction of -0.7% in 2017, due to the decrease in oil production in the context of the OPEC agreement coupled with the adverse spillover effects of fiscal consolidation, economic activity is set to improve this year, as the growth dampening impact of VAT introduction fades and consumption and investment pick-up in response to the fiscal stimulus. The rise in government spending, coupled with the substantial increase in spending on infrastructure and a private sector stimulus, would boost non-oil growth.
- Current account returned to surplus on the back of reinforced external position**
Supported by a rise in oil prices and a relative retreat in imports, Saudi's external position was reinforced considerably in 2017. The current account returned to positive territory last year for the first time since 2014, moving from a deficit of US\$ 23.8 billion in 2016 (or -3.7% of GDP) to a surplus of US\$ 15.2 billion in 2017 (or 2.2% of GDP), on the back of a significant surge in trade surplus mainly driven by a tangible increase in oil exports and a retreat in imports. The current account is expected to remain in surplus this year, with a forecasted 5.4% of GDP as per the IMF, supported by further rise in oil prices and limited growth of imports.
- Fiscal position on firmer foot marking some progress in fiscal consolidation strategy**
Supported by stronger oil receipts, Saudi's fiscal position relatively improved, yet fiscal figures continue to underscore the challenges Saudi Arabia faces in consolidating its finances and delivering on productive public spending. As such, with improved economic conditions, and an announcement by authorities of fewer fiscal constraints in 2018, the fiscal outlook incorporates a continued strong commitment to reform efforts as the fiscal deficit in 2018 budget is expected to narrow to 7.3% of GDP this year, from an actual 9.0% of GDP in 2017.
- First deflationary pressures in more than a decade along with tighter monetary stance**
The year 2017 marked the first deflationary pressures in Saudi Arabia in more than a decade, while Saudi rates continued to track US interest rate hikes given the peg, noting that the Kingdom witnessed in March 2018 the first change in repo rate since 2009 due to interest rate differentials. In parallel, SAMA's reserve assets were on the decline in 2017, mainly due to net capital outflows more than offsetting the country's current account surplus, before bouncing back during the first four months of 2018 to reach US\$ 507 billion at end-April.
- Resilient banking sector financial standing despite quasi-absence of deposit growth**
Saudi Arabia's banking sector witnessed another period of relatively subdued activity growth in 2017 and so far this year. Total sector activity, as measured by the aggregated assets of banks operating in the Kingdom, rose by 2.2% in 2017, before slightly edging down by 1.0% in the first four months of this year. But banks maintained sound financial standing in terms of liquidity, capital adequacy and asset quality and have lately benefited from widening net interest margins and good cost control measures along with high operational efficiency, all translating into a decent 8.2% yearly rise in net profits in 2017 and a further 11.1% yearly increase in the first four months of 2018, consequently generating an increase in return ratios.
- Saudi equities on the rise, bond prices under downward pressure after 2017 price gains**
Saudi equities registered shy price gains in 2017, before posting a strong price rally of 12.9% during the first five months of 2018, mainly buoyed by hopes of an upgrade of Saudi Arabia to emerging market status following a series of market reforms undertaken by the Saudi Tadawul in the aim of improving market access and efficiency, enhancing liquidity, bolstering investor security and further aligning market practices with global best practices. In parallel, the Saudi fixed income market saw price increases in 2017, before coming under downward price pressures during the first five months of 2018, mainly tracking US Treasuries move.

The Saudi Arabia Economic Report can be accessed via internet at the following web address: <http://www.bankaudigroup.com>

The Kingdom's economic prospects have somewhat improved, supported by fiscal stimulus and higher oil prices. Almost three years of fiscal consolidation, along with improving oil prices, have noticeably contributed to the easing of pressures on the budget. Noticeable progress is being made to improve the business climate, with recent efforts focusing on the legal system and business licensing and regulation. Not less importantly, the government is focusing on job creation for nationals in the private sector within the context of a 12% unemployment rate among Saudis.

While real GDP growth has reported a net contraction of -0.7% in 2017, due to the decrease in oil production, in the context of the OPEC agreement coupled with the adverse spillover effects of fiscal consolidation, economic activity is set to improve this year, as the growth dampening impact of VAT introduction fades and consumption and investment pick-up in response to the fiscal stimulus. The rise in government spending, coupled with the substantial increase in spending on infrastructure and a private sector stimulus, would boost non-oil growth.

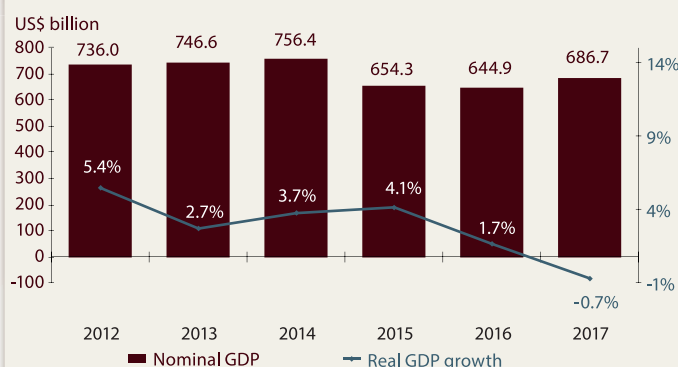
At the external level, developments have been relatively mixed so far this year. The moderate pace of FX reserves loss in the first quarter of 2018 may reflect lingering capital outflows. However, the higher oil prices should result in an entrenched current account surplus. The latter, which moved from a 3.7% deficit to GDP ratio in 2016 to a surplus of 2.2% in 2017, is expected to rise further to 5.4% in 2018.

At the public finance level, the fiscal performance remains weak, though slightly improving. Reflecting continued low oil prices and overreliance on oil revenues, the central government budget is expected to post a fiscal deficit of 7.3% in 2018. This yet compares to higher deficit ratios of 12.9% in 2016 and 9.0% in 2017. Though debt issuance remains the main source of deficit financing, gross public debt remains contained at 17.2% of GDP in 2017 and is expected at 20.0% of GDP in 2018.

At the monetary level, the Kingdom has continued to peg its currency to the US\$, which given recent depreciation could help rebalance pressures on non-oil exports. SAMA has several tools to manage liquidity conditions and steer interbank rates short of raising the policy rate corridor off-cycle. The recent changes to the loan-to-deposit calculation suggest a desire to stimulate credit activity and rely on non-interest rate tools, to the extent possible. Meanwhile, inflation which reported a negative figure of -0.9% in 2017 is expected at 3.7% in full-year 2018 (2.8% reported so far as an annual average for the first four months of 2018).

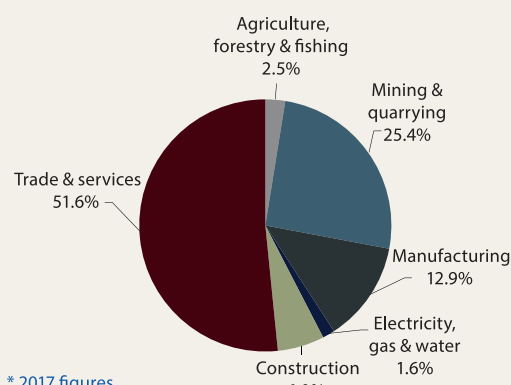
At the banking level, the banking sector has remained resilient on the overall. While asset growth remains low in the quasi absence of deposit growth, financial soundness indicators reflect good financial standing. Banks remain well capitalized on the back of strong capital adequacy ratios with an average Tier 1 ratio in excess of 18%. With loans to deposits remaining well below the regulatory level of 90%, liquid assets to

NOMINAL AND REAL GDP



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

GDP BREAKDOWN BY ECONOMIC ACTIVITY*



* 2017 figures

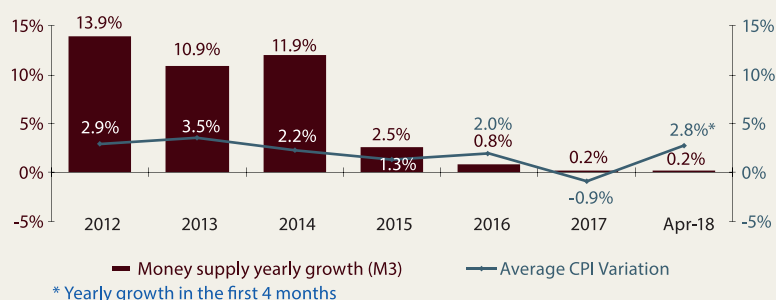
Sources: General Authority for Statistics, Bank Audi's Group Research Department

short term liabilities have increased. Net profits have relatively improved as well, growing by 8.2% in 2017 and providing support to slight rises in return ratios. Asset quality remains sound, on the back of a NPL ratio of 1.7% coupled with sound provisioning effort.

At the capital markets level, equity and fixed income markets mirrored the relative improvement in economic conditions. The Kingdom's 5-year CDS spreads contracted by 21 bps between end-2016 and end-May of this year, reflecting an improvement in markets perception of sovereign risks. Equity prices rose by 12.9% over the first five months of this year after a quasi price stability in 2017. The price rise comes within the context of a rise in trading activity, with the stock market turnover ratio reporting 52.6% over the first five months of 2018, against 49.5% in 2017.

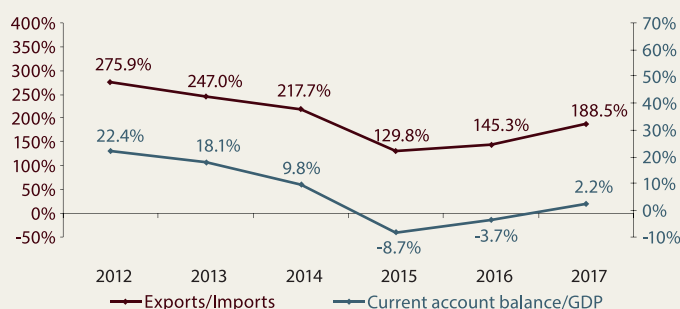
The detailed developments in the real sector, external sector, public sector and financial sector are outlined in the sections that follow while the concluding remarks address Saudi Arabia's near to middle term economic outlook looking forward.

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 under pressure amidst crude oil supply strain

In an environment of higher oil prices supported by the OPEC production cuts, Saudi Arabia's hydrocarbon sector came under pressure amidst the crude oil supply strain. The sector contracted by 3.5% in 2017, against a growth rate of 2.8% in 2016.

Saudi Arabia's daily average crude oil output went down by 4.4% from 10,406 thousand barrels per day (b/d) in the previous year to 9,954 thousand b/d in 2017. It is worth noting that the Kingdom's production constituted 30.7% of the total OPEC countries' daily crude oil production. The country also captures one fifth of the world's proven oil reserves, with the figure standing at 266 billion barrels at the end of 2016.

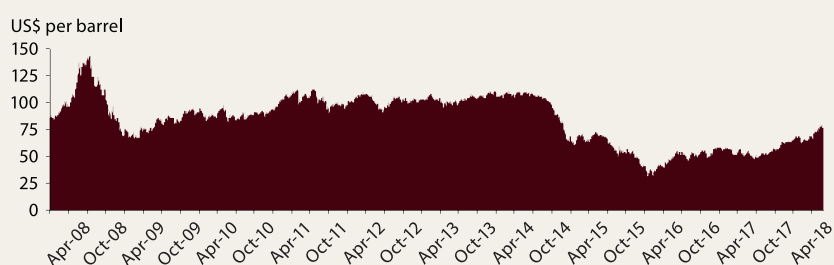
Furthermore, amidst a 5.8% annual rise in the price of oil in the past year, the hydrocarbon sector's share out of total GDP amounted to 25.4% in 2017 from 22.6% in 2016. Despite still being a major constituent of the Kingdom's GDP, the sector's share fell from 39.8% of GDP in 2014 thanks to the country's diversification efforts.

Moving on to the external front, the value of Saudi Arabia's hydrocarbon exports, namely mineral product exports, expanded by 24.9% annually to attain US\$ 170.6 billion in 2017, against US\$ 136.6 billion in 2016. In addition, the bulk of the Kingdom's crude oil exports was accounted for by countries of Asia and the Far East region, constituting circa 65.6% of the total. The latter was followed by North America, which claimed 15.8% of crude oil exports. Western Europe came in third position, where it received 11.7% of crude oil exports.

As for public finances, relatively higher oil prices, supported by the OPEC production cuts, had a positive impact on actual oil revenues which rose by 43.8% to reach US\$ 128 billion over the past year, against US\$ 89 billion in 2016. The latter is forecast to reach US\$ 131.1 billion in 2018, as per the General Authority for Statistics. Additionally, the actual oil revenues' share out of total revenues increased in 2017, forming 69.4% of total revenues in 2017 from 65% of total revenues in 2016.

The consumption of oil in Saudi Arabia witnessed a slight drop in 2017. As a matter of fact, consumption of refined products in the Kingdom reached 2,399.8 thousands of barrels per day on average in 2017, marginally down from 2,436.3 thousands of barrels per day on average in the previous year. It is worth noting that fuel subsidy reforms had a drag on Saudi Arabian fuels consumption growth, partly offsetting firm economic and demographic fundamentals.

CRUDE OIL PRICES



Sources: Bloomberg, Bank Audi's Group Research Department

The country's gas sector saw its reserves expand by 1.0% to 303 trillion standard cubic feet by end-2017, against 300 trillion standard cubic feet by end-2016. Gas production in the country reached an estimated 136.1 billion cubic meters (bcm) in 2017, against 131.1 bcm in 2016, according to BMI Research.

As for upstream oil and gas projects, Saudi Aramco recently announced that it plans to invest US\$ 300 billion over the next ten years, with the latter mainly comprising of upstream, onshore, offshore and joint ventures in the Kingdom and outside of the Kingdom. The State-owned oil company plans to make the investment to reinforce its preeminent position in oil, maintain its spare oil production capacity, and pursue a large exploration and production program centering on conventional and unconventional gas resources. The company signed US\$ 4.5 billion worth of total contracts with international companies to boost its gas production and processing capacity, as well as crude oil and gas related facilities for two offshore fields, Zuluf and Safaniyah.

Last but not least, Saudi Arabia plans to continue to grow its oil production in order to maintain its oil export commitments in the face of growing domestic demand. The latest data for Q1 2018 puts Saudi crude production at 9.95 million barrels per day (b/d), in line with the average for 2017. The OPEC production cut agreement is set to end in December 2018 and the Kingdom has been investing heavily to maintain its substantial spare hydrocarbon capacity. As the global lack of upstream investment pulls the market into deficit post-2020, Saudi Arabia would bring this capacity into play to further strengthen its hydrocarbon sector.

1.1.2. Non-hydrocarbon Sector

Mixed performance in the components of the sector accompanying slow growth

The non-hydrocarbon sector continued to take over nearly three quarters of the country's total GDP last year, keeping the same share it had over the past two years, amidst continued efforts of the Saudi government to diversify the economy. This comes in accordance with the economic vision for 2030, which represents a comprehensive plan to diversify the economy and mitigate concentration risk away from oil dependence. The plan includes enhancing the tourism, agricultural and industrial sectors, among others. Accordingly, the sector grew at 1.0% in 2017, up from a 0.2% growth in the previous year.

The trade and services sector remained the highest contributor to the country's diversification strategy with a share of 51.6% in 2017, down from 54.2% in 2016. In details, the number of passengers at the airport grew by 9.7% to stand at 78.0 million passengers in 2017. Alongside, the number of flights rose to 593,866 in 2017, up by 5.0% year-on-year. It is worth noting the number of passengers is expected to adopt a rising

REAL SECTOR INDICATORS

	2013	2014	2015	2016	2017	Var 17/16
Industrial production						
Number of operating industrial units	6,670	6,989	7,007	7,746	7,759	0.2%
Number of workers in operating industrial units	868,105	950,024	989,915	1,042,720	1,051,686	0.9%
Power generation capacity (in MW)	47,414	50,119	51,315	55,718	57,433	3.1%
Number of subscribers (in 000s)	7,143	7,602	8,094	8,589	9,050	5.4%
Power sold (in millions of KWh)	256,688	274,502	286,103	287,442	288,656	0.4%
Construction activity						
Cement production (in 000s of tons)	56,238	57,223	61,492	55,943	47,134	-15.7%
Trade and services						
Imports (US\$ million)	152,119	157,195	156,539	125,821	116,989	-7.0%
Exports (US\$ million)	375,685	342,225	203,231	182,843	220,511	20.6%
Foreign trade (US\$ million)	527,804	499,420	359,770	308,664	337,500	9.3%
Number of passengers (International airports, in millions)	57.6	62.7	68.4	71.1	78.0	9.7%
Number of flights (International airports)	462,773	475,973	518,652	565,456	593,866	5.0%

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

trend as well this year despite a slower pace at the beginning of the year, with the bulk expected to come during the holy month of Ramadan and Adha in alliance with an influx of millions of pilgrims.

The hospitality sector is yet not following the same path whereby occupancy rates of four and five star hotels in Jeddah decreased by 9.2% year-on-year to 53.5% in the first four months of 2018, those of Makkah declined by 9.2% to 66.4% in the aforementioned period, Riyadh's occupancy rates rose by a yearly 2.3% to 63.6% in the first four months of 2018 and Madina's occupancy rates increased by an annual 1.4% to 71.0% in the same period. In this context, Jeddah's average room rate fell by a yearly 2.6% to US\$ 196 in the first four months of this year. Riyadh's average room rate declined by 1.3% year-on-year to US\$ 186 in the aforementioned period of 2018, that of Makkah fell by a yearly 16.3%, and that of Madina retreated to stand at US\$ 166 in the first four months of 2018. Consequently, rooms' yield declined in, Jeddah, Makkah and Madina, yet rose in Riyadh.

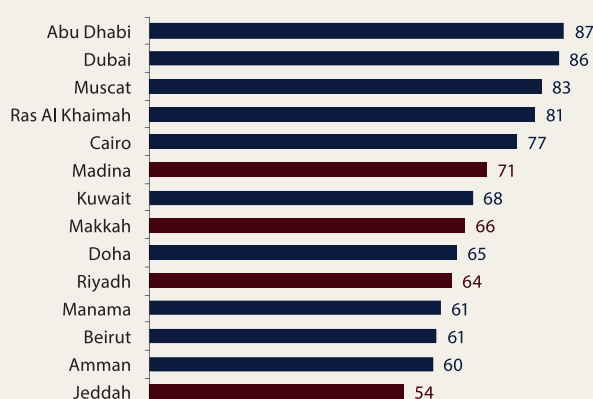
However, the outlook for the Saudi Arabian tourism sector is positive, owing to strengthening government investment and increasing interest by foreign investors. The market is based on a solid foundation of religious pilgrimage, with the number of international pilgrims rising annually, as per BMI Research.

The manufacturing sector is as well one of the main contributors to the non-oil economy in the Kingdom. The sector contributed by 12.9% to the country's GDP in 2017, slightly higher than its 2016 level of 12.6%. In a detailed look at the sector, the number of industrial units rose by a yearly 0.2% from 7,746 in 2016 to 7,759 in 2017. Accordingly, the number of workers in operating industrial units rose to 1,051,686 in 2017, up by 0.9%.

Moreover, the electricity, water and gas sector contributed to 1.6% of the country's GDP in 2017, maintaining the same level it had in the previous year. Growth in the indicators of the sector was positive whereby the country's power generation capacity improved by a yearly 3.1% to 57,433 MW in 2017. The number of subscribers rose by 5.4% year-on-year to 9.1 million subscribers, while the power sold registered 288,656 million KWh, rising by an annual 0.4%.

The construction sector which contributed by 6.0% to the country's GDP in 2017, slightly lower than the contribution made in 2016. The sector's indicators reported a relatively sluggish performance with construction delays limiting the arrival of fresh, quality supply to the open market, lackluster demand for commercial space leading to declines in rental costs, as landlords incentivize their offerings to attract tenants, and the implementation of VAT which has weakened business activity and weighed on domestic demand, in addition to the decrease in cement production by a yearly 15.7% to 47,134 thousand tons in 2017.

COMPARATIVE HOTEL OCCUPANCY RATES (%)*



* First 4 months of 2018, four and five star hotels

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

Finally, in an effort to boost economic diversification in the aftermath of the prolonged oil price slump, the government is committed to actively developing the non-hydrocarbon sector in its Vision 2030 economic strategy. Government spending on tourism transportation, accommodation and infrastructure are all geared towards boosting religious and domestic tourism and to create a luxury tourism sector.

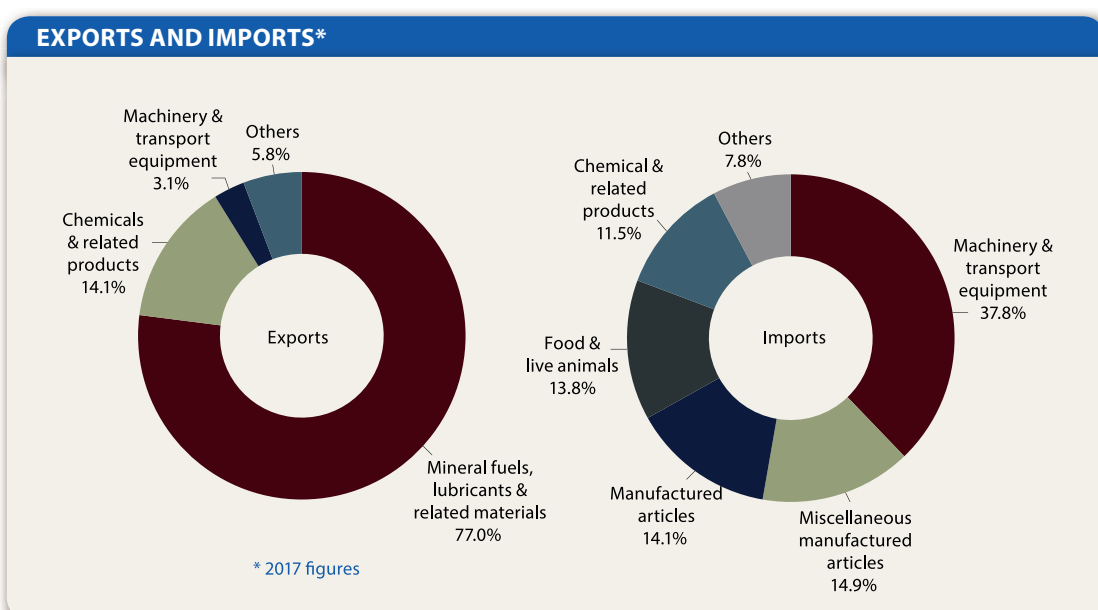
1.2. EXTERNAL SECTOR

Current account returned to surplus on the back of reinforced external position

Supported by a further rise in oil prices and a relative retreat in imports, Saudi's improving external position was reinforced considerably in 2017. In fact, the current account returned to positive territory last year for the first time since 2014, moving from a deficit of US\$ 23.8 billion in 2016 (or -3.7% of GDP) to a surplus of US\$ 15.2 billion in 2017 (or 2.2% of GDP), on the back of a significant surge in trade surplus mainly driven by a tangible increase in oil exports and a retreat in imports within the context of a sluggish economic activity.

In fact, Saudi Arabia's foreign trade figures showed a significant rise in exports by 20.6% alongside a 7.0% drop in imports in 2017 compared to 2016, contributing to a considerable hike in the foreign trade surplus by 81.5%, according to the General Authority for Statistics. Saudi's merchandise trade surplus rose from US\$ 57.0 billion in 2016 to US\$ 103.5 billion in 2017, to reach the equivalent of 15.1% of Saudi's GDP (from 8.8% of GDP in 2016). As such, Saudi's foreign trade activity posted a net improvement in terms of volume, as the sum of exports and imports went up by 9.3% moving from US\$ 308.7 billion in 2016 to US\$ 337.5 billion in 2017. Accordingly, the exports to imports coverage ratio rose for the first time since 2014, moving from 145.3% in 2016 to 188.5% in 2017.

Going further into details, total exports reached US\$ 220.5 billion in 2017, an increase from US\$ 182.8 billion in 2016, on the back of improving oil prices. 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 77.0%, posted a hike of 25.0% year-on-year, followed by chemicals with an increase of 11.5% and manufactured goods with a rise of 6.7%. On the other hand, the main items to have displayed a drop were miscellaneous manufactured articles with a drop of 4.2%, followed by machinery and transport equipments with a decline of 2.6%. The geographic distribution of exports indicates that 12.1% of total exports went to Japan, followed by China with 11.8% of the total, South Korea and India with 8.9% each, USA with 8.3% and UAE with 6.7% of total exports.



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

At the level of imports, a total of US\$ 117.0 billion was registered in 2017, compared to US\$ 125.8 billion in 2016. The breakdown of imports by category suggests that imports of machinery and transport equipments posted the highest share of 37.8% of total imports, followed by manufactured articles and miscellaneous manufactured articles with 29.1%, food and live animals with a share of 13.8% and chemicals and related products with 11.5% of total imports. The breakdown of imports by country of origin shows that 15.3% of the inward merchandise in 2017 came from China, followed by USA with 13.6% of the total, UAE with 6.5%, Germany with 5.9%, and Japan and India with 4.1% of total imports each.

On the other side of the external sector, the financial account returned to a surplus of US\$ 10.4 billion in 2017, from a deficit of US\$ 91.4 billion in 2016. This was mainly due to other investment balance that reported a shift from a small deficit of US\$ 0.8 billion in 2016 to a large surplus of US\$ 55.8 billion in 2017, mainly as a result of the restructuring of the investment portfolio of one of the large pension funds (the General Organization for Social Insurance, GOSI), foreign investments by the Saudi Public Investment Fund, and a substantial increase in private sector deposits with BIS reporting banks.

Last but not least, it is worth mentioning that Saudi's external sector continued to post large surpluses during the first quarter of 2018, as the trade surplus witnessed a surge by 54.6% when compared to the first quarter of 2017, from US\$ 21.6 billion to US\$ 33.5 billion. The growing trade surplus was the result of increasing exports by 16.4%, mainly tied to a 15.9% rise in oil exports (constituting 78% of total exports), amid declining imports by 8.3%. The current account is expected to remain in surplus this year, with a forecasted 5.4% of GDP as per the IMF, supported by further rise in oil prices and limited growth of imports.

1.3. PUBLIC SECTOR

Fiscal position on firmer foot marking some progress in fiscal consolidation strategy

Supported by stronger oil receipts, Saudi's fiscal position relatively improved in 2017 compared to 2016, yet fiscal figures continue to underscore the challenges Saudi Arabia faces in consolidating its finances and delivering on productive public spending. In fact, current spending, which typically accounts for the bulk of total government expenditure, remained relatively elevated despite the efforts to control its growth. Within this context, the public deficit went down by 25.9% in 2017 relative to 2016, as a result of a tangible hike of 33.9% in public revenues against a lower rise of 11.5% in public expenditures.

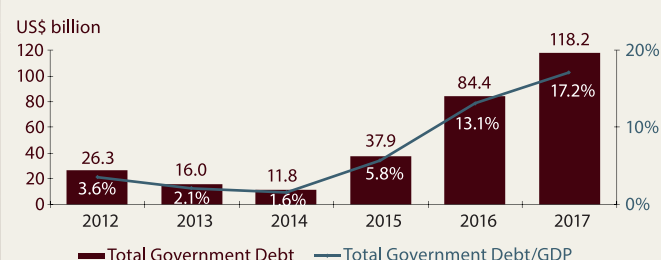
Going further into details, 2017 actual figures, as released by the Ministry of Finance, showed that public revenues went up from SR 519.4 billion (or US\$ 138.5 billion) in 2016 to SR 695.8 billion in 2017 (or US\$ 185.5 billion), on the back of a significant hike in oil revenues by 31.9% relative to 2016 level (constituting 63.3% of total public revenues) on the one hand, and driven by a surge in non-hydrocarbon revenues by 37.6% on the other hand, as many reforms, announced in the Fiscal Balance Program that was published in December 2016, were implemented. Reforms included the adjustment of visa and municipality fees, the implementation of the expat levies, and the application of excise tax on some products, such as tobacco and its derivatives, soft drinks and energy drinks. It is worth mentioning that public revenues are expected to grow in the 2018 budget by 12.6%, helped mainly by the rise in oil revenues and the recent

SELECTED PUBLIC FINANCE INDICATORS

US\$ billion	2013	2014	2015	2016	2017
Public revenues	308.4	278.4	163.4	138.5	185.5
Public revenues/GDP	41.3%	36.8%	25.0%	21.5%	27.0%
Public expenditures	265.3	304.2	267.0	221.5	247.0
Public expenditures/GDP	35.5%	40.2%	40.8%	34.3%	36.0%
Fiscal balance	43.2	-25.7	-103.6	-83.0	-61.5
Fiscal balance/GDP	5.8%	-3.4%	-15.8%	-12.9%	-9.0%

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

PUBLIC INDEBTEDNESS AND DEBT RATIO



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

introduction of the VAT.

On the spending front, and despite the fiscal consolidation efforts, total public expenditures went up from SR 830.5 billion in 2016 (or US\$ 221.5 billion) to SR 926.4 billion in 2017 (or US\$ 247.0 billion). In fact, the increase in public spending was triggered by a 7.2% increase in current expenditures, the biggest outlays with 80.6% of total expenditures, and by a 34.2% rise in capital expenditures. The rise in expenditures was mainly driven by higher compensation of employees due to the retroactive payment of allowances, as well as appropriations for new programs and projects to pay private contractors and suppliers within sixty days. In addition, and given the geopolitical context, military expenditures weighed heavily on public finances in 2017, to reach US\$ 69.4 billion, or approximately one third of total government spending. It is worth mentioning that government spending in the 2018 budget is envisaged to increase by 5.6%, noting that the government restored in January 2018 public sector allowances and announced additional social spending to mitigate the impact of the VAT and higher fuel prices.

As such, higher oil revenues, combined with a sizeable increase in non-oil revenues, have more than offset the increase in spending, leading to a narrower fiscal deficit of SR 230.6 billion (US\$ 61.5 billion or 9.0% of GDP) in 2017 from SR 311.1 billion (US\$ 83.0 billion or 12.9% of GDP) in 2016. Within this context, debt issuance remained the main source of deficit financing. As such, the public debt went up significantly by 40.0% in 2017 from US\$ 84.4 billion as at end-2016 (or 13.1% of GDP) to US\$ 118.2 billion as at end-2017 (or 17.2% of GDP).

In parallel, actual figures for the first quarter of 2018 showed that the fiscal deficit widened from SR 26 billion in the first quarter of 2017 to SR 34 billion in the first quarter of 2018, a yearly rise of 31%. The larger deficit was due to an 18% rise in public expenditures to SR 201 billion, as the bulk of the new spending went to higher employee compensation, which rose by 20% year-on-year, due to the disbursement of exceptional bonuses to the public sector in January, after the budget had committed to freezing the public sector wage bill. Social benefit spending spiked, as expected, with the launch of the Citizen's Account cash transfer program. On the revenue side, the introduction of VAT in January led to a SR 17 billion increase in goods and services tax receipts, helping cover some of the spending growth and pushing non-oil revenues up by 63% year-on-year to SR 52 billion. As such, total public revenues climbed to SR 166 billion in the first quarter of 2018, a 15% rise from a year earlier, reflecting the success of medium-term fiscal plans and efforts to diversify the sources of the government's income.

Within this context, recovering oil prices in 2018, in addition to other revenue measures, should be supportive of the government's revenue growth and headline fiscal consolidation, despite substantial expenditure growth. As such, with improved economic conditions, and an announcement by authorities of fewer fiscal constraints in 2018, the fiscal outlook incorporates a continued strong commitment to reform efforts as the fiscal deficit in 2018 budget is expected to narrow to SR 195 billion (US\$ 52 billion) or 7.3% of GDP this year, from an actual 9.0% of GDP in 2017.

1.4. FINANCIAL SECTOR

1.4.1. Monetary Situation

First Saudi deflationary pressures in more than a decade along with tighter monetary stance

The year 2017 marked the first deflationary pressures in Saudi Arabia in more than a decade, while Saudi rates continued to track US interest rate hikes given the peg, noting that the Kingdom witnessed in March 2018 the first change in repo rate since 2009 due to interest rate differentials. In parallel, SAMA's reserve assets were on the decline in 2017, mainly due to net capital outflows more than offsetting the country's current account surplus, before bouncing back during the first four months of 2018 to reach US\$ 507 billion at end-April 2018.

In details, consumer prices turned negative in Saudi Arabia in 2017, with the cost of living index contracting by 0.9%, marking the Kingdom's first deflation since 2001, amid falling food prices and as the effects of the energy and water price increases implemented in December 2015 dropped out of the yearly comparison. However, consumer prices started to pick up thereafter, growing by 2.8% year-on-year during the first four months of 2018, reflecting the impact of a 100% excise tax on tobacco products and

energy drinks and a 50% tax on soft drinks starting June 2017, in addition to the introduction of the Value Added Tax in January 2018 and a rise in oil prices.

The breakdown of the cost of living index by category in 2017 shows that the clothing and footwear segment contracted by 3.0%, followed by the recreation and culture segment with -2.8%, the transport segment with -2.0%, the furnishings, household equipment & routine household maintenance segment with -1.8%, the communication segment with -0.9%, the food and non-alcoholic beverages segment with -0.9%, the housing, water, electricity, gas, and other fuels segment with -0.7%, and the miscellaneous goods and services segment with -0.1%. In contrast, the tobacco segment reported a significant yearly rise of 26.7% in 2017, reflecting the impact of the introduction of new taxes, followed by the restaurants and hotels segment with +0.6% and the education segment with +0.5%, while the health segment saw no change in prices over the year.

The Saudi government remains committed to the Saudi riyal peg to the US dollar at SR 3.75/US\$ 1, given the comfortable levels of SAMA's foreign reserves and the importance of the peg both as a monetary anchor and for the certainty it provides for trade and investment. Within this context, SAMA continued to broadly track US interest rates in 2017, raising its reverse repo rate three times over the year by a cumulative of 75 bps, and lifting it by a further 25 bps in March 2018 to reach 1.75% at present.

In parallel, SAMA raised its repo rate by 25 bps in March 2018 to reach 2.25% at present, noting that this was the first time that Saudi monetary authorities change the repo rate since January 2009. This unusual move aimed at preventing resident capital outflows, resulting from interest rate differential, as the spread between the 3-month SIBOR and the 3-month US LIBOR narrowed since mid-2017, before turning negative recently, prompting Saudi investors to seek higher returns overseas.

A closer look at the monthly average 3M SIBOR shows that it has contracted by 26 bps in 2017, moving from 2.07% at end-December 2016 to 1.81% at end-December 2017 amid eased liquidity pressures in the Kingdom, primarily resulting from subdued credit growth, international sovereign bond issuances, and as the government cleared large volumes of overdue payments to contractors. However, SIBOR picked up to 2.32% at end-April 2018 following the Saudi rate increase in March 2018.

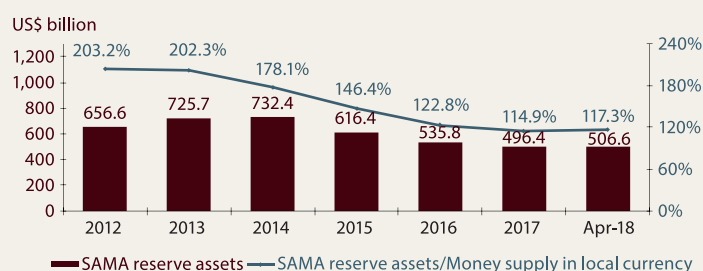
The narrow measure of money supply (M1) grew by 2.4% in 2017 to reach US\$ 313 billion at end-December, given a 1.0% rise in money in circulation and a 2.7% increase in demand deposits. This was followed by a 3.7% expansion in (M1) during the first four months of 2018. The broader money supply (M2) contracted by 1.0% in 2017 (the equivalent of US\$ 4.3 billion) to reach US\$ 432 billion, driven by an 8.9% drop in time and saving deposits, yet remained relatively stable during the first four months of 2018 on the back of a rise in (M1) and a 9.6% fall in time and saving deposits. The money supply in its broadest sense (M3) expanded by a shy 0.2% in 2017 (the equivalent of US\$ 1.0 billion), within the context of a 13.1% rise in quasi-money deposits, yet registered a 0.4% decline during the first four month of 2018. Given a higher growth in demand deposits than money supply (M3) in 2017, the demand deposits to broader money

EVOLUTION OF MONETARY SITUATION

Variation (US\$ million)	2013	2014	2015	2016	2017	4M-18
Net foreign assets	69,886	13,666	-97,708	-101,564	-39,157	9,012
SAMA	69,126	7,519	-115,362	-80,276	-39,731	10,001
Commercial Banks	761	6,147	17,654	-21,289	574	-989
Domestic Assets	36,319	36,736	37,798	36,266	16,515	13,003
Claims on private sector	33,205	35,351	30,857	8,946	-3,140	9,131
Claims on public sector	1,903	935	8,806	24,602	20,267	6,527
Claims on Non-financial						
Public Sector Enterprises	1,211	450	-1,866	2,718	-611	-2,655
Broad Money (M3)	40,372	49,122	11,718	3,748	1,009	-1,727
Money Supply (M1)	30,222	38,000	482	-87	7,398	11,416
Quasi-Money	10,150	11,121	11,235	3,835	-6,389	-13,143
Government Deposits	33,279	-21,556	-106,183	-76,559	-36,722	-6,509
Other Items (Net)	32,555	22,836	34,555	7,513	13,071	30,252

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

supply (M3) ratio reached 55.8% at end-December 2017 (up from 54.5% at end-December 2016) and rose further to 57.9% at end-April 2018. In parallel, the M1/M3 ratio was quoted at 65.4% at end-December 2017, moving up from 64.0% at end-December 2016, and reached 68.1% at end-April 2018.

SAMA's reverse assets continued to follow a downward trajectory for the third consecutive year, as resident capital outflows more than offset non-resident inflows and the surplus in the current account in 2017, while the Kingdom continued to dip into its huge stock of foreign reserves to cover its fiscal deficit. SAMA's reserve assets fell by 7.3% or the equivalent of US\$ 39.4 billion in 2017 to reach US\$ 496 billion at end-December, yet rose by 2.0% or the equivalent of US\$ 10.1 billion during the first four months of 2018 to reach US\$ 507 billion at end-April 2018, mainly supported by a US\$ 11 billion international bond issue in April 2018 and due to current account surpluses (owing to a rise in oil receipts). Accordingly, SAMA's reserve assets covered 114.9% of Money Supply in Saudi riyals at end-2017, down from 122.8% at end-2016, with this ratio reaching 117.3% at end-April 2018.

In the coming period, Saudi monetary policy shall remain focused on preserving the peg and reducing capital outflows, while roughly tracking movements in US interest rates. The Kingdom's foreign reserves may continue growing in the medium-term thanks to privatization plans, inclusion in emerging markets benchmarks and higher oil prices. The IMF forecasts inflation to average 3.7% in 2018, following the introduction of a 5% VAT in early 2018 and the sharp increase in domestic fuel prices.

1.4.2. Banking Activity

Resilient financial standing despite quasi-absence of deposit growth

Saudi Arabia's banking sector witnessed another period of relatively subdued activity growth in 2017 and so far this year, in line with overall economic activity momentum and given that oil prices remain well below previous few years' highs. Total sector activity, as measured by the aggregated assets of banks operating in the Kingdom, rose by 2.2% in 2017 on the back of surging claims on the public sector, before slightly edging down by 1.0% in the first four months of this year, due to lower deposits and foreign liabilities offsetting a continued uptick in claims on the public sector and some pick-up in claims on the private sector to reach the equivalent of US\$ 608.6 billion at end-April 2018.

To begin with, a major and traditional engine of growth in the sector accounting for 70% of total balance sheets, namely total deposits at banks, witnessed its slowest yearly growth in volumes on record (from at least the early 1990s) of 0.1% in 2017. Furthermore, deposits registered a small contraction of 1.0% in the first four months of 2018 to reach the equivalent of US\$ 427.6 billion at end-April.

BANKING SECTOR RATIOS

	2012	2013	2014	2015	2016	2017	Apr-18
Banking sector dimension in economy							
Assets/GDP	62.8%	67.6%	75.2%	90.0%	93.3%	89.5%	86.3%
Deposits/GDP	45.7%	50.1%	55.6%	65.4%	66.9%	62.9%	60.6%
Loans to private sector/GDP*	34.8%	38.4%	42.5%	53.9%	55.9%	52.0%	51.8%
Loans to public sector/GDP*	1.4%	1.6%	1.6%	1.6%	2.0%	1.8%	1.4%
Growth rates (YTD)							
Assets	12.3%	9.2%	12.6%	3.6%	2.2%	2.2%	-1.0%
Loans to the private sector*	16.4%	12.1%	11.9%	9.8%	2.2%	-0.9%	2.3%
Investments	1.0%	16.9%	21.6%	-8.5%	-11.2%	11.6%	3.8%
Deposits	14.2%	11.2%	12.4%	1.9%	0.8%	0.1%	-1.0%
Capital and reserves	10.2%	7.8%	9.9%	9.2%	10.3%	6.3%	5.4%
Profit growth (year-on-year)	8.4%	6.5%	12.5%	6.3%	-5.4%	8.2%	11.1%
Financial ratios							
Primary liquidity/Deposits	23.5%	19.5%	18.5%	17.1%	19.8%	21.2%	17.6%
Loans to the private sector/Deposits*	76.2%	76.8%	76.5%	82.4%	83.6%	82.8%	85.5%
Capital accounts/Assets	14.0%	13.8%	13.5%	14.2%	15.0%	15.7%	15.4%
ROAA	2.04%	1.97%	2.00%	1.97%	1.81%	1.91%	2.16%
ROAE	14.4%	14.1%	14.6%	14.2%	12.4%	12.5%	13.9%

* excluding investment in securities; deposits are total deposits at banks

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

This was mostly due to lower time and savings deposits on behalf of both the public sector on the one hand and the business sector and retail depositors on the other hand. On the overall and across categories, public sector deposits rose last year (before slightly inching downwards so far this year) and this could partly be attributed to improving oil prices and the authorities' decision to start funding the fiscal deficit partly by tapping international wholesale debt markets rather than withdrawing funds from banks. But private sector deposits contracted, reflecting pressure on corporate profits and household income before renewing with growth in this year's first four months amid the relative improvement in domestic economic momentum.

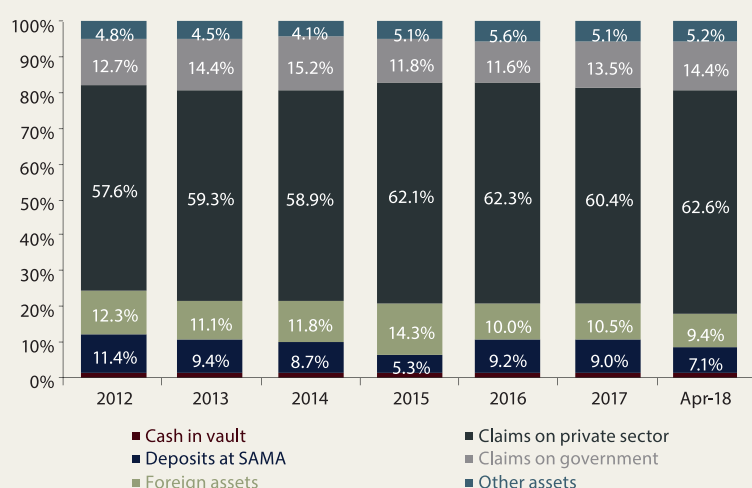
While the retail Saudi depositor base is relatively large and banks have well-established franchises across the Kingdom, banks have structurally high depositor concentrations, with Moody's estimating the top 20 depositors accounting for a third of total customer deposits on average, and that close to half of these are government or quasi-government entities. This exposes banks to the risk of material withdrawals, especially given the fiscal deficit and volatile (albeit improving) oil price environment. Having said that, Saudi banks have on the other hand shielded themselves from often-volatile international markets by maintaining low reliance on external financing with foreign liabilities at no more than 3% of total balance sheets and even decreasing so far this year.

Amid tight funding conditions on the overall, Saudi banks saw last year the first contraction in private sector lending volumes this decade. Claims on the private sector actually declined by 0.8% last year before recouping its losses and advancing by 2.5% in this year's first four months amid the relative improvement in domestic economic activity. This could be explained on the one hand by the challenging domestic conditions until recently that impacted banks' appetite for exposure to new risk and on the other hand by the public sector's persistent financing needs, which lead banks to allocate a chunk of their liquidity to funding the government.

As a matter of fact, claims on the public sector recorded their second most important yearly increase in volume in 2017 (after the previous year's), the equivalent of +32.4%, and rose by an additional 4.8% in the first four months of 2018. And in both cases (last year and during 4M2018), banks were actually directly subscribing to the government's and quasi-government's newly issued papers on debt markets rather than extending credit to public sector companies which contracted throughout the covered period.

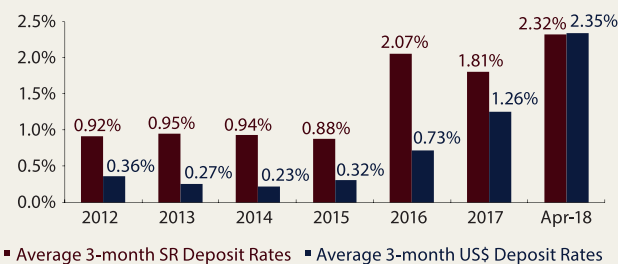
Over the 15 months to end-Q1 2018 (latest sector breakdown data), the three sectors to have witnessed the largest increase in volume were commerce, electricity, water, gas and health services, and transport and communications in respective order. On the other hand, manufacturing and processing followed by building and construction witnessed the largest decreases over the same period. At the retail level, the breakdown of consumer and credit card loans reveals that the sectors benefiting the most from new

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

credit over the same period were vehicles and private transport means and furniture and durable goods. As for the maturity of loans, new credit continued to be geared towards the short-term (one year and less) while medium and long-term personal loans barely inched up or declined, which cannot but favorably impact maturity mismatches between deposits and lending.

With deposit and lending volumes evolving more or less similarly in a tighter liquidity period, the loans-to-deposits ratio (LDR) didn't change much last year and remained at around 80%. But some methodology changes as of April 2018 caused a slight improvement (i.e. decline) in the ratio to 78%. In fact, loans are accounted for minus provisions and commissions and deposits are calculated as the sum of deposits with banks (demand deposits, time and savings deposits, repo agreements and others) plus long-term debt (syndicated loans, bonds and Sukuks), subordinated debt and others. Effective April 2018, the LDR calculation was modified by SAMA through placing higher weights for long-term deposits to encourage banks to introduce savings products. The LDR remains well under the 90% limit set by SAMA and suggests new waves of loans could easily be extended once conditions improve further.

Another measure of liquidity is the core liquidity ratio, which we define as the ratio of core liquid assets to deposits. Core liquid assets comprise cash in vault and deposits with SAMA in addition to foreign assets such as dues from banks and branches abroad. The core liquidity ratio improved from 19.8% at end-2016 to 21.2% at end-2017 before retreating back to 17.6% at end-April 2018 due to lower "other deposits" with SAMA and deposits at branches abroad, thus shedding light on the overall tight liquidity conditions in the Kingdom.

On another note, banks' exposure to the sovereign surged in recent times, with the banks' investments in government bonds and quasi-government bonds reaching 79% of total capital accounts at end-April 2018, against 70% at end-2017 and 53% at end-2016. As such, banks' exposure to the sovereign has been mounting given persistent public sector financing needs yet without causing many worries on spillovers to banks as the sovereign remains solid and solvent with substantial wealth and assets.

Moreover, banks in the Kingdom remain resilient to pressures on their capital base as they have sufficient buffers in this respect. The regulatory capital to risk-weighted assets ratio reached 20.4% at end-March 2018 (further strengthening from 19.5% at end-2016), the bulk of which is composed of Tier 1 capital (Tier 1 capital ratio of 18.4% at end-March 2018). Those capitalization ratios are well above minimum requirements and regional and international averages. Besides, Saudi authorities are supportive of the banks' stability and alignment with international regulations and have ensured a strong support to banks historically speaking, with depositors and creditors having incurred no losses.

Along the same lines, asset quality metrics remain more than sound. The banks' non-performing loans to total loans ratio remains very low in absolute and relative terms at 1.7% at end-March 2018, even if it has somewhat increased from 1.6% at end-2017 and 1.4% at end-2016. NPLs are more than fully provisioned for, noting that the NPLs net of provisions to capital ratio is increasingly negative at -6.1% at end-March 2018. Saudi Arabia has a well-established credit bureau and personal debt burden limits are comparatively conservative. Having said that, we must pinpoint that delay in the full repayment of dues to government contractors might have an impact on asset quality indicators in the period ahead.

Last but certainly not least, banks have lately benefited from widening net interest margins owing to higher interest rates positively impacting asset yields on the one hand and funding costs under control on the other hand, bearing in mind the high share of non-interest bearing deposits. Banks also saw a reduction in funding costs last year as they managed to shed expensive deposits collected during 2016. Banks also exhibited good cost control measures and high operational efficiency (non-interest expenses to gross income ratio at 36.2% in Q1 2018). All of this allowed banks to post a decent 8.2% yearly rise in net profits in 2017 after a decline in the previous year and a further 11.1% yearly increase in the first four months of 2018, consequently leading to an increase in return ratios (annualized ROAA of 2.2% and ROAE of 13.9% in 4M 2018) for the resilient Saudi banking sector.

1.4.3. Equity and Bond Markets

Saudi equities on the rise, bond prices under downward pressure after 2017 price gains

Saudi equities registered shy price gains in 2017, before posting a strong price rally during the first five months of 2018, mainly buoyed by hopes of an upgrade of Saudi Arabia to emerging market status following a series of market reforms undertaken by the Saudi Tadawul in the aim of improving market access and efficiency, enhancing liquidity, bolstering investor security and further aligning market practices with global best practices. In parallel, the Saudi fixed income market saw price increases in 2017, before coming under downward price pressures during the first five months of 2018, mainly tracking US Treasuries move.

In details, the Saudi Tadawul registered shy price gains in 2017, with the Tadawul All-Share Index (TASI) closing at 7,226 at end-2017 as compared to 7,210 at end-2016, up by a shy 0.2%. This came within the context of healthy oil price rises, an agreement between OPEC and Russia to prolong oil production cuts until the end of 2018, and improved investor sentiment after the Saudi cabinet passed the 2018 State budget with historic expenditures and an expected reduction in fiscal deficit. This helped overshadowing the negative impact of increased regional political tensions and KSA's anti-corruption probe in November 2017, especially amid signs that the Kingdom's massive crackdown on corruption was winding down without causing major damage to the economy.

The shy price gains in Saudi equities in 2017 were followed by a strong price rally during the first five months of 2018, with the Tadawul All-Share Index surging by 12.9% to close at 8,161.08 at end-May 2018. This was mainly supported by a long-awaited upgrade of Saudi Arabia to secondary emerging market status by index compiler FTSE on March 28, 2018, effective March 2019, following the implementation of a series of market reforms, and in anticipation of a potential upgrade of Saudi Arabia to emerging market status by index compiler MSCI on June 20, 2018.

The Saudi Tadawul has implemented far-ranging market reforms over the year 2017, including the following: (1) the introduction of a new industry classification in accordance with the Global Industry Classification Standard (GICS) early-January 2017, in the aim of enhancing equity market transparency, providing more reliable information on sector performance, and enabling comparability of corporates across markets and easier analysis of sector performance; (2) the launch of Nomu in February 2017, a parallel equity market for Qualified Investors that offers lighter listing requirements and serves as an alternative platform for small and medium-sized enterprises to go public; (3) the amendment of the settlement cycle from (T+0) to (T+2) in order to increase the level of asset safety for investors and to unify settlement duration with global standards; (4) the introduction of a Delivery versus Payment Model (DvP), which ensures the delivery of securities occurs only if the corresponding payment occurs; (5) the introduction of securities borrowing and lending and covered short-selling to enhance the ease of trading and create new opportunities for local and global market participants; and (6) the elimination of the cash pre-funding requirement for institutional investors.

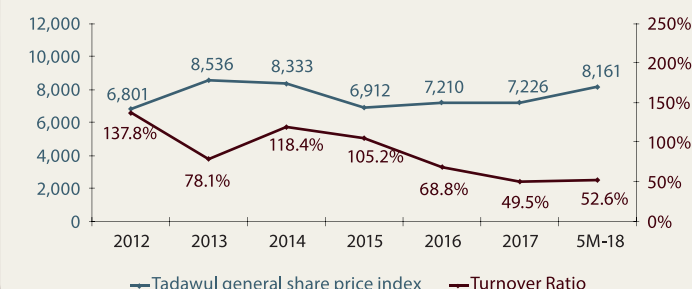
The breakdown of the TASI by the newly-introduced industry groups in 2017 shows that the media sector reported the highest index surge with +51.1%, followed by the retailing sector with +14.7%, the food &

SELECTED STOCK MARKET INDICATORS

	2012	2013	2014	2015	2016	2017	May-18
Market capitalization (US\$ billion)	373.3	467.5	483.4	421.1	448.5	450.6	522.0
Market capitalization/GDP	50.7%	62.6%	63.9%	64.4%	69.5%	65.6%	73.5%
Trading value (in US\$ billion)	514.5	365.2	572.4	442.8	308.5	223.0	114.4
Number of transactions (in millions)	42.1	29.0	35.8	30.4	27.3	21.9	11.3
Number of listed companies	158	163	169	171	176	179	185
Change in share price index	6.0%	25.5%	-2.4%	-17.1%	4.3%	0.2%	12.9%
Price/Earnings ratio	12.8x	15.5x	14.0x	13.8x	15.7x	15.2x	17.9x
Price/Book value ratio	1.8x	2.2x	2.0x	1.7x	1.7x	1.7x	1.9x
5-year CDS spreads (bps)	72	55	67	156	113	92	92

Sources: Tadawul, Bank Audi's Group Research Department

CAPITAL MARKETS PERFORMANCE



Sources: Tadawul, Bank Audi's Group Research Department

staples retailing sector with +11.0%, the banks sector with +8.2%, and the materials sector with +1.4%. In contrast, the Pharma, Biotech and life science sector registered a fall in its index of 26.2%, followed by consumer services sector with -23.8%, the transportation sector with -21.3%, the diversified financials sector with -19.2%, the commercial and professional services sector with -16.6%, the telecommunication services sector with -15.0%, the energy sector with -14.0%, the capital goods sector with -13.0%, the healthcare equipment and services sector with -11.5%, the consumer durables and apparel sector with -10.9%, the REITs sector with -7.4%, the real estate management and development sector with -6.4%, the utilities sector with -6.2%, the insurance sector with -3.8%, and the food & beverage sector with -0.1%.

Alongside the shy increase in equity prices in 2017, the number of listed companies rose from 176 companies at end-2016 to 179 companies at end-2017, following the listing of seven new companies in the REITs and materials industry groups, and the delisting of four existing companies. That being said, the market capitalization increased by 0.5%, moving from US\$ 448.5 billion at end-2016 to US\$ 450.6 billion at end-2017, and grew further by 15.9% during the first five months of 2018 to reach US\$ 522.0 billion at end-May 2018 on the back of strong price gains and an increase in the number of listed companies to 185 companies. That being said, the market capitalization-to-GDP ratio declined from 69.5% at end-2016 to 65.6% at end-2017, yet rose to 73.5% at end-May 2018.

The total trading value in the Saudi Tadawul amounted to US\$ 223.0 billion in 2017, falling by 27.7% relative to the previous year. The division of the total turnover by category in 2017 showed that four out of 20 sectors captured 69% of the total, namely the banks sector with 23%, the materials sector with a similar 23%, the insurance sector with 12%, and the real estate management and development sector with 11%. Given a large drop in the total trading value and a shy rise in the market capitalization in 2017, the annualized turnover ratio dropped from 68.8% in 2016 to 49.5% in 2017.

In parallel, the total turnover reached US\$ 114.4 billion during the first five months of 2018 as compared to US\$ 101.7 billion during the corresponding period of 2017, up by 12.5%. The market capitalization reached US\$ 522.0 billion at end-May 2018 as compared to US\$ 432.7 billion at end-May 2017, up by 20.6%. Accordingly, the annualized turnover ratio, measured by the annualized trading value to market capitalization, reached 52.6% during the first five months of 2018 as compared to 56.4% during the corresponding period of 2017.

As to fixed income markets, Saudi Arabia was the largest sovereign bond issuer in the MENA region in 2017, raising the total of US\$ 21.5 billion from the sale of Islamic and conventional bonds, as debt issuance remains the main source of deficit financing. In details, the Kingdom raised US\$ 9 billion in its first dollar-denominated Islamic bond sale in April 2017. The government sold a US\$ 4.5 billion five-year Sukuk tranche at 100 bps over the mid-swap rate and an equally sized ten-year tranche at a spread of 140 bps to the benchmark. Also, Saudi Arabia raised US\$ 12.5 billion from an international bond issue in October 2017 after drawing orders worth US\$ 40 billion. In details, the government sold US\$ 3 billion in five-year notes priced at 110 bps above US Treasuries, US\$ 5 billion in the 10-year papers priced at 145 bps above US Treasuries and US\$ 4.5 billion in 30-year papers priced at 180 bps above US Treasuries.

Saudi Arabia continued to tap international debt markets for the third year in a row in April 2018, raising US\$ 11 billion through the sale of US\$ 4.5 billion notes maturing in 2025 at 140 bps over US Treasuries as compared to an initial price guidance of 170 bps over UST, US\$ 3 billion notes maturing in 2030 at 175 bps over US Treasuries as compared to an initial price guidance of 200 bps over UST, and US\$ 3.5 billion notes maturing in 2049 at 210 bps over US Treasuries as compared to an initial price guidance of 235 bps over UST, noting that the bond sale attracted orders of circa US\$ 52 billion.

Saudi debt papers saw mostly upward price movements in 2017, before coming under downward price pressures during the first five months of 2018, mainly tracking US Treasuries move amid steady US economic growth and rising US inflation expectations that fueled bets about further interest rate hikes by the US Federal Reserve. In details, sovereigns maturing between 2021 and 2047 recorded price drops ranging between 1.40 pt and 10.10 pts during the first five months of 2018. Prices of SABIC'18 and '20 declined by 0.34 pt and 1.54 pt respectively. SECO papers maturing between 2022 and 2044 registered price retreats of up to 6.10 pts.

As to the cost of insuring debt, Saudi Arabia's five-year CDS spreads, which measures the markets perception of sovereign risk, contracted by 21 bps in 2017 to reach 92 bps at end-December 2017, and remained quoted at this level at end-May 2018, noting that it is the third lowest CDS level in the MENA region after Abu Dhabi (63 bps) and Kuwait (67 bps).

As to credit ratings, Fitch affirmed in November 2017 Saudi Arabia's long-term foreign currency Issuer Default Rating at "A+" with a "stable" outlook. Saudi Arabia's ratings are supported, according to Fitch, by strong fiscal and external balance sheets, including exceptionally high international reserves, low government debt, significant government assets and strong commitment to an ambitious reform agenda. These strengths are balanced by high oil dependence, the prospect of slow non-oil growth, weak World Bank governance and business environment indicators and large fiscal deficits.

Also, Standard & Poor's affirmed in April 2018 its "A-/A-2" unsolicited long-term and short-term foreign and local currency sovereign credit ratings on Saudi Arabia, with "stable" outlook. The "stable" outlook is based on S&P's expectation that economic growth will accelerate moderately in 2018, supported by rising government investment.

In parallel, Moody's affirmed in April 2018 Saudi Arabia's long-term issuer and senior unsecured ratings at "A1", with "stable" outlook. The affirmation of Saudi Arabia's "A1" ratings is supported by Moody's baseline view that the fiscal consolidation expected at the time of the last rating action will continue over the medium term; and Moody's continuing expectation that the government's ambitious structural reform agenda will, over time, reduce the exposure of Saudi Arabia's economy and public sector balance sheet to oil prices. The "stable" outlook indicates that the risks to the ratings are broadly balanced.

Looking forward, Saudi Arabia would pursue the development of its debt markets in order to support growth. Within this context, it is worth mentioning that the Saudi Tadawul began on April 8, 2018 listing and trading local currency government bonds, which is an important milestone in the development plan of the Sukuk and bond market that comes in line with the Kingdom's Vision 2030. This move would undoubtedly deepen the debt market, boost liquidity in the secondary market, and enhance the attractiveness of debt instruments for both investors and issuers.

2. CONCLUDING REMARKS

Looking ahead, growth is expected to pick up this year and over the medium term as reforms take hold. After a negative growth last year, real growth is expected at 1.7% in 2018 and at 2% over the next five years. Non-oil growth in particular could accelerate in the medium term to reach circa 4% at a five-year horizon, as megaprojects are being implemented and progress is made in improving the business environment and diversification at large.

A relatively sound progress is being made in implementing the ambitious reform program under Vision 2030. The government remains committed to wide-ranging economic and social reforms to transform the national economy away from its heavy oil dependence and to create a more dynamic private sector that would ensure inclusive growth. Over the medium term, the main challenge to the Kingdom's economy would rest on its ability to translate general strategic directions into specific policies.

At the fiscal level, higher oil prices, combined with additional non-hydrocarbon revenue and cut in fuel subsidies, should more than offset the increase in public spending, leading to a narrower fiscal deficit in 2018 and 2019. The government should focus on delivering on its objective to reach a balanced budget by 2023. Reforms to enhance the budget process and the fiscal framework, increase fiscal transparency and develop macro-fiscal analysis are making good process.

At the external level, recovering oil prices are expected to further strengthen the current account balance. Having said that, while the current account surplus would most probably widen this year, official reserves might continue to decline, though at a much slower pace than in the past three years. Looking further

ahead, a sharp rise in non-resident capital inflows is likely to see the light, partly due to the classification of the Kingdom as an emerging market which is likely to attract more foreign capital on the overall.

At the monetary level, the exchange rate peg continues to serve Saudi Arabia well given the structure of the economy. The banking sector remains sound, with strong capitalization and adequate liquidity, and the gradual pick-up in growth would improve private sector credit demand. But the increase in policy rates may tighten financial conditions and weigh on credit growth and non-oil economic activity. As to inflation, following a rise this year driven by the introduction of VAT and the sharp increase in domestic fuel prices which are considered both one-off shocks, consumer prices are likely to soften to 2.1% over the next five years in the absence of a domestic demand boom.

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 substantial hydrocarbon reserves and oil export capacity, the relatively low public and external debt metrics, the high - though declining - external financial assets and the sound banking system on the overall.

At the level of risks constraining the outlook, we mention the over-reliance on oil windfalls and associated structural fiscal vulnerabilities, the weakening public finances in view of prolonged periods of low oil prices, the institutional weaknesses and geopolitical risk factors and the challenging democratic profile and long-term socio-economic issues stemming from a fast-growing population and workforce. While those risk factors are real challenges, we believe strengths outpace weaknesses and opportunities outweigh threats at the horizon.

According to the just released IMF Article IV report for Saudi Arabia, the primary challenge for the government going forward is to sustain the implementation of the broad structural changes that are underway, meet the medium term fiscal targets it has set, and resist the temptation to re-expand government spending in line with higher oil prices. The respective roles of the public and private sectors in developing the non-oil economy need to be carefully considered. While the public sector can be a catalyst for the development of some new sectors, it is important that it does not crowd-out private sector involvement, nor remain a long-term player in markets where private enterprises can thrive on their own, thus raising key challenges for the Kingdom's policy makers at large.

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