# SAUDI ARABIA ECONOMIC REPORT

## CONFIDENCE FACTOR ON A NOTICEABLE RISE AMID AMBITIOUS WIDE-RANGING REFORM MOMENTUM

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- Economic reforms starting to yield positive results

  The Kingdom's economic reforms are beginning to yield positive results despite persisting challenges. Following a net contraction in 2017, Saudi Arabia's real GDP growth rebounded to 2.2% in 2018, within the context of rising government spending, which has offset the effect of the exit of expatriate workers and dependents. Actually, real oil GDP grew by 2.8% in 2018, while non-oil GDP growth rose to 2.1%. More recent monthly indicators for the year 2019 have been positive on the overall, and the year-to-date rise in oil prices is helping to support the confidence factor.

- Current account surplus showing a considerable improvement led by surging oil exports

  Driven largely by higher oil prices, Saudi Arabia witnessed a tangible improvement in its external position for the second consecutive year. In fact, the current account balance witnessed a considerable hike in its surplus from US$ 10.5 billion in 2017 (or 1.5% of GDP) to US$ 72.3 billion in 2018 (or 9.2% of GDP). Saudi Arabia's foreign trade figures actually showed a strong rise in exports by 32.8% alongside a 0.5% pick-up in imports in 2018, contributing to a surge in the foreign trade surplus by 73.2%.

- Adequate fiscal room paving the way for a looser fiscal stance

  The recovery in oil prices in 2018 helped to narrow Saudi's fiscal deficit and enabled a loosening of the fiscal stance to support the economy and social stability, marking a shift of focus away from austerity towards a more growth-supportive fiscal policy. Low government indebtedness ratios and large financial buffers, combined with mobilization of additional non-oil revenues, kept the fiscal position on a sustainable footing over the year. In fact, public deficit went down by 43.1% in 2018, as the substantial increase in oil and non-oil revenues by 29.4% more than offset the 10.8% rise in spending.

- Price deflation this year following last year's inflationary pressures

  Saudi monetary conditions saw resurgent inflationary pressures in 2018, before grappling with deflation at the beginning of the year 2019, as the high base effect resulting from the VAT introduction in January 2018 kicked in. In parallel, Saudi rates continued to track US interest rate hikes over the year 2018 given the Saudi riyal peg to the US dollar, while staying stable at the beginning of the year 2019 following the US Federal Reserve pivot to a more patient monetary policy normalization stance.

- Lending activity resumes in a remarkably solid financial sector

  The Saudi banking sector has renewed with positive private sector lending activity growth this year while providing further financing to the public sector, and continues to boast satisfactory liquidity, favorable asset quality, strong capital adequacy and resilient profitability indicators. Measured by the aggregated assets of banks operating in Saudi Arabia, banking sector activity grew by 2.5% in full year 2018 and by a further 0.6% in this year's first four months to reach the equivalent of US$ 633.8 billion at end-April 2019.

- Saudi equities on the rise, bonds under downward price pressures before bouncing back

  Saudi equities registered healthy price gains in 2018 and during the first four months of 2019, mainly supported by an oil price recovery and an upgrade of Saudi Arabia to secondary emerging market status, which is set to draw billions of dollar in foreign inflows. Tadawul All-Share Index closed 2018 with a rise of 8.3% and surged by 18.9% year-to-April 2019. In parallel, the Saudi fixed income market saw price falls in 2018, before bouncing back year-to-date, mainly tracking US Treasuries move.

- Growth set to be impacted by the oil production restraint, before bouncing back therafter

  Looking forward, growth is likely to be impacted by the crude oil production restraint following the new OPEC+ agreement. Overall real GDP growth is set to slow moderately to 1.8% in 2019 as higher government spending offsets the impact of oil price production cuts implemented in the first half of 2019. Growth would then recover to 2.2% in 2020, as oil production cuts are reversed and as large infrastructure projects generate positive spillovers to private sector growth. It will still be also supported by higher non-hydrocarbon sector growth, which will benefit from the lagged effects of the fiscal stimulus during 2018 and from spending increases planned for 2019.

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The Kingdom's economic reforms are beginning to yield positive results despite persisting challenges. Following a net contraction in 2017, Saudi Arabia's real GDP growth rebounded to 2.2% in 2018, within the context of rising government spending, which has offset the effect of the exit of expatriate workers and dependents. Actually, real oil GDP grew by 2.8% in 2018, while non-oil GDP growth rose to 2.1%. More recent monthly indicators for the year 2019 have been positive on the overall, and the year-to-date rise in oil prices is helping to support the confidence factor.

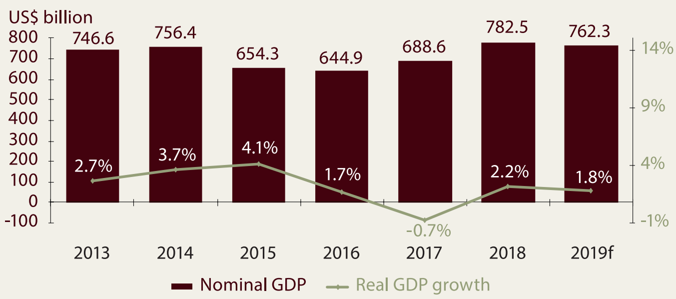
At the monetary level, consumer prices declined by 2.1% year-on-year in April 2019, mainly driven by base effects. The tighter monetary policy offsets some of the gains from the expansionary fiscal stance. Monetary tightening is coinciding with a relative slowdown in bank lending. Still, liquidity conditions have improved with the recovery in oil prices. The 3-month SIBOR (the Kingdom's interbank borrowing rate) was only marginally higher than the US 3-month Libor rate by the date of the finalization of this report (2.85% versus 2.52% respectively).

At the external level, Saudi Arabia's current account surplus increased from 1.5% of GDP in 2017 to 9.2% in 2018, driven primarily by a rebound in oil prices, which boosted oil export growth, while import growth was constrained by a modest domestic demand for goods. The rising current account surplus arrested the decline in the Central Bank's reserve assets, which stabilized at US$ 497 billion in 2018 and slightly rose to US$ 505 billion at end-April 2019, representing 114% of Money Supply in local currency and 28 months of imports.

At the fiscal level, the public finance deficit retreated to 4.6% of GDP in 2018, against 9.2% in 2017 and double digit levels in the previous two years. In parallel, government debt to GDP, though rising over the past few years, remains modest relative to international peers, and standing at 19.1% at end-2018, relative to an emerging markets average of 53% and an advanced countries average of 103%. While the medium term fiscal vulnerabilities have increased as a result of contracting government net financial assets, higher government spending has somewhat supported growth and the implementation of reforms.

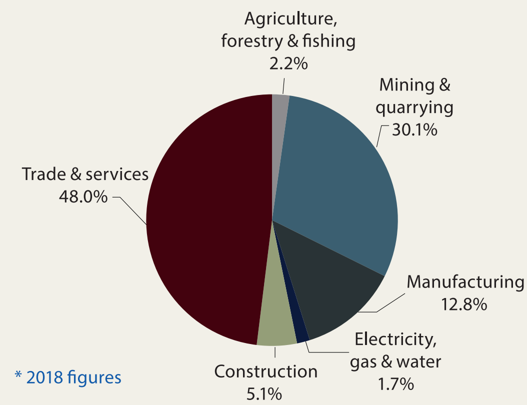
At the banking sector level, while activity growth continues to be modest at 2.5% in 2018 (0.6% year-to-date up to April 2019), it is still managing to display positive in the various activity aggregates. Despite the more challenging operating environment, the asset quality of Saudi Arabian banks can still be considered good. The sector's wide NPL ratio increased to a still low 2.0% in December 2018, from 1.6% in December 2017. The capital buffer of banks is very good as the average capital adequacy ratio exceeds 20%. In parallel, the banking sector benefits from low reliance on external funding and good profitability with the return on assets standing at 2.1% and the return on equity at 13.6% in 2018.

## NOMINAL AND REAL GDP




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

## GDP BREAKDOWN BY ECONOMIC ACTIVITY*

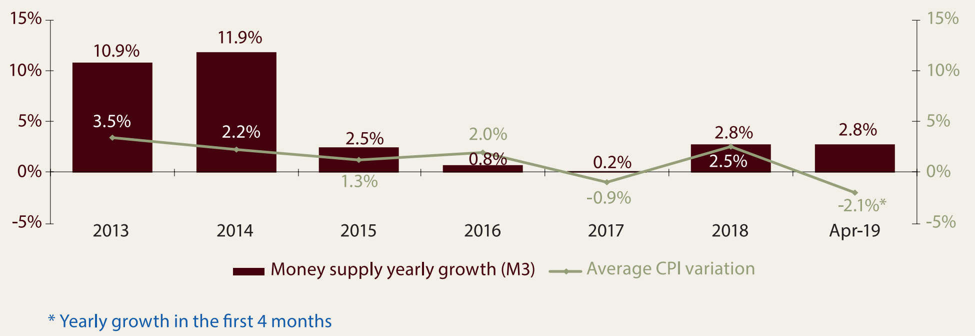



*Sources: Saudi Arabian Monetary Agency, Bank Audi's Group Research Department*

As to capital markets, equity and fixed income markets mirrored the improved macro performance. The share price index grew by 8.3% in 2018 and by a further 18.9% in the first four months of 2019. The rise in prices is yet realized amid a weaker trading volume. The turnover ratio, which represents the annual value traded as a percentage of market capitalization, fell from 49.5% in 2017 to 46.8% in 2018 and to 34.9% in the first four months of 2019. In parallel, the Kingdom's 5-year CDS spreads, a measure of the market perception of sovereign risks, rose from 92 bps in 2017 to 105 bps in 2018 but then declined again to 77 bps in April 2019.

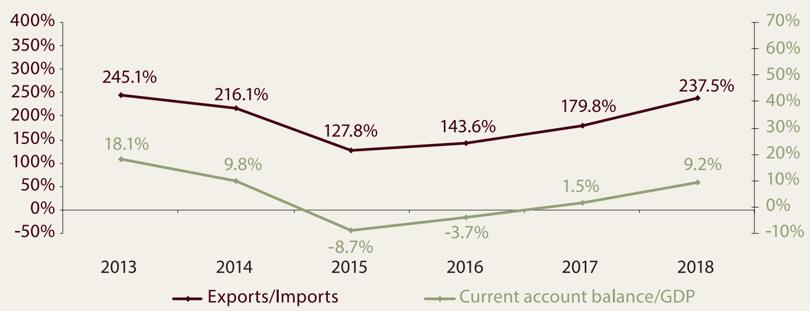
The detailed developments in the real sector, external sector, public sector and financial sector are outlined in the sections that follow while the concluding remarks address Saudi Arabia's near to middle term economic outlook looking forward.

## 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 recovers amidst higher crude oil price*

During the past year, the Kingdom's hydrocarbon sector performed positively in an environment of higher oil prices where there was a further decline in Venezuelan and Iranian crude oil production. The sector grew by 3.2% in 2018, against a contraction of 3.5% in 2017.

The Kingdom's daily average crude oil output increased by 3.6% from 9.96 million barrels per day (b/d) in the previous year to 10.32 million b/d in 2018. Saudi Arabia forms one fifth of the world's proven oil reserves, with the figure standing at 267 billion barrels at the end of 2018. Moreover, the Kingdom's production constituted 27.6% of the total OPEC countries' daily crude oil production.

Additionally, the hydrocarbon sector's share out of total GDP amounted to 30.1% in 2018, slightly up from 25.4% in 2017. The latter took place amidst a double-digit annual rise in the price of oil in the past year. Despite still being a major constituent of the Kingdom's GDP, the sector's share fell from 39.8% of GDP in 2014 because of Saudi Arabia's diversification efforts.

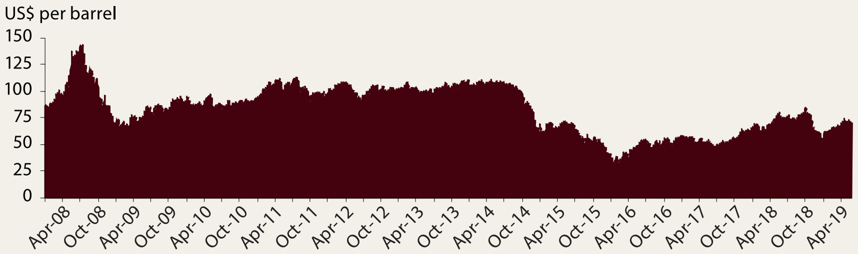
On the external front, the value of the Kingdom's hydrocarbon exports, namely mineral product exports, expanded by 36.2% annually to attain US$ 232.4 billion in 2018, against US$ 170.6 billion in 2017.

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 67.5% of the total. The latter was followed by North America, which claimed 13.8% of crude oil exports. Western Europe came in third position, where it received 11.8% of crude oil exports.

Moving on to the Kingdom's public finances, relatively higher oil prices, supported by the OPEC production cuts, had a positive impact on actual oil revenues which rose by 39.3% to reach US$ 161.9 billion in 2018, against US$ 116.2 billion in the previous year. The latter is forecasted to reach US$ 176.4 billion in 2019, as per the General Authority for Statistics. Also, the actual oil revenues' share out of total revenues increased in 2018, forming 68% of total revenues from 63% of total revenues in 2017.

The Kingdom's oil consumption witnessed a small drop in the past year. As a matter of fact, consumption of refined products in the Kingdom reached 2,338.2 thousands of barrels per day on average in 2018, marginally down from 2,410.5 thousands of barrels per day on average in the previous year.

**CRUDE OIL PRICES**




*Sources: Bloomberg, Bank Audi's Group Research Department*

The country's gas sector saw its reserves expand by 4.1% to 320 trillion standard cubic feet by end-2018, against 308 trillion standard cubic feet by end-2017. Gas production in the country reached an estimated 129.9 billion cubic meters (bcm) in 2018, against 128.6 bcm in 2017, according to Fitch Solutions.

As for upstream oil and gas projects, Saudi Aramco is expanding the giant Khurais oilfield, adding 300,000 b/d of additional production capacity. The project was scheduled for completion in 2017 but was subsequently delayed. Other projects that are in the tendering stage include expansions at Marjan (300,000 b/d) and Berri (250,000 b/d) and capacity maintenance at Safaniyah. Expansions at Zuluf (600,000 b/d) and Fazran (75,000b/d) are also reportedly in the planning stage, although these projects appear to be less developed.

As of January 2019, there were 123 drilling rigs active in the Kingdom, compared to 112 in the same period last year. Moreover, during the third quarter of 2018, Saudi Arabia released its 2017 annual performance report, which identified three new discoveries for the year: two oil discoveries (Sakab and Zumul) and one gas discovery (Jauf).

Last but not least, the prospects for oil production have weakened, due to a slowdown in global oil demand. It is anticipated that Saudi Arabian oil production will trend higher, as the Kingdom brings its large spare production capacity into play to meet a rising deficit in the global oil market. In order to support exports, the Kingdom has looked to increase the role of gas in the domestic power and industrial sectors.

### 1.1.2. Non-hydrocarbon Sector

*Non-hydrocarbon sector continues to grow in line with Saudi Arabia's diversification efforts*

Saudi Arabia's economic diversification efforts continued in 2018 as the non-hydrocarbon sector maintained a share of nearly 70% last year. The Vision 2030 National Development Plan maintains its role as the cornerstone of the country's diversification plan away from hydrocarbon dependence. In 2018, the non-hydrocarbon sector grew at a mere 1.5%, compared to 1.0% in 2017.

In a detailed look at the sectors, trade and services continued to take over the lion's share with 48.0% in 2018, down from 51.6% in 2017. This was followed by manufacturing that took over a share of 12.8%, compared to a share of 12.9% in 2017. Construction followed with a share of 5.1% down from a share of 6.0% over the same period. Agriculture took over a share of 2.2% in 2018, compared to a share of 2.5% in 2017. The smallest share was taken by electricity, gas and water, which contributed by 1.7% in 2018, slightly up from 1.6% in the previous year.

**REAL SECTOR INDICATORS**

| | 2014 | 2015 | 2016 | 2017 | 2018 | Var 18/17 |
|---|---|---|---|---|---|---|
| **Industrial production** | | | | | | |
| Number of operating industrial units | 6,989 | 7,007 | 7,746 | 7,759 | 7,520 | -3.1% |
| Number of workers in operating industrial units | 950,024 | 989,915 | 1,042,720 | 1,051,686 | 1,046,490 | -0.5% |
| Power generation capacity (in MW) | 49,025 | 50,171 | 54,632 | 56,361 | 53,534 | -5.0% |
| Number of electricity subscribers (in 000s) | 7,602 | 8,094 | 8,589 | 9,050 | 9,414 | 4.0% |
| Power sold (in millions of KWh) | 274,502 | 286,037 | 287,692 | 288,657 | 289,929 | 0.4% |
| **Construction activity** | | | | | | |
| Cement production (in 000s of tons) | 55,858 | 62,055 | 55,925 | 47,128 | 41,937 | -11.0% |
| **Trade and services** | | | | | | |
| Imports (US$ million) | 158,462 | 159,271 | 127,843 | 123,401 | 124,041 | 0.5% |
| Exports (US$ million) | 342,457 | 203,537 | 183,607 | 221,862 | 294,544 | 32.8% |
| Foreign trade (US$ million) | 500,919 | 362,808 | 311,451 | 345,262 | 418,585 | 21.2% |
| Number of passengers (International airports, in millions) | 63 | 70 | 72 | 90 | 97 | 7.8% |
| Number of flights (International airports) | 475,973 | 528,743 | 577,819 | 712,234 | 741,893 | 4.2% |

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

Looking at trade and services, the overall activity at the airports in the country revealed a positive performance. The number of airport passengers expanded by 7.8% to stand at 97.0 million passengers in 2018. Moreover, the number of flights rose to 741,893 in 2018, up by 4.2% year-on-year. In the context of tourism, Saudi Arabia benefits from its position as a religious site for the Muslim faith, with increasing numbers of pilgrims each year from a variety of source countries.

In the first quarter of 2019, the hospitality sector saw an overall positive performance in terms of occupancy, whereby occupancy rates rose in Jeddah, Makkah and Riyadh, however, retreated in Madina. On the contrary, average room rates were mostly on the decline. Occupancy rates of four and five star hotels in Jeddah rose by 0.7% year-on-year to 49.0% in the first three months of 2019, those of Makkah increased by 9.2% to 72.9% in the aforementioned period, Riyadh's occupancy rates rose by a yearly 6.0% to 67.0% in the first quarter of 2019, while Madina's occupancy rates declined by an annual 10.7% to 63.5% in the same period. Jeddah's average room rate fell by a yearly 12.5% to US$ 165 in the first three months of this year. Riyadh's average room rate declined by 13.3% year-on-year to US$ 164 in the aforementioned period of 2019, that of Makkah fell by a yearly 14.7%, while that of Madina rose to stand at US$ 119 in the first three months of 2019. Consequently, rooms' yield declined in Jeddah, Makkah, Madina and Riyadh, as per EY.

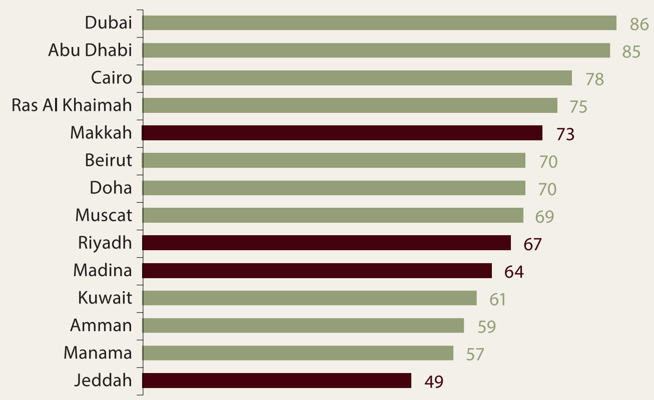
In a detailed look at manufacturing, the sector encountered a slight setback in some of its indicators. The number of industrial units contracted by a yearly 3.1% from 7,759 in 2017 to 7,520 in 2018. Accordingly, the number of workers in operating industrial units retreated to 1,046,490 in 2018, down by 0.5%.

Moreover, the electricity, water and gas sector contributed to 1.7% of the country's GDP in 2018. The indicators of the sector revealed a mixed performance whereby the country's power generation capacity declined by a yearly 5.0% to 53,534 MW in 2018. The number of subscribers rose by 4.0% year-on-year to 9.4 million subscribers, while the power sold registered 289,929 million KWh, rising by an annual 0.4%.

Moving to the construction sector, the increasing supply maintains its downward pressure on income-producing assets in the office and retail segments. A robust development pipeline will put pressure on rental costs, though will be less evident in the prime-end of the market. It is worth noting that industrial rent will continue with a stable trajectory owing to a balance in demand-supply. Regional market pressures and rising global interest present headwinds to the sector, and it is expected to encounter a further drop in rent before prices bottom out.

In conclusion, the country's diversification effort continues at a robust pace. Furthermore, the situation is set to improve over the long term, owing to initiatives by the Saudi government to stimulate economic activity in line with Vision 2030.

**COMPARATIVE HOTEL OCCUPANCY RATES (%)***




* First quarter of 2019, four and five star hotels

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

## 1.2. EXTERNAL SECTOR

*Current account surplus showing a considerable improvement led by surging oil exports*

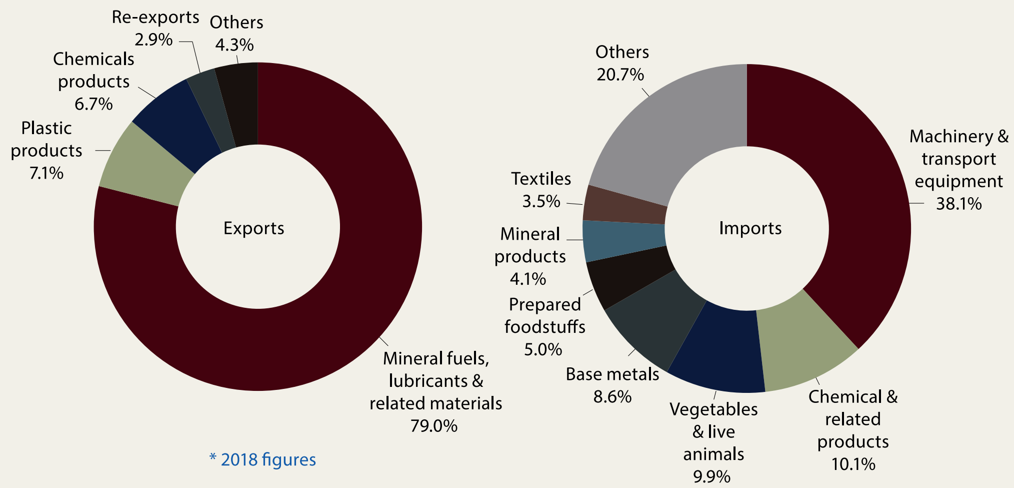
Driven largely by higher oil production and prices in 2018, Saudi Arabia witnessed a tangible improvement in its external position for the second consecutive year. In fact, the current account balance, after shifting from a deficit to a surplus in 2017, showed a renewed improving trend with a considerable hike in its surplus from US$ 10.5 billion in 2017 (or 1.5% of GDP) to US$ 72.3 billion in 2018 (or 9.2% of GDP), on the back of a significant surge in trade surplus mainly driven by a strong increase in oil exports and a relative stability in Saudi imports (following a moderate retreat in imports over the previous year).

Saudi Arabia's foreign trade figures actually showed a strong rise in exports by 32.8% alongside a 0.5% pick-up in imports in 2018 compared to 2017, contributing to a considerable hike in the foreign trade surplus by 73.2%, according to SAMA. Saudi's merchandise trade surplus rose from US$ 98.5 billion in 2017 to US$ 170.5 billion in 2018, to reach the equivalent of 21.8% of GDP, the highest since 2014 (from 14.3% of GDP in 2017). Accordingly, the exports to imports coverage ratio reached 237.5% in 2018, the highest since 2013, from 179.8% in 2017.

Going further into details, total exports reached US$ 294.5 billion in 2018, an increase from US$ 221.9 billion in 2017, on the back of improving oil prices. The breakdown of exports by category, according to SAMA, suggests that exports of mineral products, grabbing the lion's share of total exports with 79% of the total, posted a hike of 36.0% year-on-year, while exports of chemicals, with a share of 6.7% of total exports, went up by 41.2%, followed by plastic products with an increase of 22.6% in 2018. The geographic distribution of exports indicates that 13.3% of total exports went to China, followed by Japan with 11.2% of the total, India with 8.9%, South Korea with 8.8%, USA with 8.7% and UAE with 5.6% of total exports in 2018.

At the level of imports, a total of US$ 124.0 billion was registered in 2018, compared to US$ 123.4 billion in 2017, marking a tiny pick-up within the context of a relative recovery in economic activity over the year 2018. The breakdown of imports by category suggests that imports of machinery and transport equipments posted the highest share of 38.1% of total imports, followed by chemicals and related products with 10.1%, vegetables and live animals with a share of 9.9%, base metals with 8.6% and prepared foodstuffs with 5.0% of total imports. The breakdown of imports by country of origin shows that 15.9% of the inward merchandise in 2018 came from China, followed by USA with 13.7% of the total, UAE with 8.5%, Germany with 5.5%, India with 4.1%, Japan with 4.0% and France with 3.8% of total imports.

**EXPORTS AND IMPORTS***




* 2018 figures

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

On the other side of the external sector, the financial account surplus recorded a considerable hike from US$ 7.4 billion in 2017 to US$ 66.0 billion in 2018. This was mainly due to direct investment that reported an increase from a surplus of US$ 5.9 billion in 2017 to US$ 18.0 billion in 2018, in addition to a shift in portfolio investment from a deficit of US$ 2.5 billion to a surplus of US$ 6.6 billion, and to a smaller deficit in reserve assets of US$ 217 million in 2018, compared to a large deficit of US$ 39.4 billion in 2017. It is worth mentioning that resident capital outflows exceeded non-resident inflows in 2018 mainly on the back of the foreign investments by the Saudi Public Investment Fund. Capital flows attributable to residents reached US$ 101 billion, in addition to US$ 21 billion in FDI outflows, US$ 20 billion in portfolio investment outflows, and US$ 53 billion in other investment outflows, and the remainder in capital transfers and unidentified outflows in errors and omissions.

Last but not least, a combination of lower oil prices with oil production cuts implemented in the first half of 2019, is expected to lead to a renewed weakening in Saudi's external performance this year. As such, Saudi Arabia is forecasted to post a current account surplus of 3.5% of GDP in 2019 as per the IMF (down from 9.2% of GDP in 2018). However, and despite the volatility in oil prices, the external accounts will be supported by rising volumes of non-oil exports, particularly aluminum, phosphates and petrochemicals (the latter boosted by the ramping-up of production at the giant Sadara integrated chemical plant), ensuring that the trade balance will continue to post sizable surpluses over the coming period.

## 1.3. PUBLIC SECTOR

*Adequate fiscal room paved the way for a looser fiscal stance in 2018*

The recovery in oil prices in 2018 helped to narrow Saudi's fiscal deficit and enabled a loosening of the fiscal stance to support the economy and social stability, marking a shift of focus away from austerity towards a more growth-supportive fiscal policy. Low government indebtedness ratios and large financial buffers, combined with mobilization of additional non-oil revenues, kept the fiscal position on a sustainable footing over the year. In fact, public deficit went down by 43.1% in 2018 relative to 2017, as the substantial increase in oil and non-oil revenues by 29.4% have more than offset the lower rise in spending by 10.8% over the year.

Going further into details, 2018 actual figures, as released by the Ministry of Finance, showed that public revenues went up from SR 691.5 billion (or US$ 184.4 billion) in 2017 to SR 894.7 billion in 2018 (or US$ 238.6 billion), on the back of a significant hike in oil revenues by 39.3% relative to 2017 level (constituting 67.9% of total public revenues) on the one hand, and driven by an increase in non-oil revenues by 12.4% on the other hand, reflecting several structural improvements including the introduction of a 5% VAT (amounting to 1.6% of GDP), increases in household electricity tariffs and a rise in levies on expatriates and their dependents, along with the introduction of other new fees and excises.

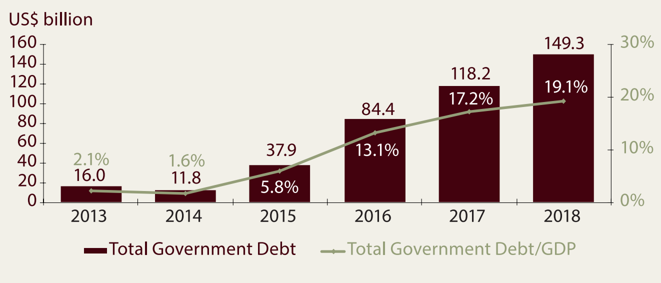
On the spending front, total public expenditures went up from SR 930.0 billion in 2017 (or US$ 248.0 billion) to SR 1,030.4 billion in 2018 (or US$ 274.8 billion), mainly reflecting transfers made to low and middle-income families to mitigate the impact of introducing the VAT and rising fuel prices in early 2018. In fact,

### SELECTED PUBLIC FINANCE INDICATORS

| US$ billion | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|
| Public revenues | 277.4 | 163.4 | 138.5 | 184.4 | 238.6 |
| Public revenues/GDP | 36.7% | 25.0% | 21.5% | 26.8% | 30.5% |
| Public expenditures | 304.2 | 267.0 | 221.5 | 248.0 | 274.8 |
| Public expenditures/GDP | 40.2% | 40.8% | 34.3% | 36.0% | 35.1% |
| Fiscal balance | -26.8 | -103.6 | -82.9 | -63.6 | -36.2 |
| Fiscal balance/GDP | -3.5% | -15.8% | -12.9% | -9.2% | -4.6% |

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

### PUBLIC INDEBTEDNESS AND DEBT RATIO




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

the increase in public spending was triggered by a 14.3% increase in current expenditures, the biggest outlays with 80.0% of total expenditures, while capital spending stagnated. The rise in expenditures was mainly driven by higher compensation of employees and social benefits reflecting a set of measures to cushion the impact of reforms. These measures included transfers from the SR 32 billion Citizen's Account, a SR 72 billion stimulus program focused on infrastructure, SMEs, and export financing, and a SR 50 billion "Citizenship Stimulus" package consisting of monthly allowances to government and military personnel and retirees.

As such, higher oil revenues, combined with a favorable increase in non-oil revenues, have more than offset the increase in spending, leading to a narrower fiscal deficit of SR 135.7 billion (US$ 36.2 billion or 4.6 % of GDP) in 2018 from SR 238.5 billion (US$ 63.6 billion or 9.2% of GDP) in 2017. Within this context, debt issuance remained the main source of deficit financing. As such, the public debt went up by 26.3% in 2018 from US$ 118.2 billion as at end-2017 (or 17.2% of GDP) to US$ 149.3 billion as at end-2018 (or 19.1% of GDP).

In parallel, actual figures for the first quarter of 2019 showed a budget surplus of SR 27.8 billion (or US$ 7.4 billion), the first surplus since oil prices plunged in 2014, as per the Ministry of Finance. In fact, oil revenue rose to about SR 149 billion in the first quarter of 2019, from around SR 114 billion in the same period of the previous year, while non-oil revenues grew to SR 76.3 billion, up from SR 52.3 billion. Expenditures in the first quarter amounted to SR 217.6 billion, slightly higher than the previous year's first quarter. It is worth mentioning that the 2019 budget projects a deficit of around 4% of GDP, down from an actual SR 135.7 billion in 2018 to a projected SR 130.7 billion in 2019. Spending is budgeted to increase by 7.3% from the actual figures of 2018, rising to an all-time high of SR 1,106 billion (or US$ 295 billion). On the revenue side, the 2019 budget expects a rise in total revenues by 9.0% from the actual figures of 2018, on the back of an increase in oil revenues by 7.4%, assuming that Brent oil prices should average US$ 77 per barrel in 2019 (as compared with US$ 72 in 2018).

## 1.4. FINANCIAL SECTOR

### 1.4.1. Monetary Situation

*Price deflation this year following last year's inflationary pressures*

Saudi monetary conditions saw resurgent inflationary pressures in 2018, before grappling with deflation at the beginning of the year 2019, as the high base effect resulting from the VAT introduction in January 2018 kicked in. In parallel, Saudi rates continued to track US interest rate hikes over the year 2018 given the Saudi riyal peg to the US dollar, while staying stable at the beginning of the year 2019 following the US Federal Reserve pivot to a more patient monetary policy normalization stance.

In details, consumer prices in Saudi Arabia grew by 2.5% on average in 2018, mainly 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 a 5% Value Added Tax in January 2018 and a rise in average oil prices over the year. Yet, consumer prices turned negative during the first four months of 2019, with the cost of living index contracting by 2.1% year-on-year, mainly due to the fading impact of VAT imposed on most goods and services, and given lower food and raw materials prices.

The breakdown of the cost of living index by category in 2018 shows that the tobacco segment registered the largest yearly expansion of 24.9%, followed by the transport segment with +10.7%, the restaurants and hotels segment with +7.5%, the food and non-alcoholic beverages segment with +6.5%, the health segment with +3.8%, the furnishings, household equipment & routine household maintenance segment with +1.4%, the communication segment with +1.3%, the recreation and culture segment with +1.1%, the education segment with +0.3% and the miscellaneous goods and services segment with +0.2%. In contrast, the clothing and footwear segment reported a yearly contraction of 7.0% in 2018, followed by the housing, water, electricity, gas, and other fuels segment with -1.2%.

Given the Saudi riyal peg to the US dollar at SR 3.75/US$, the Saudi Arabian Monetary Authority continued to broadly track US rates, raising its repo and reverse repo rates four times in 2018 by a cumulative 100 bps each to reach 3.00% and 2.50% respectively at end-December 2018, while keeping policy rates unchanged during the first four months of 2019 after the US Federal Reserve suggested at its March 2019 FOMC meeting to keep rates the same for the rest of the year 2019.

In parallel, the narrow measure of money supply (M1) grew by 3.9% in 2018 to reach US$ 325 billion at end-December, given a 4.7% rise in money in circulation and a 3.8% increase in demand deposits. This was followed by an extended expansion in (M1) of 1.6% during the first four months of 2019. The broader money supply (M2) widened by 2.3% in 2018 (the equivalent of US$ 9.9 billion) to reach US$ 442 billion amid a 2.0% drop in time and saving deposits, and expanded slightly by 0.3% during the first four months of 2019 on the back of a rise in (M1) and a 3.6% fall in time and saving deposits. The money supply in its broadest sense (M3) expanded by 2.8% in 2018 (the equivalent of US$ 13.4 billion), within the context of a 7.7% rise in quasi-money deposits, yet registered a 0.3% decline during the first four months of 2019. Given a higher growth in demand deposits than money supply (M3) in 2018, the demand deposits to broader money supply (M3) ratio reached 56.4% at end-December 2018, up from 55.8% at end-December 2017, and rose to 57.3% at end-April 2019. In parallel, the M1/M3 ratio was quoted at 66.1% at end-December 2018, moving up from 65.4% at end-December 2017, and reaching 67.5% at end-April 2019.

SAMA's reserve assets ended the year 2018 flat when compared to the previous year, reaching US$ 496.6 billion at end-December 2018 against US$ 496.4 billion at end-December 2017, despite the issuance of US$ 13 billion worth of bonds and Sukuks. Stability in SAMA's reserve assets is mainly explained by heavy capital outflows attributable to residents, estimated at US$ 101 billion, which have far exceeded non-resident inflows, because of the mandate of the Public Investment Fund to invest part of oil earnings abroad as a means of diversification. Yet, SAMA's reserve assets saw a rebound during the first four months of 2019, rising by 1.7% or the equivalent of US$ 8.5 billion to reach US$ 505 billion at end-April 2019, mainly supported by a US$ 7.5 billion international bond issue in January 2019.

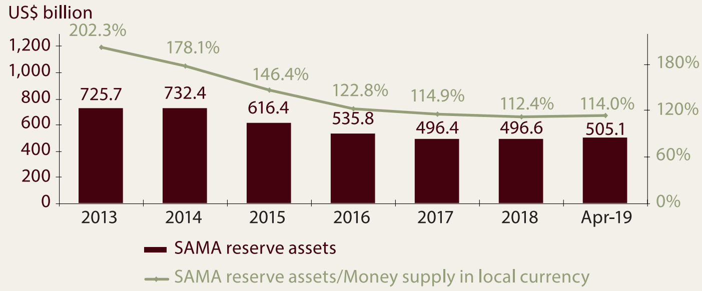
In the coming period, deflationary risks are forecast to persist due to a relatively subdued economic activity, pressure on expat labor following labor market reforms, and the introduction of new housing supply in the Kingdom. Within this context, the IMF expects consumer prices in Saudi Arabia to contract by 0.7% on average in 2019, while Saudi monetary policy is set to continue to track movements in US interest rates given the Saudi riyal peg to the US dollar.

## EVOLUTION OF MONETARY SITUATION

| Variation (US$ million) | 2014 | 2015 | 2016 | 2017 | 2018 | 4M-19 |
|---|---|---|---|---|---|---|
| **Net foreign assets** | **13,666** | **-97,708** | **-101,564** | **-39,157** | **-5,264** | **2,299** |
| SAMA | 7,519 | -115,362 | -80,276 | -39,731 | 670 | 8,702 |
| Commercial Banks | 6,147 | 17,654 | -21,289 | 574 | -5,934 | -6,403 |
| **Domestic Assets** | **36,736** | **37,798** | **36,266** | **16,515** | **24,565** | **17,659** |
| Claims on private sector | 35,351 | 30,857 | 8,946 | -3,140 | 10,985 | 5,929 |
| Claims on public sector | 935 | 8,806 | 24,602 | 20,267 | 13,470 | 10,186 |
| Claims on Non-financial Public Sector Enterprises | 450 | -1,866 | 2,718 | -611 | 110 | 1,543 |
| **Broad Money (M3)** | **49,122** | **11,718** | **3,748** | **1,009** | **13,361** | **-1,573** |
| Money Supply (M1) | 38,000 | 482 | -87 | 7,398 | 12,205 | 5,347 |
| Quasi-Money | 11,121 | 11,235 | 3,835 | -6,389 | 1,157 | -6,921 |
| **Government Deposits** | **-21,556** | **-106,183** | **-76,559** | **-36,722** | **-14,993** | **6,888** |
| **Other Items (Net)** | **22,836** | **34,555** | **7,513** | **13,071** | **20,933** | **14,643** |

*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*

### 1.4.2. Banking Activity

*Lending activity resumes in a remarkably solid financial sector*

The Saudi banking sector has renewed with positive private sector lending activity growth this year while providing further financing to the public sector, and continues to boast satisfactory liquidity, favorable asset quality, strong capital adequacy and resilient profitability indicators allowing it to withstand geopolitical uncertainties and bouts of overall slow economic activity warranting overall low banking aggregates growth rates. Measured by the aggregated assets of banks operating in Saudi Arabia, banking sector activity grew by 2.5% in the full year 2018 and by a further 0.6% in this year's first four months to reach the equivalent of US$ 633.8 billion at end-April 2019.

On the funding side, Saudi banks benefit from a low-cost and stable core deposit base accounting for the bulk of funding, while external funding remains limited. While deposit growth proved more or less subdued in the past few years amid low oil prices and soft economic conditions, the relative pick-up in oil prices during 2018 and the clearance of a large chunk of payment arrears to the private sector have contributed to higher deposits parked with banks. During 2018, total deposits rose by 2.6% (largely owed to higher private sector demand deposits) within the context of a healthy rise in average oil prices after an insignificant yearly change in the previous year before almost stabilizing year-to-date to reach US$ 439.9 billion at end-April 2019.

As such, deposit growth lead balance sheet growth on the funding side during 2018, while foreign liabilities and equity drove the increase so far this year. Foreign liabilities rose in the first four months of 2019 but continue to account for only 4.6% of total balance sheets, which shields the sector from potential swings in global credit conditions. Capital accounts progressed by 5.0% in the covered period of 2019, ensuring even better capitalization ratios for the sector.

On the asset utilization side, the additional liquidity at hand was channeled towards more lending to both the private sector and the public sector, which was coupled with some decline in banks' liquidity with the SAMA. Banks' claims on the private sector resumed their positive growth after a contraction in 2017 for the first time in nearly a decade. Claims on the private sector progressed by 3% in 2018 and by a further 1.5% in the first four months of 2019 alone, reaching US$ 388.6 billion at end-April.

In particular, mortgage lending is continuing to grow swiftly amid lower real estate prices in recent years. Residential new mortgage finance for individuals provided by banks rose by a record US$ 7.2 billion last year and by a further US$ 5.3 billion in 4M2019 alone. Authorities are actually encouraging higher home ownership among Saudis as part of its Vision 2030. To this end, the government deployed several initiatives

**BANKING SECTOR RATIOS**

| | 2014 | 2015 | 2016 | 2017 | 2018 | Apr-19 |
|---|---|---|---|---|---|---|
| **Banking sector dimension in economy** | | | | | | |
| Assets/GDP | 75.2% | 90.0% | 93.3% | 89.3% | 80.5% | 81.7% |
| Deposits/GDP | 55.6% | 65.4% | 66.9% | 62.7% | 56.6% | 56.7% |
| Loans to private sector/GDP | 42.5% | 53.9% | 55.9% | 51.9% | 47.0% | 48.1% |
| Loans to public sector/GDP | 1.6% | 1.6% | 2.0% | 1.8% | 1.6% | 1.8% |
| **Growth rates (YTD)** | | | | | | |
| Assets | 12.6% | 3.6% | 2.2% | 2.2% | 2.5% | 0.6% |
| Loans to the private sector | 11.9% | 9.8% | 2.2% | -0.9% | 2.9% | 1.5% |
| Investments | 114.5% | -8.5% | -11.2% | 11.6% | 8.4% | 9.9% |
| Deposits | 12.4% | 1.9% | 0.8% | 0.1% | 2.6% | -0.7% |
| Capital and reserves | 9.9% | 9.2% | 10.3% | 6.3% | -4.3% | 15.6% |
| Profit growth (year-on-year) | 12.5% | 6.3% | -5.4% | 8.2% | 10.7% | 12.4% |
| **Financial ratios** | | | | | | |
| Primary liquidity/Deposits | 18.5% | 17.1% | 19.8% | 21.2% | 19.0% | 16.3% |
| Loans to the private sector/Deposits | 76.5% | 82.4% | 83.6% | 82.8% | 83.0% | 84.8% |
| Capital accounts/Assets | 13.5% | 14.2% | 15.0% | 15.7% | 14.9% | 15.6% |
| ROAA | 2.00% | 1.97% | 1.81% | 1.91% | 2.07% | 2.35% |
| ROAE | 14.6% | 14.2% | 12.4% | 12.5% | 13.6% | 15.4% |

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

to help homebuyers such as an increase in the maximum loan-to-value ratio for first-time buyers to 90%, a lowering of risk-weights for residential mortgages from 75% to 50% last year, and the supply of low-cost homes by the public sector, as per Moody's. For low-income households, authorities plan to subsidize housing loans, loan guarantees and support down payments for homes.

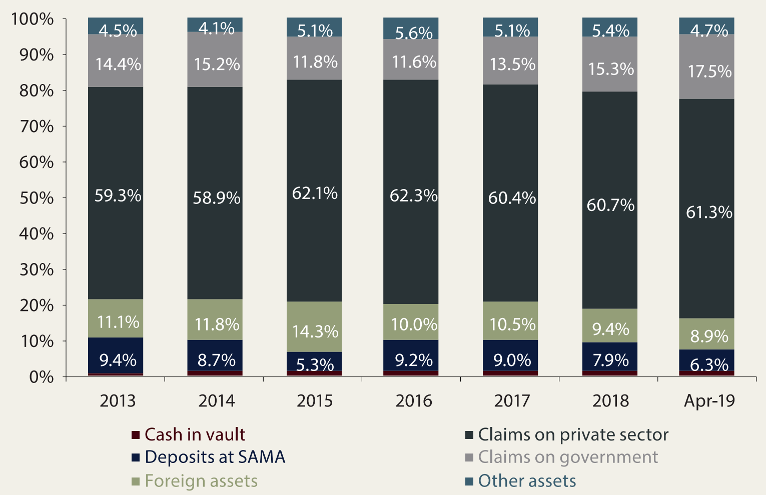
The quarterly breakdown of bank credit by economic activity (excluding banks' investments in private securities) reveals that during the covered 15 months to end-Q1 2019, the largest beneficiary of new bank credit among major sectors was the building and construction sector. It was followed by the electricity, water, gas and health services sector, and the manufacturing and processing sector, while the portfolio of loans to the commerce sector reported the largest contraction.

In parallel, banks' claims on the public sector continued to increase, with a 16.9% growth in 2018 and a 12.5% rise so far this year to close April at US$ 105.6 billion. This is largely attributable to banks' continued investments in government and quasi-government bonds issued for funding purposes. At the same time, this increased further banks' exposure to the sovereign, with investments in government bonds and quasi-government bonds at 93% of total capital accounts at end-April 2019, against 87% at end-2018 and levels under the 30% mark three years and a half years ago. This is mostly due to persistent public sector financing needs but should not be worrisome as the sovereign remains comfortably solvent with substantial wealth reserves.

Having said that, accrued government securities holdings have tilted the profile of liquid assets from largely short-term (cash, liquidity with SAMA and other banks, Tbs) to a mix of short-term/long-term liquid assets that can be repo-ed or sold when and if needed. The liquidity measure we usually calculate and track is the core liquidity ratio (i.e. readily available or primary liquidity), defined as the sum of cash and deposits with the Central Banks and other banks (in KSA and abroad) to total deposits, and which remains more or less satisfactory despite a decline lately. The core liquidity ratio reached 16.3% at end-April, noting that government securities are not included in readily available liquidity. But when including other liquid assets, the liquid assets to short-term liabilities ratio published by the SAMA reached a comfortable 35.5% at end-2018 as per the latest disclosures.

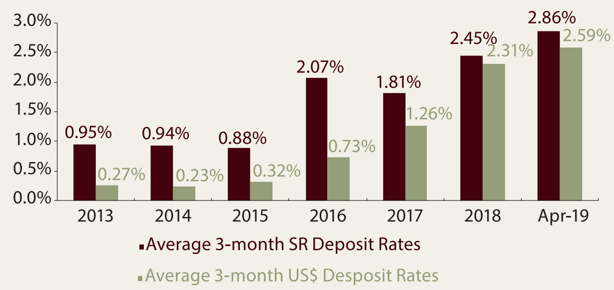
Besides, the loan-to-deposit ratio remains under the SAMA regulatory limit of 90%, reaching 79.2% at end-April 2019, against a slightly lower 77.4% at end-2018 as banks' lending activity progressed rather swiftly so far this year. This suggests that banks operating in the Kingdom are apt to extend new waves of loans without significant pressure on their liquidity base. It is worth noting that methodological changes implemented during 2018 called for loans to be accounted for minus provisions and commissions and deposits 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

**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* 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.

Saudi banks also maintain more than favorable asset quality metrics. In fact, the latest SAMA figures point out to a sector-wide non-performing loans to total gross loans ratio of a mere 2.0% at end-2018, albeit increasing slightly from 1.6% at end-2017 amid slow economic activity growth, and that remains much lower than regional, emerging market and global benchmarks. Besides, Saudi banks' NPLs are more than fully provisioned for, as reflected by a negative ratio of NPLs net of provisions to total capital.

Furthermore, Saudi banks are strongly capitalized, with a regulatory capital to risk-weighted assets ratio of 20.3% at end-2018. The bulk of regulatory capital consists of Tier 1 capital, as the regulatory Tier 1 ratio stood at 18.5% at end-2018. Those ratios confirm the strong capital buffers that Saudi banks benefit from and that would serve them well should pressures on their capital base arise.

Last but not least, the structurally low funding costs and high efficiency of banks (cost-to-income of 36%), favorable tax regime, improved interest margins and pick-up in credit volumes, have likely contributed to a 10.7% rise in full year 2018 net profits followed by a 12.4% increase on a yearly basis in the first four months of 2019. As such, the ROAA moved from 1.9% in 2017 to 2.1% in 2018 and to 2.4% in 4M2019, and the ROAE moved from 12.5% in 2017 to 13.6% in 2018 and to 15.4% in 4M2019, shedding light on strengthening profitability ratios for Saudi banks.

### 1.4.3. Equity and Bond Markets

*Saudi equities on the rise, bonds under downward price pressures before bouncing back*

Saudi equities registered healthy price gains in 2018 and during the first four months of 2019, mainly supported by an oil price recovery and an upgrade of Saudi Arabia to secondary emerging market status, which is set to draw billions of dollar in foreign inflows. In parallel, the Saudi fixed income market saw price falls in 2018, before bouncing back during the first five months of 2019, mainly tracking US Treasuries move after the US Federal Reserve suggested to keep rates unchanged over the year 2019.

In details, Saudi equities benefited from improved investor sentiment in 2018, mainly helped by an oil price rebound, with Brent oil prices reaching US$ 70 per barrel on average in 2018 as compared to an average of US$ 55 per barrel in 2017, in addition to a long-awaited upgrade of Saudi Arabia to secondary emerging market status by FTSE on March 28, 2018 and MSCI on June 20, 2018, amid bets that this would help attracting several billion dollars of passive index-linked foreign funds. Within this context, the Tadawul All-Share Index closed the year 2018 with a rise of 8.3% to reach 7,826.73 at end-December.

The TASI pursued its upward trajectory during the first four months of 2019, surging by 18.9% since year-end 2018, to close at 9,304.2 at end-April. This was mainly driven by extended oil price gains following OPEC's decision in December 2018 to cut oil production by 1.2 mbpd during the first half of the year 2019, in addition to the Kingdom's announcement of a sweeping infrastructure plan worth US$ 425 billion under Vision 2030, which has triggered strong price gains in Saudi cement stocks, and as internationals were net buyers of Saudi stocks over the first four months of 2019 despite expensive prices (stocks trading P/E of 18.8x in April 2019 against 15.8x in 2018), mainly in anticipation of Saudi Arabia's inclusion in two major international indexes (the FTSE Russell and S&P Dow Jones' emerging markets indices) on March 18, 2019, and KSA's inclusion in MSCI emerging market index on May 28, 2019 (with an aggregate weighting of 1.42%).

The breakdown of the TASI by the industry groups in 2018 shows that the media & entertainment sector reported the highest index surge with +31.6%, followed by the banks sector with +31.1%, the telecommunication services sector with +27.1%, the retailing sector with +21.9%, the energy sector with +13.3%, the food & staples retailing sector with +5.9% and the materials sector with +3.9%. In contrast, the real estate management and development sector registered a fall in its index of 31.3%, followed by the utilities sector with -26.1%, the REITs sector with -21.8%, the food & beverage sector with -20.6%, the consumer services sector with -20.0%, the healthcare equipment and services sector with -15.4%, the diversified financials sector with -13.7%, the transportation sector with -13.3%, the insurance sector with

-11.6%, the consumer durables and apparel sector with -11.5%, the capital goods sector with -10.1%, the pharma, biotech and & life science sector with -2.3% and the commercial and professional services sector with -1.7%.

Alongside equity price gains in 2018, the number of listed companies rose from 179 companies at end-2017 to 190 companies at end-2018. That being said, the market capitalization increased by 10.0%, moving from US$ 450.6 billion at end-2017 to US$ 495.7 billion at end-2018, and grew further by 17.6% during the first four months of 2019 to reach US$ 582.9 billion at end-April 2019 due to extended price gains and an increase in the number of listed companies to 192 companies. The market capitalization-to-GDP ratio declined from 65.4% at end-2017 to 63.4% at end-2018, yet rose to 75.1% at end-April 2019.

The total trading value in the Saudi Tadawul amounted to US$ 232.2 billion in 2018, rising by 4.1% relative to the previous year. The division of the total turnover by category in 2018 showed that three out of 20 sectors captured 68% of the total, namely the materials sector with 31.4%, the banks sector with 25.5% and the real estate management and development sector with 11.4%. Given an increase in the total trading value and a higher rise in the market capitalization in 2018, the annualized turnover ratio retreated from 49.5% in 2017 to 46.8% in 2018.

In parallel, the total turnover reached US$ 67.8 billion during the first four months of 2019 as compared to US$ 92.1 billion during the corresponding period of 2018, down by 26.4%. The market capitalization reached US$ 582.9 billion at end-April 2019 as compared to US$ 514.6 billion at end-April 2018, up by 13.3%. Accordingly, the annualized turnover ratio, measured by the annualized trading value to market capitalization, reached 34.9% during the first four months of 2019 as compared to 53.7% during the corresponding period of 2018.

As to fixed income markets, Saudi Arabia accounted for the largest share of bond issuances in the MENA region in 2018 and during the first five months of 2019 (26% and 39% respectively). A closer look at bond issuances shows that Saudi Arabia remained the largest sovereign bond issuer in 2018, for the second consecutive year, raising the total of US$ 13 billion from the sale of Islamic and conventional bonds, as the debt issuance remains the main source of deficit financing. In details, the Kingdom raised US$ 11 billion in April 2018 through the sale of US$ 4.5 billion notes maturing in 2025 at 140 bps over UST, US$ 3 billion notes maturing in 2030 at 175 bps over UST, and US$ 3.5 billion notes maturing in 2049 at 210 bps over UST. The bond sale attracted orders of circa US$ 52 billion. The Kingdom also raised US$ 2 billion in September 2018 through the sale of a 10-year Sukuk at a coupon of 4.303%.

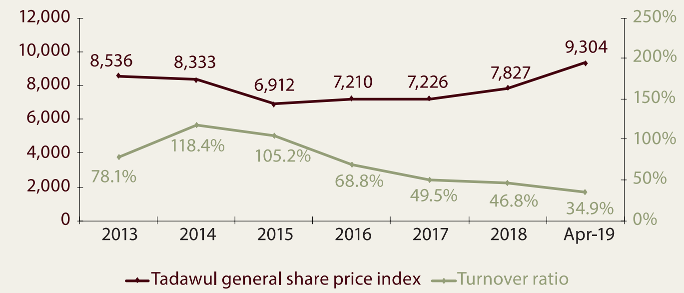
Saudi Arabia continued to tap international bond markets in 2019 through the sale of a US$ 7.5 billion dual-tranche bond in January, detailed as follows: US$ 4 billion maturing in 2029 at a coupon of 4.375% and US$ 3.5 billion bond maturing in 2050 at a coupon of 5.25%. Also, Saudi Arabia witnessed in April 2019 the first-ever debt issuance from State oil producer Saudi Aramco. In fact, Saudi Aramco raised US$ 12 billion through the issuance of a five-tranche debt that has attracted more than US$ 100 billion in orders and is detailed as follows: US$ 1 billion three-year bond priced at +55 bps over US Treasuries; US$ 2 billion five-year bond priced at +75 bps over US Treasuries; US$ 3 billion 10-year bond priced at +105 bps over US Treasuries; US$ 3 billion 20-year bond priced at +140 bps over US Treasuries; and US$ 3 billion

## SELECTED STOCK MARKET INDICATORS

| | 2014 | 2015 | 2016 | 2017 | 2018 | Apr-19 |
|---|---|---|---|---|---|---|
| Market capitalization (US$ billion) | 483.4 | 421.1 | 448.5 | 450.6 | 495.7 | 582.9 |
| Market capitalization/GDP | 63.9% | 64.4% | 69.5% | 65.4% | 63.4% | 75.1% |
| Trading value (in US$ billion) | 572.4 | 442.8 | 308.5 | 223.0 | 232.2 | 67.8 |
| Number of transactions (in millions) | 35.8 | 30.4 | 27.3 | 21.9 | 25.0 | 8.9 |
| Number of listed companies | 169 | 171 | 176 | 179 | 190 | 192 |
| Change in share price index | -2.4% | -17.1% | 4.3% | 0.2% | 8.3% | 18.9% |
| Price/Earnings ratio | 14.0x | 13.8x | 15.7x | 15.2x | 15.8x | 18.8x |
| Price/Book value ratio | 2.0x | 1.7x | 1.7x | 1.7x | 1.8x | 2.1x |
| 5-year CDS spreads (bps) | 67 | 156 | 113 | 92 | 105 | 77 |

*Sources: Tadawul, Bank Audi's Group Research Department*

## CAPITAL MARKETS PERFORMANCE




*Sources: Tadawul, Bank Audi's Group Research Department*

30-year bond priced at +155 bps over US Treasuries.

Regarding plans for new issues, Saudi Arabia's Public Investment Fund announced early-May 2019 plans to tap the debt market over the coming months, as part of its efforts to support the Kingdom's ambitious economic transformation plans.

Saudi debt papers came under downward price pressures in 2018, posting price falls of up to 11.10 pts, mainly tracking an emerging market weakness after the US Federal Reserve raised its benchmark interest rate four times over the year 2018. Yet, Saudi papers witnessed a price recovery during the first five months of 2019, tracking US Treasuries move after the US Federal Reserve suggested at its March 2019 FOMC meeting to keep rates the same for the rest of the year 2019, and given a "flight to safety" mode amid deepening US-China trade disputes.

In details, sovereigns maturing between 2021 and 2049 recorded decent price gains ranging between 2.36 pts and 9.13 pts during the first five months of 2019. Prices of SABIC'23 and '28 rose by 2.97 pts and 5.44 pts respectively. SECO papers maturing between 2022 and 2044 registered price gains of up to 7.96 pts. Dar Al Arkan'22 and '23 were up by 2.96 pts and 3.21 pts respectively.

As to the cost of insuring debt, Saudi Arabia's five-year CDS spreads, which measure the market's perception of sovereign risks, expanded by 13 bps in 2018 to reach 105 bps at end-December, before contracting to 92 bps towards the end of May 2019, which is well below the average regional sovereign five-year CDS spreads of 235 bps.

As to credit ratings, Standard and Poor's affirmed in March 2019 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 reflects S&P's expectation that Saudi Arabia would maintain a pace of moderate economic growth and retain strong government and external balance sheets over the next two years, despite wider fiscal deficits.

Also, Fitch Ratings affirmed in April 2019 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 and significant government assets. These strengths are balanced by oil dependence, weak World Bank governance indicators and high geopolitical risks.

Looking forward, the significant reforms that have taken place in the Saudi debt market including the introduction of a primary dealer system and the extension of the government yield curve to long-dated maturities are expected to help financial sector development and the deepening of the private debt market, as per the IMF, noting that additional external debt issuances are likely to happen, alongside a growing reliance on domestic debt for fiscal financing, particularly given the postponement of the Aramco IPO.

## 2. CONCLUDING REMARKS

Looking forward, growth is likely to be impacted by the crude oil production restraint following the new OPEC+ agreement. Overall real GDP growth is set to slow moderately to 1.8% in 2019 as higher government spending offsets the impact of oil price production cuts implemented in the first half of 2019. Growth would then recover to 2.2% in 2020, as oil production cuts are reversed and as large infrastructure projects generate positive spillovers to private sector growth. It will still be also supported by higher non-hydrocarbon sector growth, which will benefit from the lagged effects of the fiscal stimulus during 2018 and from spending increases planned for 2019.

At the monetary level, the stance of the Kingdom's monetary policy would depend on that of the US Federal Reserve. By the time of the finalization of this report, no more hikes were expected for the remainder of 2019 and for 2020. With respect to inflation, consumer prices are expected to remain muted in 2019, as VAT effects wear off and food and housing costs moderate. At the external level, foreign surpluses are expected to remain positive though relatively weakening as infrastructure-related imports increase over the medium term. It is within this context that the current account surplus is foreseen to register 3.5% of GDP in 2019 and an average of 1.7% over the next five years.

At the fiscal level, the 2019 budget projects a deficit of around 4% of GDP. Total spending is budgeted to increase by 7.3% from the estimated actual of last year. Unlike 2018, most of the increase in expenditures will be allocated to public investment. On the revenue side, fees on expatriate workers and their families are set to increase, in addition to the rise in fees on businesses that employ foreign workers, in the aim of encouraging them to hire more Saudi nationals. It is expected that the authorities would continue tapping domestic and foreign debt sources to financing the fiscal deficits, while they remain committed to keeping the debt-to-GDP ratio below 30% over the medium term.

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 large stock of proved oil reserves and low extraction costs, the low public debt levels, the large net external asset position, the sound banking system amid prudent financial regulation, in addition to the momentum for structural reforms under Vision 2030 within an era of change bringing a stream of opportunities to the Kingdom.

At the level of risks constraining the outlook, we mention the still heavy reliance of economic growth and public finances on oil revenues, the rigid government spending structure, the substantial geopolitical risks, the persisting institutional weaknesses, the socio-economic challenges due to rapid population growth and high unemployment, in addition to the possible slowdown in the global economy and related fall in oil demand which would hurt prospects for KSA growth. While those risk factors are real challenges, we believe strengths outpace weaknesses and opportunities outweigh threats at the horizon.

In its just released IMF Article IV report for Saudi Arabia, the Fund provides a number of recommendations for the Kingdom. Among these rise the need for fiscal policy to strike the right balance between fiscal sustainability, social spending and development. In parallel, labor market reforms should focus on four areas to encourage Saudi nationals to work in the private sector, namely through reducing the availability and attractiveness of government work, strengthening education, training and career development, increasing the mobility of expatriate workers through reform of the visa system and further increasing female participation and employment. Finally, while reforms should be increasingly inclusive, government interventions in the economy should focus on areas where they crowd-in private investment at large.

## DISCLAIMER

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