Saudi Economic Perspectives

2017 **2018**

Transitioning Towards a Balanced Economy

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Transitioning Towards a Balanced Economy

- Growth forecasts for advanced economies in 2017 and 2018 stands at 2.0% slightly improving over past estimates. On the other hand, in emerging and developing economies (EMDEs), growth is expected to upturn to 4.5% in 2017 and 4.8% for 2018. The changing policy mix in the US and China will create a positive global spillover that will provide support for emerging and developing markets whereas persistent perils in their economies continue to offer a weaker prospect for the global economy as risks have become more pronounced. The IMF upwardly revised global growth to 3.5% in 2017 and 3.6% in 2018 according to their latest World Economic Outlook report which reaffirms the expectations of two more rate hikes by the US Fed in 2017 and another three in 2018.

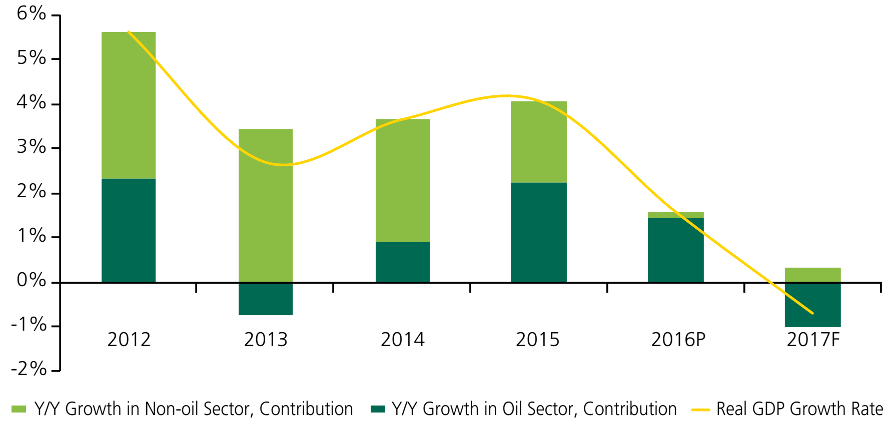
- Real GDP is expected to marginally decline by 0.7%, mainly due to a contraction in real oil GDP as OPEC's production cut agreement had been extended beyond 2017. Saudi is expected to reduce production to 10.1MMBD, contributing to a shrinkage in oil GDP real growth by 2.3%. The non-oil sector will retain its slow pace, marginally growing by 0.6% in real terms, due to government expenditure rationalization that pressured business and consumer sentiment since the oil collapse. Although, adopting a gradual and transparent fiscal plan is expected to improve domestic and international sentiment.

- A semblance of normalcy, however, had materialized in oil markets after the first production cut by OPEC since 2008. The cut agreed upon in November 2016 amounted to 1.2 MMBD and became effective starting January 2017, pushing crude prices into a higher range between USD50-60/bbl. The fact that 11 non-OPEC countries agreed with OPEC to cut an additional 558 thousand barrels per day, the first such deal between OPEC and non-OPEC members in 15 years, was also a supporting factor. According to our baseline scenario for 2017, we assume Arabian Light prices to average USD51/bbl and Saudi production at 10.1MMBD, with OPEC and non-OPEC members to jointly maintain reduced production levels to achieve an oil market balance.

- Liquidity concerns have been mitigated by SAMA's interventions in 2016 coupled with the response of the Debt Office Management to tap international markets. Broad money supply (M3) concluded year 2016 positively, albeit registering a mediocre annualized growth of 0.7%, standing at SAR1.78 trillion. The monetary base (M0) edged up by 0.3% Y/Y to SAR302.4 billion in 2016 affected by a deceleration in currency outside banks and banks' deposits with SAMA. The liquidity squeeze is expected to ease in 2017 as SAIBOR fell to 1.73% by the end of the first quarter of 2017. The differential between SAIBOR and LIBOR has converged to settle between 50-60bps as the Fed continues its normalization policy. In our opinion, liquidity will find some respite given the recent Royal Decree to restore public employee allowances and the expected pick up in the oil market which will trickle down into the monetary system.

- A major risk to our economic outlook is the absence of a long-term resolution to the geopolitical tensions in the region. Despite the importance of securing the Kingdom's borders, the Yemeni war continues to burden the government's finances amidst low oil revenues. Additionally, the six-year civil war in Syria poses a significant threat to the region as tensions between the US, Russia, and Iran intensified following the use of chemical weapons. Although a heightened military scenario will support oil prices and Saudi's oil revenues, an ensuing regional conflict would result in negatively impacting consumer and investor sentiment. Globally, North Korea's missile test defiance against western nations threatens to destabilize global macroeconomics. In addition, the nationalist movement which resulted in appointing Theresa May to steer the UK towards a Brexit, followed by Donald Trump being elected president of the US, as well as the populist candidates in France, Italy, and the Netherlands that are gaining supporters could trigger global trade protectionism similar to the era post the first World War.

Business Cycles in KSA



Sources: SAMA and NCB

2017 and 2018 Projections

Our macroeconomic projections are based on an average crude oil price (Arabian Light) of USD51/bbl and an average daily crude oil production level of 10.1MMBD (out of which 69% is exported) in 2017. The fiscal reforms, coupled with a rebound in oil revenues, will positively contribute towards an improvement in the fiscal and current accounts that will reach 7.5% and 1.5% to GDP, respectively. Real GDP is expected to marginally decline by 0.7%, mainly due to a contraction in real oil GDP as OPEC's production cut agreement had been extended beyond 2017. Following 2016's 0.2% gain, the non-oil sector is expected to accelerate by 0.6% this year as a transient spike in the retail, utilities, and transport sectors support growth. While the drive towards fiscal adjustment and consolidation will continue unabatedly, the gradual implementation of fiscal reforms will provide a solid footprint and the needed firepower to accelerate economic growth post 2020. Declining fiscal deficits and the utilization of debt markets will lessen the pace of withdrawals from net foreign assets, we expect another international debt issuance this year along with a cautious return to domestic debt issuances. A major risk to our economic outlook is the absence of a long-term resolution to the geopolitical tensions in the region, the nationalist political movements across the globe, and OPEC's compliance commitments in the second half of this year that can pose risks to our crude oil prices and production forecasts whether to the upside or downside given the inherent volatility of oil markets.

Key Macroeconomic Indicators	2012	2013	2014	2015	2016P	2017F	2018F	Latest	Date
Real Sector									
Weighted Average KSA Crude Spot Price, Arab Light, USD/BBL	110.2	106.4	97.2	50.2	40.9	50.6	53.1	51.8	4M17
Average Daily Crude Oil Production, MMBD	9.8	9.6	9.7	10.2	10.4	10.1	10.2	9.90	4M17
GDP at Current Market Prices, SAR billion	2,752.3	2,799.9	2,836.3	2,444.1	2,398.6	2,525.5	2,679.4	-	-
GDP at Current Market Prices, USD billion	734.9	747.6	757.4	652.6	640.5	674.4	715.5	-	-
Real GDP Growth Rate	5.7%	2.7%	3.7%	4.1%	1.4%	-0.7%	1.2%	-	-
Oil Sector GDP Growth Rate	5.1%	-1.6%	2.1%	5.3%	3.4%	-2.3%	1.8%	-	-
Non-oil Sector GDP Growth Rate	6.1%	6.4%	4.9%	3.2%	0.2%	0.6%	0.7%	-	-
Population, million	29.2	30.0	30.8	31.5	31.7	32.6	33.1	-	-
Population Growth Rate	2.9%	2.7%	2.6%	2.4%	0.7%	2.7%	1.4%	-	-
GDP /Capita, USD	25,172.6	24,926.2	24,613.3	20,704.2	20,177.2	20,678.1	21,641.3	-	-
CPI Inflation, Y/Y % Change, Average	2.9%	3.5%	2.7%	2.2%	3.5%	2.5%	4.7%	-0.4%	Mar-17
External Sector									
Merchandise Trade Balance, USD billion	246.6	222.6	184.0	44.3	58.9	80.8	97.9	-	-
Oil Exports, USD billion	337.5	321.6	284.9	152.5	134.6	152.6	163.8	-	-
Non-oil Exports, USD billion	50.9	54.1	58.0	50.7	46.2	54.3	63.8	-	-
Merchandise Imports, USD billion	-140.7	-152.1	-157.2	-156.5	-121.8	-126.1	-129.7	-	-
Invisibles Trade Balance, USD billion	-81.8	-87.1	-110.2	-101.0	-90.5	-91.2	-83.3	-	-
Net Factor Income, USD billion	9.2	11.7	13.8	10.7	6.4	11.1	13.7	-	-
Net Unilateral Transfers, USD billion	-28.7	-34.0	-36.0	-38.2	-39.5	-40.9	-42.4	-	-
Current Account Balance, USD billion	164.8	135.4	73.8	-56.7	-31.6	-10.4	14.6	-	-
Current Account Balance/GDP	22.4%	18.1%	9.7%	-8.7%	-4.9%	-1.5%	2.0%	-	-
Net Foreign Assets with SAMA, USD billion	648.5	717.7	725.2	609.7	529.3	482.1	447.7	502	Mar-17
Fiscal Sector (Central Government)									
Budgeted Expenditure, SAR billion	690.0	820.0	855.0	860.0	840.0	890.0	928.0	-	-
Actual Revenues, SAR billion	1,247.4	1,156.4	1,044.4	612.3	528.0	700.0	784.7	-	-
Actual Expenditure, SAR billion	873.3	976.0	1,100.0	978.0	825.0	890.0	928.0	-	-
Expenditure Overrun, %	26.6%	19.0%	28.7%	13.7%	-1.8%	0.0%	0.0%	-	-
Total Revenues/GDP	45.3%	41.3%	36.8%	25.1%	22.0%	27.7%	29.3%	-	-
Total Expenditure/GDP	31.7%	34.9%	38.8%	40.0%	34.4%	35.2%	34.6%	-	-
Overall Budget Balance, SAR billion	374.1	180.3	-55.6	-365.7	-297.0	-190.0	-143.3	-	-
Budget Balance/GDP	13.6%	6.4%	-2.0%	-15.0%	-12.4%	-7.5%	-5.3%	-	-
BreaL-Even Oil Price	73.9	82.6	99.1	82.9	62.6	66.8	62.7	-	-
Financial Sector									
USD/SAR Exchange Rate	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	Mar-17
Growth in Broad Money (M3)	13.9%	10.9%	11.9%	2.6%	0.7%	0.9%	1.4%	0.0%	Mar-17
Growth in Credit to the Private Sector	16.4%	12.1%	11.9%	9.8%	2.2%	2.6%	3.1%	-0.5%	Mar-17
Average 3M SAR Deposit Rate	0.9%	1.0%	0.9%	0.9%	2.1%	2.5%	3.0%	1.8%	4M17
Average 3M USD Deposit Rate	0.4%	0.3%	0.2%	0.3%	0.7%	1.7%	2.8%	1.1%	4M17
Spread, in Basis Points, SAIBOR-LIBOR	55.2	68.7	70.4	56.4	134.7	80.0	20.0	75.7	4M17

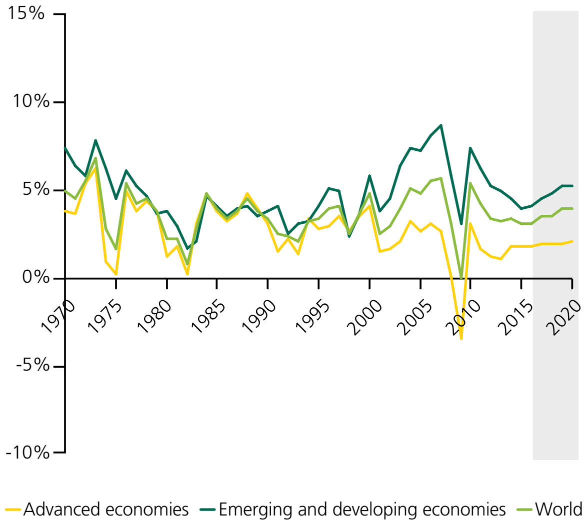
Sources: Thompson Reuters, SAMA, General Authority for Statistics, and NCB
Note: Key Macroeconomic Indicator's Data, April 2017 Update (Historical and Projections)

1. Global Economic Developments

Global GDP is expected to accelerate in 2017 to 3.5% after it was underpinned by an improvement in advanced economies in the second half of 2016. Projected fiscal stimulus in the US, sizeable appreciation of the USD, steepening yield curve, rising equity prices, in addition to firming oil prices are supporting factors for advanced economies going forward. Growth forecasts for advanced economies in 2017 and 2018 stands at 2.0% slightly improving over past estimates. On the other hand, in emerging and developing economies (EMDEs), growth is expected to upturn to 4.5% in 2017 and 4.8% for 2018. The changing policy mix in the US and China will create a positive global spillover that will provide support for emerging and developing markets whereas persistent perils in their economies continue to offer a weaker prospect for the global economy as risks have become more pronounced. The IMF revised up China's growth up to 6.6% for 2017 on the back of policy support and credit-induced growth while shifting focus away from corporate debt. Moreover, the year 2016 was marked by geopolitical shocks; Brexit in the UK, impeachment in Brazil, Japanese and US elections, in addition to an attempted coup in Turkey. The divergence between commodity exporters and importers is widening and softer manufacturing data is indicative of weaker global demand. On this note, the pro-USD forex direction remains disputed over the confidence regarding Trump's pro-growth agenda. However, the Fed's hawkish outlook in 2017 raises the potential for more capital repatriation of US foreign holdings. Job creation is expected to remain supportive, keeping unemployment below 5%. The US economy is gaining traction following the first half of 2016 with output growth averaging 1.6%Y/Y In 2017. Annualized US growth is expected to reach 2.3% in 2017 and possibly 2.5% the following year. Consumer spending and housing market improvement were underpinned by a robust job market in which wages posted the biggest gains since 2009. The trade-weighted USD ended 2016 turning up by 3.1% Y/Y to close at 102.2, and is expected to maintain a broad-based appreciation interrupted by intermittent spikes of uncertainty emanating from the fiscal side.

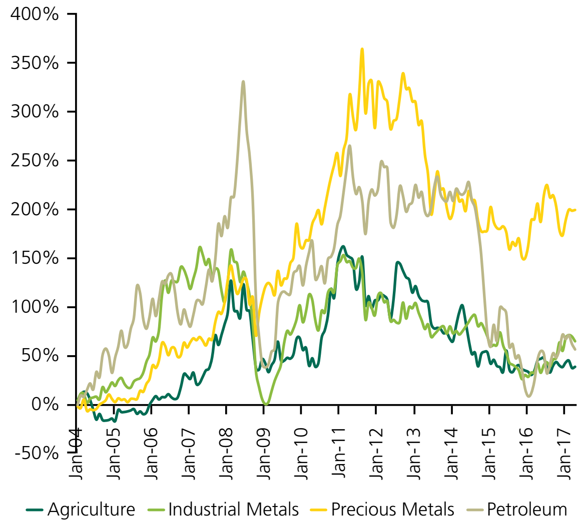
In the Eurozone, annualized growth is expected to moderate further from 2016 to hover around 1.6% in 2017 and 2018, respectively. The outlook remains below potential and bearish for the EUR as interest rate differentials are the main drag for the currency through 2017. Political risks are also expected to remain elevated due to uncertainty surrounding the Brexit aftermath. On the flip side, per capita GDP in the Eurozone managed to return to pre-crisis levels after eight painful years of near stagnation. Spain managed to bring unemployment below 20% in 2016 after peaking at 27.2% in 2013. Such success, albeit limited, allows for some hope in depression-stricken countries such as Greece which remains under a debt burden of over 177% of GDP. The hope is that fiscal and monetary discipline will bring about a convergence in the single currency bloc. Moreover, the ECB is expected to increase the Targeted Long-Term Refinancing Operations (TLTRO) upper threshold of high rated government bonds in 2017. Business surveys show a notable recovery since August 2016, and consumer confidence ended the year on a high note. The EUR slid by 3.1% Y/Y on year-end standing at USD1.05, and is expected to maintain a downward outlook throughout 2017.

1. Global GDP Growth
(Annual % change)



Sources: IMF

2. Selected Commodity Price Indices
(S&P Goldman Sachs Spot Indices; January 2004 = 100)

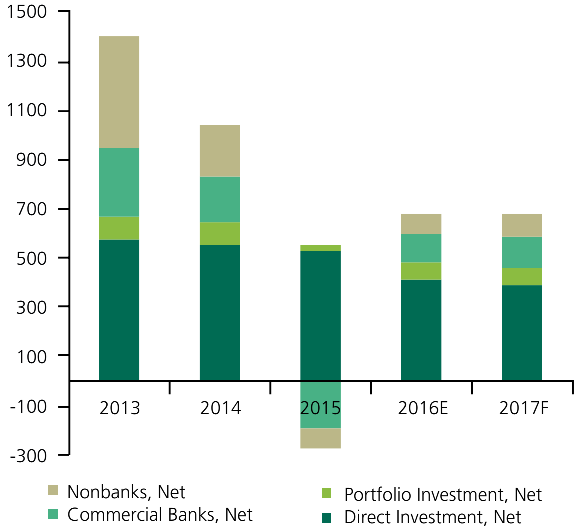


Sources: Thomson Reuters

Japan's growth in 2016 was stronger than previously estimated by the IMF, posting 1.0% Y/Y; however, interest rate differentials and Pan-American fiscal plans are adding to the challenges for Shinzo Abe's economic reform. In 2017, growth in Japan is expected to pan out at 1.2% and inch down the subsequent year to 0.6%. The Japanese yen peaked in 2016 at 99.9 for the US dollar during August but ended the year weaker at 116.9/USD, sliding by 2.9% Y/Y. We expect the JPY to remain under pressure in 2017 as a higher interest rate environment in the US increase risk premium. The Chinese yuan remains under weakening pressure against the USD on the back of persistent capital outflows. According to the International Institute of Finance, net capital outflows from China accelerated in the second half of 2016 to end the year at around USD725 billion. Political pressure on US firms to repatriate profits could further accelerate capital outflows which had caused a decline of USD320 billion in China's foreign exchange reserves. Furthermore, depreciation pressure is expected to increase in 2017 once individual transfer quotas are reset. On the other hand, the Chinese economy met its growth target at 6.7% for 2016; however, in 2017 growth will likely decelerate as fiscal stimulus fades away and the property market cools off. By the end of December 2016, the renminbi stood at CNY6.9/USD, down by 6.5% Y/Y and will likely remain under depreciative pressure owing to policy stimulus in China and a stronger USD. Declining investments in EMDEs and capital repatriation reflect that investors are seeking to benefit from interest rate differentials as US yield curves steepen. Investment growth in commodity exporting EMDEs fell from 7.1% in 2010 to just a little over half a percentage point in 2016, indicating lower growth prospects and deteriorating terms of trade. Higher political risks in some of the major EMDEs such as Brazil will also exacerbate the slowdown in investment, trickling down to the commodities exported by these countries. According to the World Bank, the fall of commodity prices account for 1.5% of the total decline in investment growth between 2011 and 2015. The repatriation of investment money from EMDEs unwinded the commodity super-cycle which tumbled the Reuters-Jeffries commodity index from 370.6 points on April 2011 to 155 points on February 2016, approximately 58.2% from peak to trough.

3. Emerging Market Economies: Capital Inflows

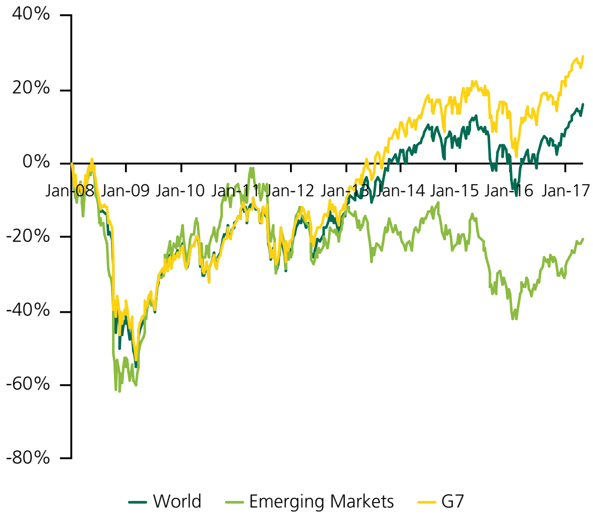
USD billion



Sources: IIF

4. Global Equity Markets

(January 2008 = 100)



Sources: Thomson Reuters

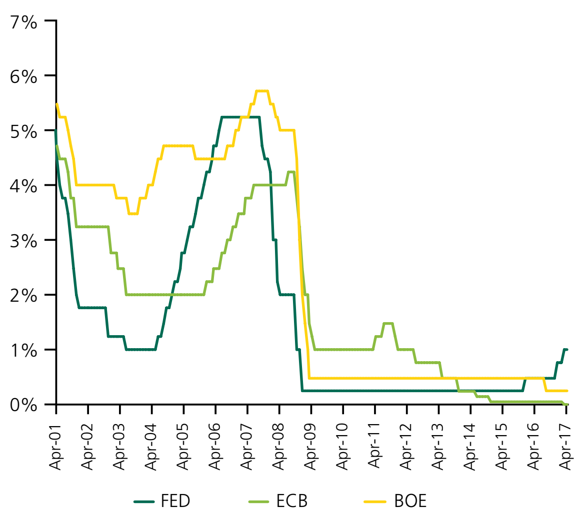
Commodity prices stabilized into 2017 despite the terms of trade shocks that befell commodity exporters in 2015-2016. Weaker investment prospects led to expectations of tighter future supply of commodities, namely base metals such as copper and aluminum. The year 2016 saw a divergence between industrial and agricultural commodities in the fourth quarter. Recurring supply concerns on base metals emanating from the closures of high-cost smelters in China as well as ore export bans in Indonesia and Malaysia are exerting an upward pressure on prices. Meanwhile, agricultural commodities face a supply abundance and record crops which did not bode well amid weakening commodity currencies. Commodities surged by 9.3% in 2016 on the back of an improving oil outlook and a substantial improvement in metals. During the second half of the year, agricultural commodities saw a range-bound movement despite ample supply and the absence of drought concerns, building the case for a better outlook in 2017. Starting the year, we witnessed the firming up of several commodities, namely oil, base metals, and food grains. Multi-year lows are improving global economic conditions, underpinning demand for commodities in 2017; albeit not driving commodity prices substantially higher. Investment in commodities and commodity stocks could hold back further this year on the back of uncertainty, allowing for an upside market correction.

Metal prices rallied following the win of Trump in the US presidential elections on account of his USD1 trillion infrastructure spending plan. Supply constraints from high-cost smelter closures are also expected to contribute to the rise in 2017. Moreover, China and Philippine governments ordered the closure of nickel and tin mines for environmental violations. In addition, Indonesia announced that it is unlikely to remove or suspend its active ban on Bauxite and nickel ore exports. Despite the bullish trend, however, base metals generally are characterized by excess capacity, especially due to heavy recycling. Copper prices surged 17.7% in 2016, standing at USD5,535/ton. The moving seasonality of the Chinese New

Year should have effectively decreased trade volumes in Q1 as China accounts for half of the world's demand for the red metal, copper prices were supported by speculation of the USD1 trillion infrastructure bill in the US. Nevertheless, the US accounted for only 8% of global copper demand in 2015, and the impact of the Trump infrastructure plan should span over 10 years. The link between the copper rally and China's growing infrastructure and construction is well established, making it the largest consumer of the red metal in the world. Therefore, we expect the Chinese economic performance in 2017 to directly impact copper prices. Moreover, the rally which started in October on the back of mine closures is adding to the optimism regarding the start of a new commodity cycle. Fundamentals will determine the direction of copper in 2017. Residual bearish sentiments are still aligned with copper futures, however; demand and supply points at an increasing upside pressure emanating from increased stockpiling in China versus additional supply constraints in Latin America and Asia.

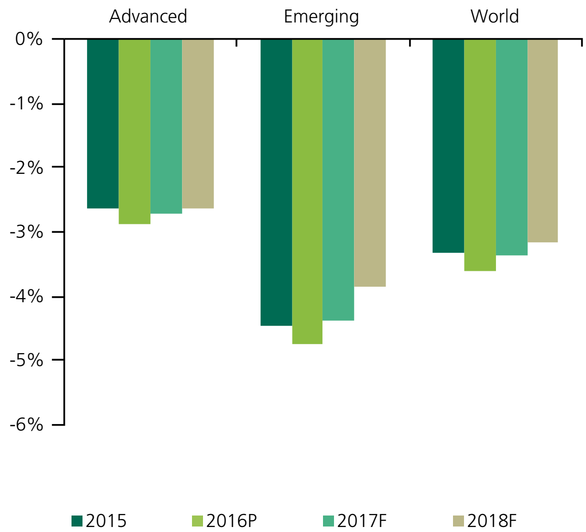
The closures of high-cost and high-carbon print smelters, in addition to ore export bans, will provide support to metals such as aluminum which marked a surge of 12.3% Y/Y, closing at USD1,693/ton by the end of 2016. The demand for aluminum was robust in the past year despite the slowdown in China. According to the National Bureau of Statistics, aluminum semis grew by 0.7% Y/Y in 2016, indicating a meager growth in production, with China consuming around 55% of the global total. Construction and automobile production is expected to keep demand for aluminum high throughout 2017, underpinning prices. Key factors that could impact aluminum in 2017 include a potential supply deficit following the Chinese curtailments of high-cost smelters. In addition, higher coal prices will likely support prices of alumina as coal is an essential input in aluminum processing, according to Alcoa.

5. Central Bank Policy Rates



Sources: Thomson Reuters

6. Fiscal Deficits
(in % of GDP)



Sources: IMF

Falling investment demand on gold in response to a stronger USD and higher interest rates in the US led the yellow metal to fall below the USD1,300 level seen during 2H2016. However, President Trump's recent rhetoric that the dollar is "too strong", coupled with his fiscal stimulus plan pressured the trade-weighted USD to moderate versus a basket of currencies. Consequently, gold prices caught respite, upturning by 8.5% Y/Y by the end of 2016, standing at USD1,152.23/oz. Downside risks for gold in 2017 include strong economic growth and more rate hikes in the US. On the other hand, upside risks include geopolitical tension, stronger physical demand in India and China, and mining shortfalls. The prolonged near-zero interest rate policy aided gold's recovery earlier in 2016 after gold lost its allure to investors as a safe haven. Moving into 2017, interest rate differentials will create more demand for the USD, thus unfavorably affecting gold prices downwards. Agricultural commodities were less bearish in 2016 than the previous year. The S&P/Goldman Sachs Agriculture index edged up by 2.6% Y/Y to 290.9 on the back of range-bound grain price movement. With limited effect from El-Nino, we expect oversupply to cap any recovery to low single digits in 2017, and improved yield prospects for food grains will limit their recovery. However, as global economic conditions improve, and as China adopts a more consumer-driven economic model, prospects remain favorable for food grains as higher production is expected to be met with increasing demand.

Box 1: Oil… Rebalancing in the Offing

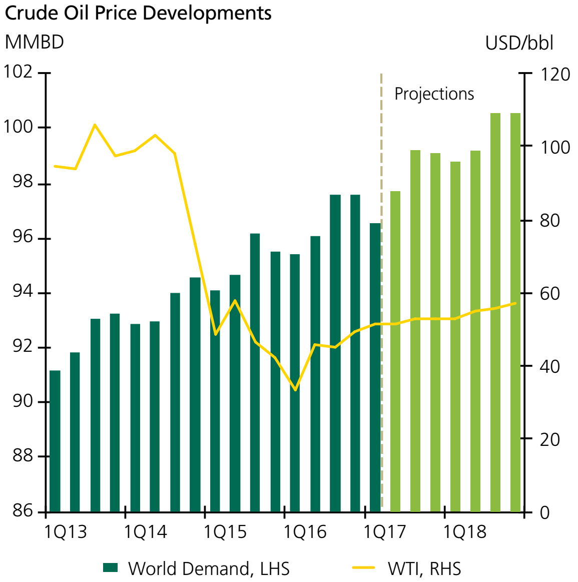
Crude oil had a third annual decrease last year with average prices for Brent and the Arabian light falling by 16.9% and 18.7%, respectively. The oversupply theme gained traction given record crude stockpiles, high production levels and decelerating oil demand growth. Most importantly, OPEC's over quota strategy and growth dynamics pertaining to the stagnation of emerging markets, mainly China, have underpinned this bearish trend and suppressed oil prices for most of last year.

A semblance of normalcy, however, had materialized in oil markets after the first production cut by OPEC since 2008. The cut agreed upon in November 2016 amounted to 1.2 MMBD and became effective starting January 2017, pushing crude prices into a higher range between USD50-60/bbl. The fact that 11 non-OPEC countries agreed with OPEC to cut an additional 558 thousand barrels per day, the first such deal between OPEC and non-OPEC members in 15 years, was also a supporting factor. Increased supplies from Libya and Nigeria that amounted to a combined 260 thousand barrels per day might impact compliance, yet the recent production data had surprisingly underscored a near 100% compliance rate, with Saudi Arabia cutting deeper than it promised. The Kingdom exceeded its compliance target of around 10.1MMBD and is currently producing 9.9MMBD, thus, making up for laggards, notably Iraq, UAE and Venezuela that are falling short on their commitments. The oversupply theme might have eased given the aforementioned, however, shale producers are bringing back a large amount of mothballed production capacity that can limit the upside movement in prices. In the US, oil investment had picked up with a dramatic turnaround in drilling activity, as producers have been able to lock in the price for future production at USD50/bbl. The number of rigs has expanded for nine months in a row, reaching 697 by the end of April, a staggering 121% growth since bottoming-out at 316 in May 2016. EIA expects the annual US oil production to reach 9.0MMBD in 2017 and 9.5MMBD in 2018.

Furthermore, the outlook for global oil demand is weakening amid signs of a slowdown in Chinese demand that is evident from the lower headline GDP growth rates of recent quarters, with the IMF expecting decelerating growth during 2017 and 2018 respectively at 6.6% and 6.2%, a slow pace of growth compared to the 11% registered in 2010. Emerging markets are also projected to expand at 4.8% next year, still well below their ten-year average of 5.6%. The OPEC and IEA are forecasting oil demand to rise between 1.15 and 1.4MMBD in 2017, slower than last year. Record US and global crude oil inventories will also remain a drag on oil markets. US crude oil inventories posted a new record around 520.2 MMbbls during 1Q2017. Additionally, the OECD's commercial total oil inventories, despite falling below the 3 billion barrels by the end of 2016, remains above the five-year average and near the historical high posted in July at 3.111 billion barrels.

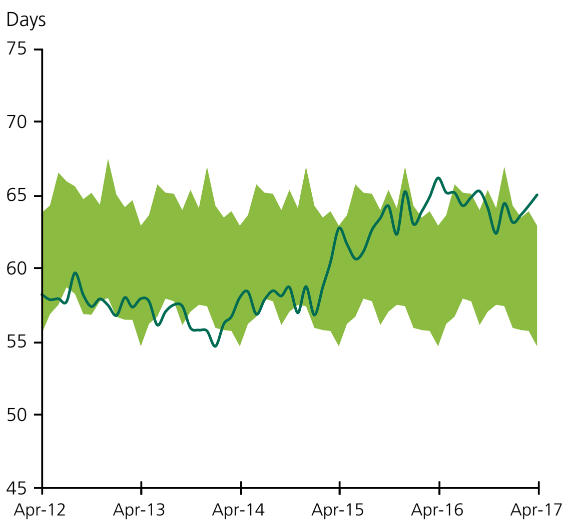
We are not expecting prices to average above USD60/bbl this year, with our Saudi crude export price projection standing at USD51/bbl. The direction of oil prices for the rest of 2017 will depend on the pick-up pace of US shale oil production, and on the impact of OPEC and non-OPEC members recent decision to extend the cuts beyond 2017.

Crude Oil Price Developments



Sources: EIA

OECD Forward Demand Cover



Sources: EIA

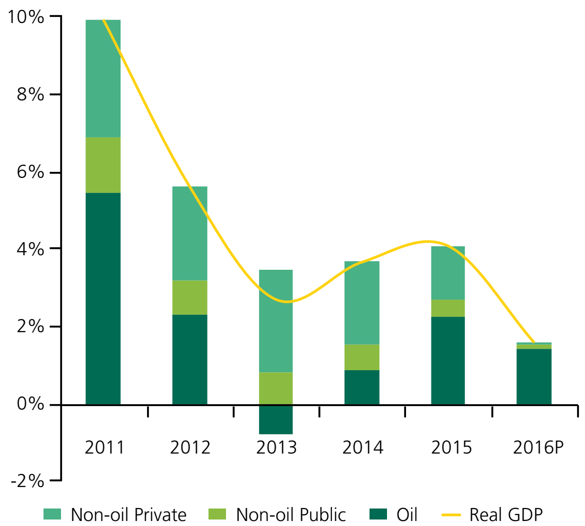
B. Saudi Economic Developments and Outlook

I. Real Sector

The undesirable byproducts of the transformative strategy will weigh heavily on the Saudi economy in 2017 as a contraction is inevitable. The government is pushing the private sector to become the main driver for the economy towards achieving 2020 and 2030 targets. However, the structural shift to lessen the dependence on the government has taken its toll on domestic business activities. In 2016, the economy registered a real growth of 1.4%, underpinned by record oil production as the non-oil sector faltered to a halt. Saudi oil production peaked at 10.7MMBD by July as local demand soared due to the summer season, contributing to a rise in oil GDP by 3.4% last year. The global oversupply theme in oil markets pressured prices for the Arabian Light to average at USD40.9/bbl for 2016, down from USD50.2/bbl in 2015. Consequently, in nominal terms, GDP contracted to SAR2'398.6 billion, declining by 1.9% and registering the second consecutive annual drop. Towards the end of 2016, the surprising inflection in OPEC's strategy to collectively cut production by 1.2MMBD has defined the outlook for the oil sector this year. Ostensibly, OPEC and non-OPEC's decision to extend production cuts beyond 2017 will contribute to a shrinkage in oil GDP real growth by 2.3%. The non-oil sector real growth will marginally rebound to 0.6% as challenges remain in place, yet, we believe the expected private sector stimulus programs to be announced in the coming months to support business activity going forward.

Economic moderation in China, a rebound in US shale production, and an increase in supply from Libya and Nigeria might contain any further upside movement for oil prices. Despite aiming to diversify away from the volatile commodity, oil revenues have the ability to accelerate the pace of progress towards Saudi Vision 2030. In 2016, oil revenues dwindled to SAR329 billion, representing 62.3% of total fiscal revenues as OPEC's "pump at will" strategy pressured oil prices. The objective to squeeze shale producers out of the market was simple, yet, the execution became more complicated as efficiencies and technological advancements, along with sluggish global demand, allowed high-cost producers to survive. By the end of 2016, OPEC and non-OPEC producers' accord of cutting supplies will provide a floor to oil prices around USD50/bbl. OPEC's compliance worries have been subdued by Saudi cutting production below its quota to make up for laggards. On a medium-term note, rebalancing the oil market is dependent on a rebound in global oil demand as inventory levels remain at historical highs. According to our baseline scenario for 2017, we assume oil prices to average USD50.6/bbl and Saudi production to average around its quota of 10.1MMBD, and in turn oil revenues are expected to rebound to SAR445.8 billion, 35.5% higher than 2016.

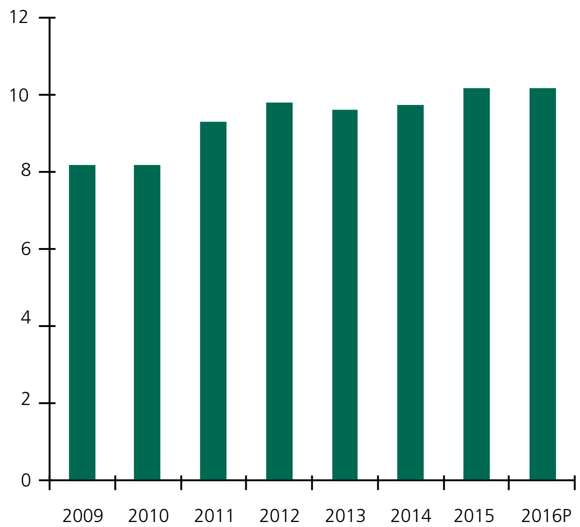
7. Real GDP Growth, Contribution



Sources: SAMA and NCB

8. Saudi Crude Oil Production

MMBD



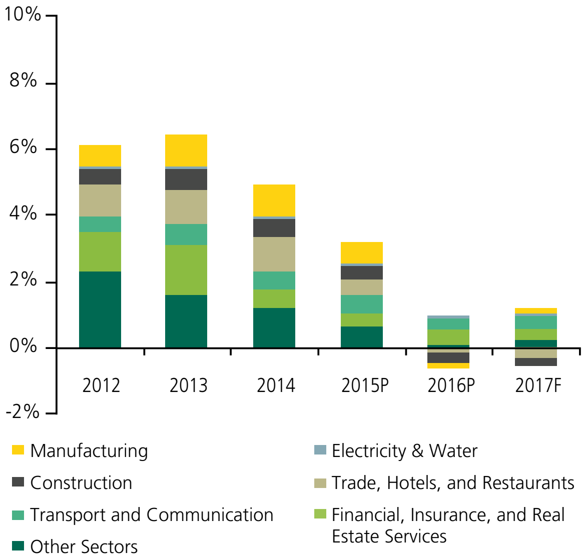
Sources: OPEC and NCB

The non-oil sector will retain its slow pace, marginally growing by 0.6% in real terms, due to government expenditure rationalization that pressured business and consumer sentiment. The high frequency of policy changes created an "announcement fatigue" last year, and as such the Fiscal Balance Program 2020 was revealed to alleviate the uncertainties regarding the government's direction. Business and consumer confidence has been negatively impacted since the oil collapse, although, adopting a gradual and transparent fiscal plan is expected to improve domestic and international sentiment. The deceleration in business activity is captured through the downfall in corporate lending, which registered a benign 0.5% gain by the end of 2016, well below an average of 12.6% annual gain during the period 2012-2015. Additionally, consumer sentiment, gauged by cash withdrawals and Points Of Sale (POS) transactions had been indicative of the aforementioned. During the first two months of 2017, cash withdrawals declined by 9.6% Y/Y, while POS transaction values retreated by 0.3% annually as consumer spending behavior adapted to public sector employee allowance cuts and adjusts for the anticipated subsidy reductions during the second half of 2017. Additionally, the expatriates' dependants levy, which is planned to be introduced in 3Q 2017, will gradually diminish non-Saudi residents' disposable income as annual increments will be charged per worker and their dependents. We expect raising the cost of non-Saudi employment will minimize the wage differential between Saudi and non-Saudi employees, thus, encouraging businesses to increase Saudization. However, the Fiscal Balance program aims to lessen the burden on Saudi consumers through the Citizen's Account program, which will cover beneficiaries earning up to SAR20'000 per household, which includes low and middle-income brackets as the average Saudi salary is SAR6'048, according to GOSI's 2015 Annual Report.

The government is embarking on a grand capital expenditure optimization program, which had already targeted 5 ministries and saved SAR100 billion through the first phase by reviewing SAR220 billion worth of projects. Additional phases will tackle projects worth a colossal SAR1.18 trillion over the next four years to cover all government sector's projects. The Minister of Finance recently announced that regulatory hurdles are being tackled by policy makers to accelerate approval procedures as government agencies are delegated with higher monetary authority. Also, plans for an "almost interest-free" loan program for labor-intensive industries is expected to be finalized soon to form a safety net and assist in rescheduling their debt burdens. As for the general sentiment, a Royal decree restoring public employee allowances is expected to spur the retail sector which suffered throughout the past two quarters. In addition, the decree included a 2-month salary bonus for actively engaged military personnel. We do believe the retail industry will experience a transient spike in the second half of 2017 as consumers attempt to avoid a 5% price hike in 2018 due to the Value Added Tax, yet over the medium-term, fiscal consolidation will limit the upside potential for the retail sector.

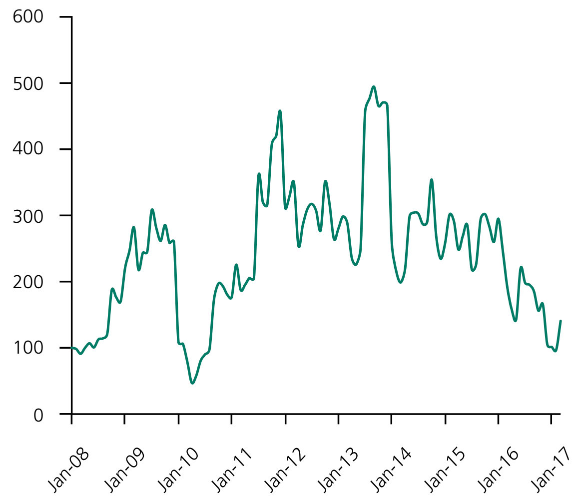
According to NCB's Construction Contracts Awards Index, projects activity rebounded in the first quarter of 2017 as the index reached 140.7, up from 105.2 by the end of 2016. Total value of contracts awards in 1Q 2017 reached SAR33.2 billion, with the transportation sector being the top recipient at 52.1%, while the water and petrochemicals sectors registered 12.3% and 9.2%, respectively. During last year, the majority of contracts awarded were attributed to the oil and gas sector which reached above SAR40 billion. Meanwhile, the real estate sector was the second most active by value as homeownership remains a high priority within the government's initiatives. We believe the construction sector will continue to consolidate over the next two years as the government targets economically viable and efficient projects.

9. Non-oil GDP Growth, Contribution



Sources: SAMA and NCB

10. NCB Construction Contracts Awards Index

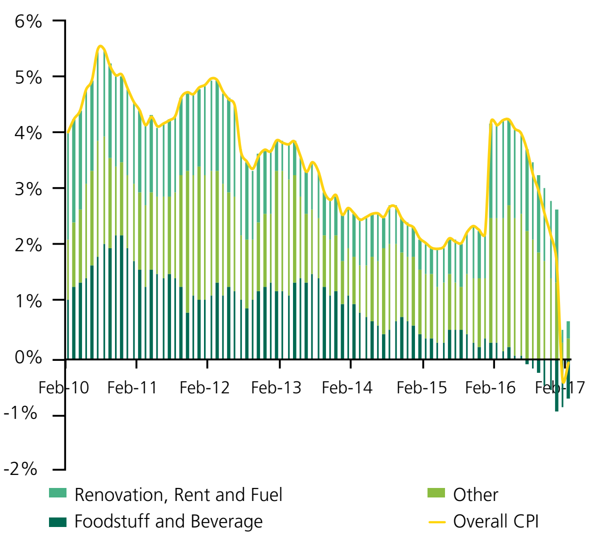


Source: NCB and MEED Projects

Foreign direct investments are expected to rise as the government aims to become globally integrated through economic diversification. In its pursuit to create the world's largest sovereign wealth fund with a value of SAR7 trillion, the Kingdom will create international ties with leading economies and businesses. We believe the spillover effects will benefit FDI inflows as non-oil sectors gain traction going forward. According to the World Investment Report 2016, issued by the United Nations Conference on Trade and Development, the Kingdom was the third-largest Foreign Direct Investment (FDI) recipient in West Asia, with receipts totaling USD8.1 billion in 2015, rebounding by 1.6% on an annual basis. Consequently, the share of FDI in gross fixed capital formation rose to 4.9% in 2015, up from 4.2% in 2014. Additionally, the 2016/17 Global Competitiveness Report prepared by the World Economic Forum ranked Saudi Arabia at 29 out of 138 countries, ahead of Spain, Indonesia and Turkey. The current efforts towards becoming an "e-government" is expected to encourage investments and increase the appeal of the Saudi market. The Saudi demographic supports emerging opportunities through horizontal diversification as 49% of the population is below the age of 25. Moreover, the current labor force participation rate of 42%, which is comparatively low, signifies the potential of tapping a young and ambitious population.

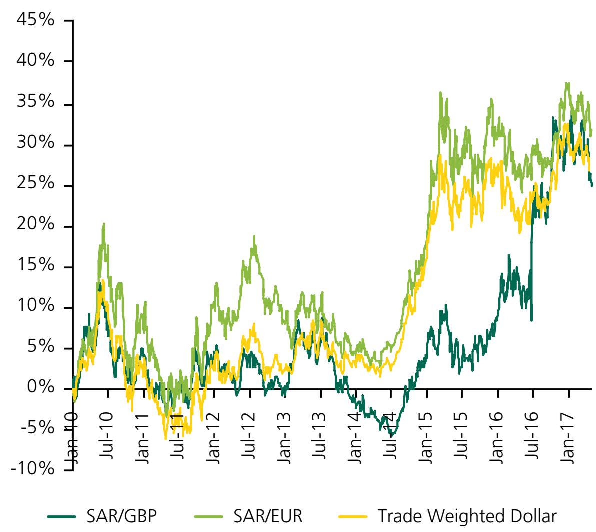
Further subsidy reductions in the second half of 2017 will lift consumer prices higher, however, the Citizen's Account program will aim to mitigate the impact for low and middle-income beneficiaries. Higher water, electricity, and fuel prices in 2016 supported rising consumer prices as the inflation rate spiked to 3.5% Y/Y following 2015's 2.2% Y/Y increase. The strength of the USD limited the upside potential for prices by reducing imported inflation. This contributed to the continued deceleration in the largest component of domestic inflation, food and beverages, which recorded a contraction of 0.6% for 2016. Towards the end of last year, the government announced the suspension for one third of public employees' allowances for the current Hijri year. Consequently, consumer sentiment took a downward trajectory and demand faltered, pressuring prices lower. The government reacted by delaying further subsidy cuts through the Fiscal Balance Program until July, allowing time to establish the Citizen's Account initiative, which is expected to disperse grants by June. Additionally, we believe the uncertainty revolving around the Ministry of Housing's initiatives and implementation of white land tax will contribute to weakening the real estate market albeit supporting rental prices. Meanwhile, additional taxes on harmful goods such as tobacco and soft drinks will also underpin consumer prices. We expect the inflation rate to average around 2.5% in 2017 largely driven by cost-push inflation, further undermining weakening consumer demand.

11. Drivers of Inflation



Sources: SAMA

12. Imported Inflation
(January 2010 = 100)



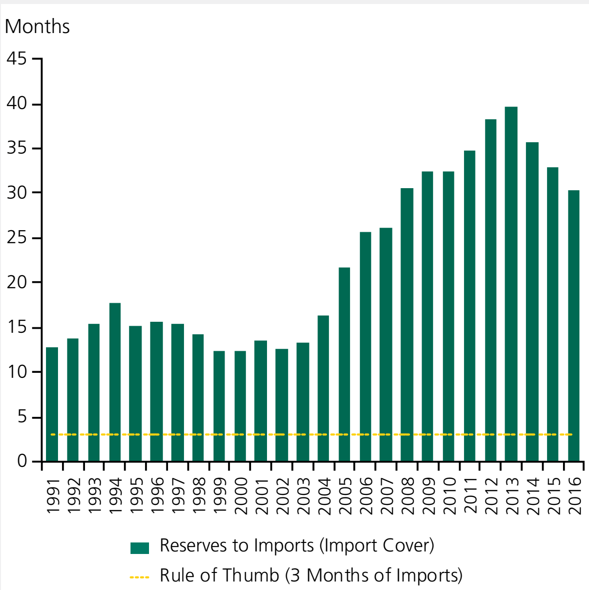
Sources: Thomson Reuters

Box 2: Assessing Adequacy of Saudi Reserves

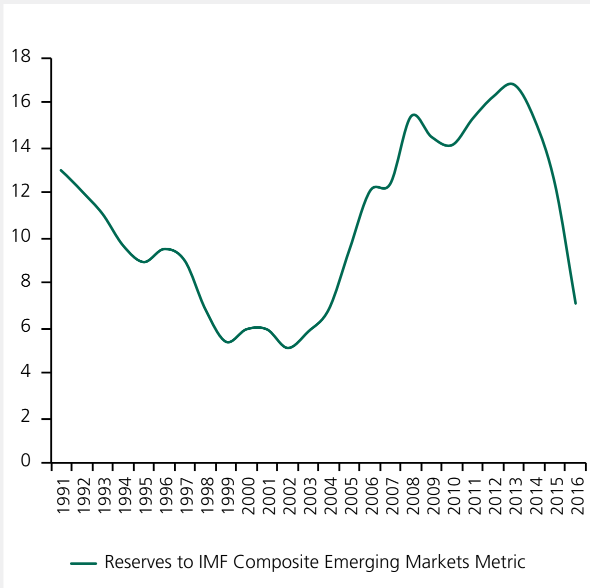
Gauging the macroeconomic risks through the adequacy of reserves, debt level, and financial stability reveals that the Kingdom is well poised to encounter possible future shocks. Despite the increase in public debt to GDP, which reached 13.2%, it remains low in comparison to international counterparts like Japan and the US that respectively registered 253% and 108%, while also faring better than regional economies, with the UAE and Kuwait posting 19.3% and 18.6%, respectively. On the banking side, the currently contained non-performing loans (NPL) ratio illustrates the prudent management and supervisory practices that have been applied by banks and SAMA. By the end of 2016, banks registered an industry-wide NPL ratio of 1.2%, in comparison to the 1.9% recorded during 2004-2008.

Reserves in the form of net foreign assets provide a critical source of liquidity support to an economy during unfavorable business cycles. The optimal level of reserves depends on economic maturity, cross-border financial transactions, size of banking system and the degree of openness of the capital account. As such, there are myriad individual metrics to assess reserve adequacy in the event of a shock, notably: (1) import coverage that is used to measure the ability to sustain imports of goods and services, with the benchmark usually used being three months' coverage, (2) reserves to short-term external debt, which measures a country's rollover/refinancing risk, with 100% coverage as the standard for emerging economies. This had been a critical metric since the 1997 East Asian financial crisis that was triggered by these countries' plunging currencies that inflated their debt burdens given the high dependence on short-term foreign lending, and (3) the ratio of reserves to money supply that is concerned with the impact on capital accounts from the risks of capital flight during a crisis. The standard of adequacy for this measure is usually cited at 20%.

Assessing the sufficiency of the Kingdom's net foreign assets given the aforementioned metrics underscores the lack of immediate stress, with all the measurements above the agreed upon adequacy standards. By the end of last year, net foreign assets covered around 30 months of imports and were also 12x the short-term external debt level whether private or public. As for the adequacy compared to the broadest measure of money supply, which in the case of Saudi can be M2 that includes demand and time & savings deposits, the ratio was at 130%, well above the 20% threshold. However, given the fact that global and regional economic crises did exhibit stress via multiple channels, the use of a metric that combines most of these variables is more realistic in capturing a range of risks than individual measures. Accordingly, the IMF metric for emerging markets with fixed currency regimes has been used since it assesses the adequacy of reserves relative to short-term debt, other liabilities, money supply as well as accounting for exports that will be negatively impacted during shocks. Even after applying this all-encompassing metric, Saudi reserves remained adequate at 7x, despite declining since 2013, which implies that the economy can cover its financing needs, withstand capital outflows and sustain its imports.



Sources: NCB and SAMA



Sources: NCB and IMF

II. Fiscal and External Balances

The fiscal deficit is expected to remain in place for the fourth year running, yet it will fall from the double digits to the single digit at 7.5% of GDP, amounting to SAR190 billion. The government adopted a targeted expansionary fiscal policy for 2017, targeting projects and initiatives that enhance the absorptive capacity of the economy. Underestimating revenues and expenditures is a discarded practice by the government as a disciplined and realistic approach ensures budget overruns are avoided here on after. Our baseline scenario assumes Arabian light spot prices to average around USD50.6/bbl this year, a rise of 24.0% over 2016, undermining the decline in crude production to 10.1MMBD as OPEC extended the production cut agreement beyond 2017 to reach the demand/supply balance needed for an upward price movement. Accordingly, we expect oil revenues to rise to SAR445.8 billion. Meanwhile, the active portfolio strategy undertaken by the government will increase SAMA's investment returns which represented 38.8% of total non-oil revenues last year. Additionally, the excise tax on harmful goods, expat dependant's levy, and water and energy price reforms will boost non-oil revenues to SAR254.2 billion in 2017, a gain of 27.7% annually. On the expenditure side, we believe the government will enforce a strict budgetary oversight to limit the expense bill at SAR890 billion, increasing 7.9% on an annual basis due to a rebound in capital expenditures which offset the decline in current expenditures. However, geopolitical tensions in the region act as the main risk for the economy going forward, in addition, the global macroeconomic backdrop and domestic liquidity remain downside risks, while a resolution to the Yemeni war would support the economy to the upside.

The current account deficit will narrow to 1.5% of GDP in 2017 as the rebound in oil markets lifted Saudi exports. Despite producing less oil, we expect oil export revenues to increase by 13.4% Y/Y to reach SAR571.5 billion this year. The vertical diversification of hydrocarbons allows Saudi to secure a larger share of the value chain as non-oil exports are expected to grow at a faster pace at 17.5% on an annual basis. Total non-oil exports are likely to reach over SAR200 billion in 2017 with petrochemicals and plastics constituting over 60%. The main exporting regional destinations for the Kingdom are the GCC, mostly for re-exporting purposes, and the Asian markets which had suffered last year due to China's moderation. Downside risks for our projections can arise from a deceleration in Chinese GDP growth below the targeted 6.5% and a compliance failure in OPEC production quotas, raising global supply and ultimately pressuring oil prices downwards. Last year, total imports settled at SAR456.6 billion, declining by 22.1% Y/Y from SAR586.2 billion in 2015, as consumer demand faltered and government rationalization efforts heavily impacted the projects market. Settled Letters of Credit (LC) for building materials dropped 12.3% and 19.6% in 2015 and 2016, respectively, while settled LCs for machinery plunged 25.9% and 34.5%, respectively, over the past two years. As a forward looking indicator, newly opened LCs declined by 27.2% in 2016 which is expected to undermine growth of total imports for 2017. On a medium to long-term note, government localization efforts and energy efficiency measures will limit upside potential movements for imports and domestic oil consumption. Accordingly, we believe the current account will return to the positive territory from 2018 onwards as oil prices steadily rise and the import bill is contained.

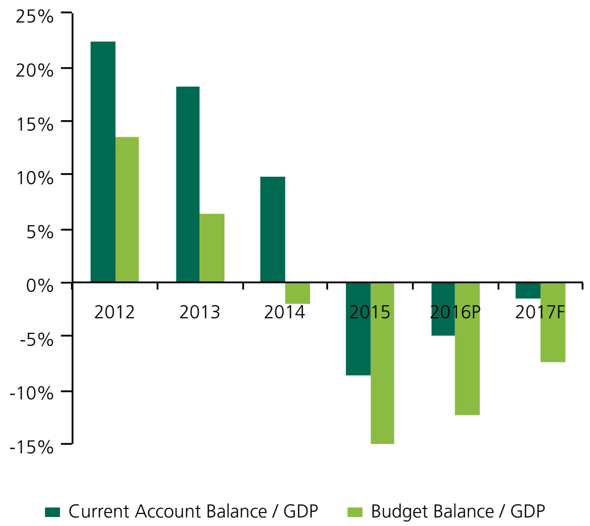
13. Government Revenue and Expenditure Balance

SAR billion	2015	2016	2017 Budget	2017 Forecast
Total Revenue	**612**	**528**	**692**	**700**
Oil	446	329	480	446
Non-Oil	166	199	212	254
Total Expenditure	**978**	**825**	**890**	**890**
Current	714	660	628	659
Capital	264	165	262	231
Deficit/Surplus	**(366)**	**(297)**	**(198)**	**(190)**

Sources: MOF and NCB

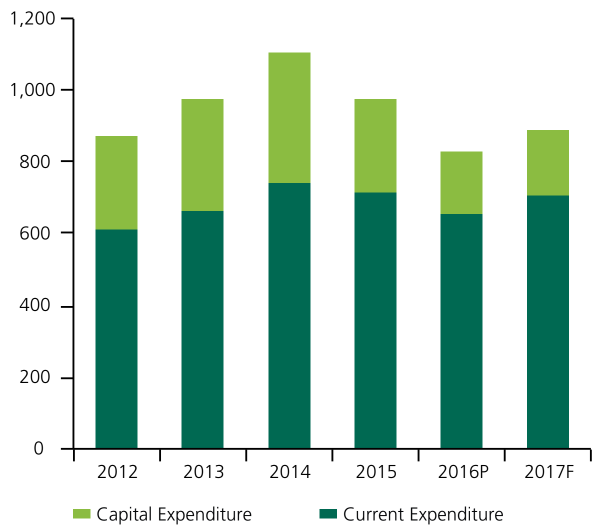
The government is expected to lessen the pace of reserves withdrawal and rely on issuing debt as the former is needed to lock-in low interest rates. Oil prices in 2016 dropped 18.7% over the previous year, pressuring the Kingdom's twin balances into the negative territory for the third year running. Accordingly, Moody's cut Saudi's debt rating by one notch to A1, stressing the challenges ahead on government finances. In addition, Fitch had recently downgraded Saudi's credit rating to A+ from AA- over concerns regarding reform execution plans. Continuous drawdowns pressured net foreign assets to settle at USD502 billion by the end of March 2017. Despite the fall from a peak of USD738.1 in August 2014, net foreign assets provided an import coverage of 52.2 months for goods by the end of last year. Furthermore, the Kingdom has adopted a dual strategy of domestic and international debt issuances to relieve the strain on domestic liquidity. Public domestic debt rose to 13.2% of GDP last year and we expect a rise to 17.1% in 2017, comparatively low to global and regional counterparts. The establishment of the Debt Management Office will seek another international issuance in 2017, along with domestic issuances worth an expected SAR70 billion, in tandem with withdrawals from foreign assets to plug the narrowing fiscal gap. As such, Moody's and Fitch maintained a stable outlook for the Saudi economy.

14. Twin Deficits



Sources: SAMA and NCB

15. Government Expenditure
SAR billion

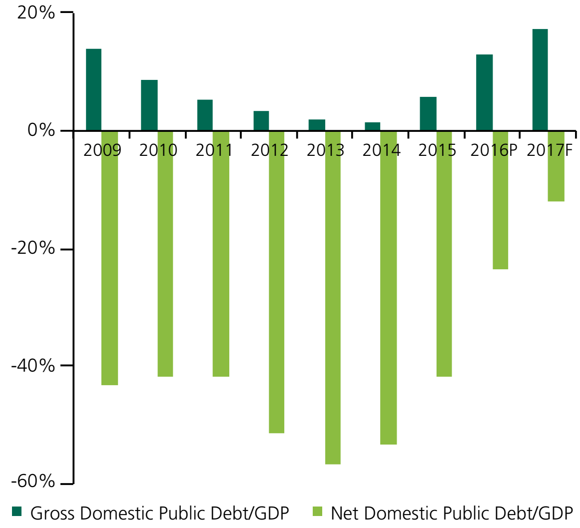


Sources: SAMA and NCB

The National Transformation Plan and the Fiscal Balance Program provide the blueprints for fiscal consolidation till 2020, setting the stage towards Saudi Vision 2030. History often repeats itself and the government is well aware of the challenges and pressures the Saudi economy endured towards the end of the 1980s up until the early 2000s. During that era, the Kingdom became accustomed to fiscal deficits and was burdened as debt to GDP rose above 100%, while net foreign assets bottomed out at USD37.9 billion in 1999. While the Kingdom had been regularly overrunning the budget, fiscal pressures resulted in record deficits that risked the stability of the economy. The oil collapse which ensued since 2014 pressured prices to below USD25/bbl by 2016. Accordingly, Saudi Vision 2030 aims to decouple the Kingdom from the volatile commodity. The initial phase through the National Transformation Plan and Fiscal Balance Program targets fiscal consolidation by the year 2020. Government expenditures are swiftly manageable relative to the exogenous nature of revenues. As such, the gradual implementation of fiscal reforms will provide a solid footprint and the needed firepower to accelerate economic growth post 2020. Additionally, the recent announcement of 10 new programs to achieve Vision 2030, most notably Housing, Strategic Partnerships, Privatization, and Improving Lifestyle, reflects the government's focus on social and economic development that will bolster investments in infrastructure, education, healthcare, and human capital. Economies around the globe have undergone such transitions, China represents an ongoing case that is willing to sacrifice double-digit growth figures to shift from manufacturing towards a service based economy that provides sustainability and prosperity.

Saudi Arabia is adamant on maintaining its new found fiscal discipline, evident by the firm stance on expenditures going forward, particularly by launching the Spending Rationalization Office that is reviewing SAR1.4 trillion worth of projects. Fiscal base case and stress scenarios announced by the government reveal expenditures are set to be limited below the SAR1 trillion, while revenues are reflective of oil prices, oil production, and non-oil revenue scenarios through 2020. In our assumptions, we expect the fiscal balance to turn positive in 2020, registering a surplus of SAR89.6 billion, or 3.1% to GDP, and maintain an upward trend to reach over SAR350 billion by 2030. We believe a recurrence of oil prices above the USD100 mark as extremely unlikely, barring major political uncertainties, resulting in oil revenues reaching around SAR670 billion while non-oil revenues are targeted to reach SAR1 trillion. The government's cost control measures is aiming to contain operational expenditures and maximizing the economic value of capital expenditures, which will progressively raise expenditures to around SAR1.3 trillion by 2030. Through privatization programs and plans to increase local content, the private sector's contribution to GDP is targeted to reach 65%, which is expected to increase non-oil exports to 50% of non-oil GDP. The cumulative outcome of the myriad programs is expected to increase the size of the domestic economy by almost twofolds to become the 15th largest economy globally, ahead of the likes of Switzerland, Turkey, and Mexico.

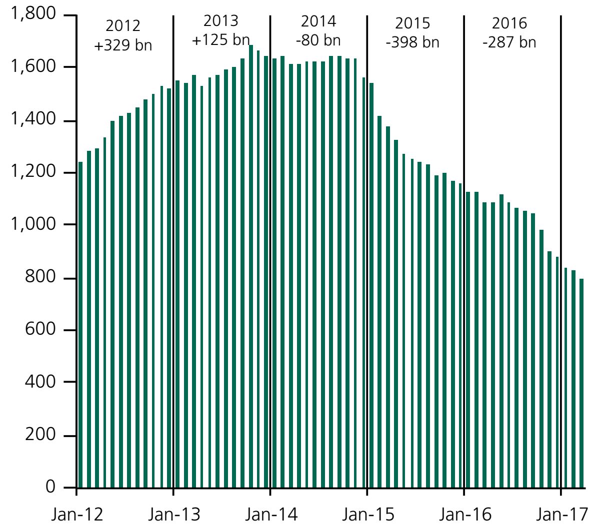
16. Domestic Public Debt



Sources: SAMA and NCB

17. Government Deposits at SAMA

SAR billion

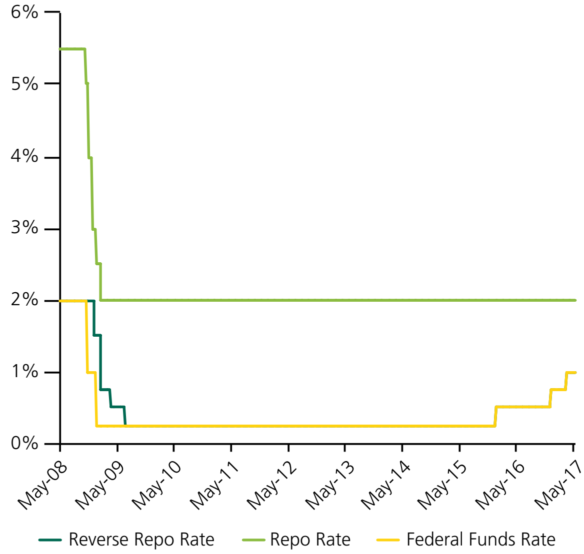


Sources: SAMA

III. Monetary Developments

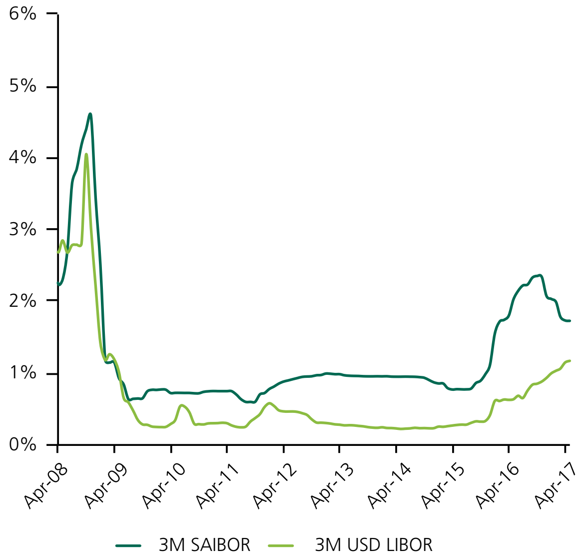
Liquidity concerns have been mitigated by SAMA's interventions in 2016 coupled with the response of the Debt Office Management to tap international markets. Following eight months of consecutive declines, money supply returned to the positive territory in October driven by liquidity injections which included the sale of sovereign bonds by the size of USD17.5 billion. Broad money supply (M3) concluded year 2016 positively, albeit registering a mediocre annualized growth of 0.7%, standing at SAR1.78 trillion. The monetary base (M0) edged up by 0.3% Y/Y to SAR302.4 billion in 2016 affected by a deceleration in currency outside banks and banks deposits with SAMA. Bank deposits with SAMA faired at SAR102.2 billion, inching down by 0.4% Y/Y amid tighter liquidity. Demand deposits which make up around 55% of money supply ended the year on a negative tone, inching down by 0.2% Y/Y to SAR974.1 billion. A higher preference to save during the low economic cycle has been explanatory for the double-digit surge of 13% Y/Y in time and savings deposits which account for 27% of money supply at SAR491.6 billion. In our opinion, liquidity will find some respite given the recent Royal Decree to restore public employee allowances and the expected pick up in the oil market which will trickle down into the monetary system.

18. SAMA and US Federal Reserve Policy Rates



Sources: Thomson Reuters and SAMA

19. Interbank Market Rates



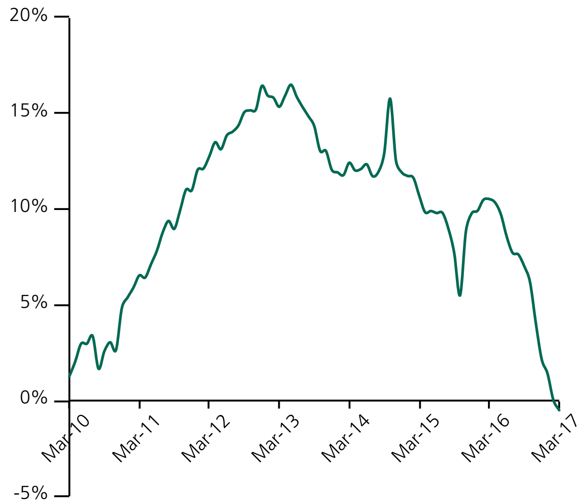
Sources: Thomson Reuters

Tough funding conditions are expected to be encountered as the macroeconomic backdrop continues to pressure the loans market in 2017 and 2018 given that economic restructuring will lessen the need for financing during the transitional phase. Annualized growth in private sector credit recorded the lowest rate since April 2010 at 2.2% Y/Y as lower economic activity translated into lower demand for financing. The divergence between loans and deposits resulted in tighter liquidity domestically. However, following the direct cash injections made by SAMA, the loan-to-deposit ratio stood at 86.6% by the end of December, reflecting that demand on credit began to moderate alongside deposits. The liquidity squeeze is expected to ease in 2017 as SAIBOR fell to 1.73% by the end of the first quarter of 2017. The differential between SAIBOR and LIBOR has converged to settle between 50-60bps as the Fed continues its normalization policy. By maturity, the allocation of credit remains mostly focused on short-term by around 50% whereas the composition of medium and long-term credit is around 20% and 30%, respectively. Credit by economic activity shows that commerce remains dominant by 21.4%, a value close to SAR300.1 billion. Secondly, the manufacturing and processing sector accounts for 12.6% of total credit at SAR176.4 billion, followed by the building and construction sector which accounts for 7.5% of total credit at SAR104.4 billion. We note a deceleration across the board in credit activity to lower single digits, and a contraction of 1.3% in the case of credit towards building and construction related activities.

20. Growth in Money Supply

Sources: SAMA

21. Growth in Private Sector Credit



Sources: SAMA

IV. Financial Sector

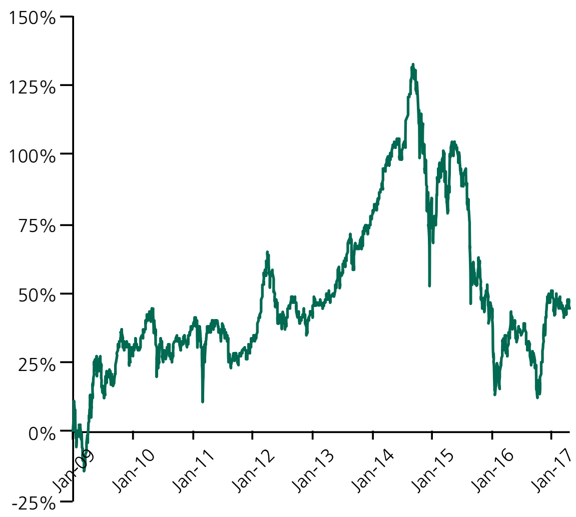
The elevated economic and credit risks triggered a wait-and-see approach by Saudi banks as the excess reserve ratio increased to 53.7%, the highest level since January 2014. The domestic banking system has been pressured since 2014 and up until October 2016 as liquidity tightened amid the government's local bond issuances, driving the loans-to-deposits (L/D) ratio above the 90% limit set by SAMA. Reduced oil revenues have decreased the flow of money into the banking system as total deposits stagnated with a marginal growth of 0.8% Y/Y in 2016. Banks are maintaining their depositary base by offering lucrative time and savings rates, made easier by the current low interest rate environment, however, two more hikes are anticipated by the Fed in 2017 and another three in 2018 which will raise banks' cost of funds over the medium-term. As for the loans market, growth decelerated to 2.8%, the slowest pace since 2009, reaching SAR1.4 trillion by the end of 2016. Banks are pressured by alternative financing channels, namely capital markets as well as conventional and Islamic bond markets, which should encourage local banks to become more innovative to entice a shrinking customer base. Banks are keen on mitigating default risks by allocating provisions which have increased to SAR31.5 billion, rising 15.4% Y/Y in 2016. Additionally, NPLs have increased by 11.3% annually, concentrated mostly in the construction and manufacturing sector, registering a share of 21.2% and 20.2%, respectively. Looking forward, past due but not impaired loans, which have increased by 24.4% Y/Y, are indicative of future strains on the banking system, a natural occurrence during a moderating business cycle. However, we do not expect much of the past due payments to become impaired given that the government pledged to settle any payments within 60 days and the recent Royal Decree restored public employee allowances. The government is expected to announce stimulus packages targeting the private sector over the coming months which will provide banks with a strategic direction going forward.

Despite rebounding towards the end of the 2016, Tadawul maintained a divergence from its international counterparts this year. Tadawul broke a two-year decline trend by turning from a bear market into a bullish one towards the end of last year. OPEC's announcement on an agreement of a production cut underpinned an inflection in market sentiment following the impact of the Royal decree pertaining to freezing salary allowances, the approval of JASTA, and expectations of lower corporate profitability. Consequently, Tadawul recovered its loss of 21.6% and registered a 4.3% gain by the end of 2016. Investors' appetite, represented by the average daily trading volumes, fell during the first quarter of 2017 to SAR3.9 billion, 16.7% below last year's average of SAR4.6 billion, underscoring a wait-and-see approach that had been adopted by businesses as the structural challenges due to economic reform unfold. Opening the local market to Qualified Financial Investors (QFI) failed to attract substantial investments as they represented 0.3% of total market capitalization by the end of this first quarter of 2017. Hence, the Capital Market Authority and Tadawul have been accelerating reforms and the recently changed settlement cycle to T+2 and relaxed revisions to QFI requirements, along with a reclassification of sectors according to GICS standards will enhance the transparency of the market. These developments will pave the way for an upgrade to an emerging market status and in turn inclusion into MSCI indices within 2019, thus providing significant capital inflows into the market.

Tadawul launched a parallel market, Numo, to provide SMEs a new source of financing in the region. Listing requirements are less stringent than the primary market as minimum capital is reduced from SAR100 million to SAR10 million, leaner financial disclosure deadlines, as well as lowering the minimum offering share to 20% from 30% in order to ease entry into capital markets for domestic and GCC businesses. Additionally, investors must qualify to trade in Numo by holding a CME-1 certification, conducting a minimum of SAR40 million worth of transactions through at least 10 deals in each of the past four quarters, and maintaining an average portfolio above SAR10 million over the past twelve months. CMA is targeting to attract 30-35 companies in the first year and will allow foreign investors to access Nomu similarly to Tadawul. During 2016, only three companies listed their shares on Tadawul as the broader economic cycle delayed expansion and capital funding plans. We do not expect private sector businesses to approach the primary capital market, yet, the government's privatization program might counter the slowdown on the part of businesses, especially that the National Center for Privatization was established with the aim of privatizing sectors such as utilities, healthcare and education.

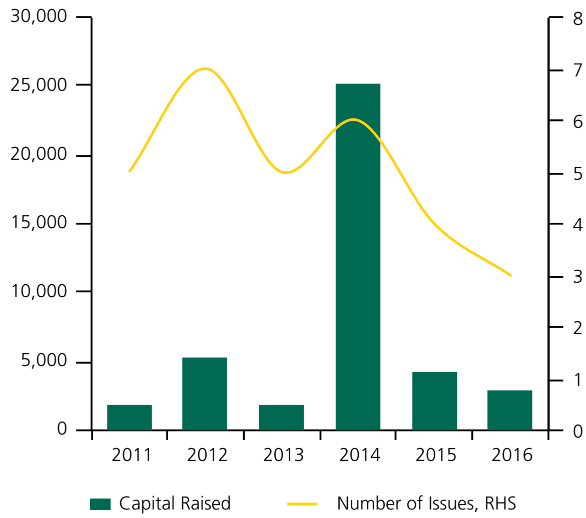
The Islamic financing alternative, sukuk, might find respite from a contracting banking sector as Saudi Vision 2030 requires multiple financing channels. The global Islamic financial market is expected to have reached USD2.2 trillion in 2016 according to Thompson Reuters' Islamic Finance Development Report. By the end of 2015, the Kingdom held the majority of Islamic finance assets, amounting to USD446.7 billion, ahead of Iran, Malaysia, and the UAE. Global issuances rebounded following a three-year downturn and registered a gain of 13.2% Y/Y in 2016, reaching USD74.8 billion. As governments reduced their spending programs, sovereign issuances dropped drastically and corporate sukuk issuances represented a share of 63.2% in 2016 on a global scale. However, new issuances in the Saudi market have deteriorated with the collapse in oil prices, hindering expansion projects and undermining the need for financing. In 2017, Aramco raised USD3 billion from a debut sukuk sale with a 7-year tenor while Dar Al Arkan issued a 5-year tenor sukuk worth USD500 million at a rate of 6.875%, with book-building requests reaching USD1.1 billion, indicating that investor appetite for the Islamic alternative is still present. As for the government, following the expected fiscal realignment within 2020, Saudi Vision 2030 is expected to support Islamic financing prospects. Accordingly, the government tapped international market by issuing dollar denominated sukuks with a value of USD9 billion, split between 5-year and 10-year tranches. The sale follows last year's conventional bond issuance of USD17.5 billion, an emerging market record. The government's debt office management is utilizing various financing products to plug the nation's deficit which will provide local businesses with a benchmark for future long-term issuances. Challenges over the medium-term for the Islamic bond market emanate from a subdued oil market, low business sentiment, and a rising interest rate environment.

22. Saudi Equity Market Index
(January 2009 = 100)



Sources: Tadawul

23. Saudi IPO Issuance
SAR million



Sources: Tadawul

IV. Risks

The Kingdom utilized a portion of its net foreign assets to plug the fiscal deficits over the past couple of years, yet, USD507.5 billion as of February 2017 remains a significant buffer for tackling further shocks to the domestic system and provides around 50 months coverage of imported goods. Additionally, capitalizing on Saudi's sovereign credit rating, the government issued international bonds and Islamic sukuk to reduce the strain on domestic liquidity experienced last year. Gauging the risks on the banking system through the capital adequacy ratio (tier-1) reveals that banks are comfortably above Basel III requirements at 17.5% by the end of last year. The NPL ratio for the banking system had recently increased, however, the coverage ratio is adequate at 178.3%, effectively mitigating the risks from the construction and manufacturing sectors. Rating agencies have maintained a stable outlook for the Kingdom, as further fiscal discipline and a rebound in revenues throughout 2020 will improve its sovereign financial position.

A major risk to our economic outlook is the absence of a long-term resolution to the geopolitical tensions in the region. Despite the importance of securing the Kingdom's borders, the Yemeni war continues to burden the government's finances amidst low oil revenues. Additionally, the six-year civil war in Syria poses a significant threat to the region as tensions between the US, Russia, and Iran intensified following the use of chemical weapons. Although a heightened military scenario will support oil prices and Saudi's oil revenues, an ensuing regional conflict would result in negatively impacting consumer and investor sentiment. Globally, North Korea's missile test defiance against western nations threatens to destabilize global macroeconomics. In addition, the nationalist movement which resulted in appointing Theresa May to steer the UK towards a Brexit, followed by Donald Trump being elected president of the US, as well as the populist candidates in France, Italy, and the Netherlands that are gaining supporters could trigger global trade protectionism similar to the era post the first World War.

24. Key Systemic Macro and Banking Sector Risk Indicators

	2010	2011	2012	2013	2014	2015	2016
1. Macro Risks							
Overall Budget Balance/GDP	4.4%	11.6%	13.6%	6.4%	-2.0%	-15.0%	-12.4%
Gross Domestic Public Debt/GDP	8.5%	5.4%	3.6%	2.1%	1.6%	5.8%	13.2%
Net Domestic Public Debt/GDP	-41.8%	-41.9%	-51.5%	-56.5%	-53.5%	-41.7%	-23.3%
Net Banking Sector Claims on the Government (SAR bn)	(931.6)	(1,140.4)	(1,474.3)	(1,591.9)	(1,507.6)	(1,076.4)	(697.0)
Overall Current Account Balance/GDP	12.7%	23.6%	22.4%	18.1%	9.7%	-8.7%	-4.9%
Net Factor Income/Merchandise Imports	5.6%	6.8%	6.6%	7.7%	8.8%	6.9%	5.3%
Net Foreign Assets/Imports of Goods and Services	254.3%	272.0%	302.9%	313.7%	281.4%	249.3%	271.6%
Net Foreign Assets/M2	178.8%	188.2%	200.5%	199.8%	176.2%	144.5%	121.2%
Merchandise Import Coverage (1YR ahead imports, in months)	54.8	54.0	55.3	56.6	55.4	46.7	52.2
2. Banking Sector Systemic Risks (12 Locally Incorporated Banks)							
Loan-to-Deposit Ratio	73.9%	74.2%	75.9%	77.4%	77.4%	82.5%	83.2%
Minimum Risk Assets/Total Assets	34.9%	33.8%	32.7%	31.4%	31.8%	29.1%	29.8%
Cash and Balances with SAMA/Total Assets	11.1%	11.7%	12.5%	10.6%	9.5%	6.8%	10.8%
Tier 1 Capital Adequacy Ratio	16.6%	16.1%	15.8%	16.4%	16.2%	16.2%	17.5%
Non Performing Loan (NPL) Ratio	2.9%	2.3%	1.9%	1.4%	1.1%	1.1%	1.2%
NPL Coverage Ratio	115.7%	133.2%	145.3%	157.4%	182.9%	171.9%	178.3%

Sources: Financial statements of commercial banks, SAMA and NCB

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