Saudi Economic Perspectives | 2018

Policy Dynamism to Stimulate Growth

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Policy Dynamism to Stimulate Growth

- Real GDP is projected to grow by 1.8% this year as non-oil GDP is also expected to support the economy by increasing 2.8% on an annual basis. Despite recent discussions of adjusting the OPEC and non-OPEC oil production cut agreement, we do not expect a substantial increase in Saudi oil production. As such, Saudi production is expected to average at 10MMBD, resulting in real oil GDP to marginally increase by 0.5% on an annual basis. Recent announcements underscore adamancy on the part of the government to utilize the realized savings from streamlining expenses towards stimulating economic growth, which is apparent from elevated budget allocations to capital expenditures, the National Transformation Plan (NTP) stimulus, the PIF medium-term strategy, and government support measures notably to low and middle-income brackets. Accordingly, we expect private non-oil GDP growth to accelerate, reaching 2.2% in 2018.

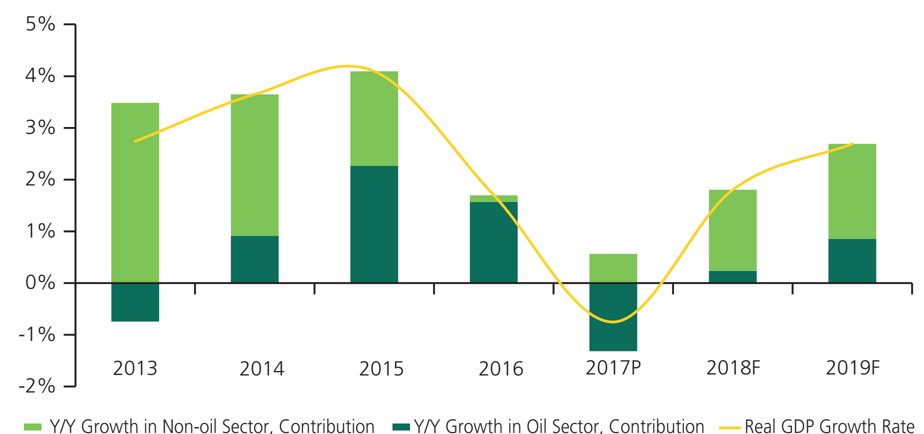
- The OPEC-led strategy to reduce global crude inventories to the industry's five-year average and thus rebalancing the markets is close to being achieved during 2H2018. In addition, fundamentals and geopolitical factors are being supportive to oil prices, with an improvement in global economic outlook, mainly from China, and high compliance levels by OPEC members. Furthermore, oil supply disruptions in Nigeria, Libya, and Venezuela although erratic and unpredictable have been supportive to prices. Nevertheless, these elevated oil prices are propping up US production that recently reached an all-time high of around 10.7 MMBD as well as higher exports that registered 1.73 MMBD by the end of October, a multi-year high.

- The three rating agencies downgraded the Kingdom's sovereign rating on multiple occasions over the past three years. However, as the macroeconomic backdrop stabilized, coupled with an improvement in the government's finances, S&P, Moody's and Fitch affirmed Saudi's rating at A-, A1, and A+, respectively, with a stable outlook. Given the investment grade ratings, international debt issuances received strong investor appetite. The government issued USD21.5 billion worth of dollar-denominated debt in 2017, bringing total public debt to SAR438 billion by the end of last year, representing 17.1% of GDP. We expect debt levels to continue rising to 20.5% of GDP, equating to SAR555 billion by the end of 2018.

- SAMA preempted the first US hike of 2018 by raising the reverse repo rate to 1.75%, the first time since 2009, and raised the repo rate by 25 basis points to 2.25% to avoid capital outflows. A corridor of 50 basis points constitutes a narrow margin that will require attentive assessment going forward. While maintaining the currency peg will continue to be a challenging task for SAMA in 2018 and 2019 due to the volatility of oil prices and rising public debt, the size of net foreign assets at USD486.2 billion by the end of March should give SAMA enough power to defend the exchange rate. We believe SAMA might resort to either direct liquidity injections, reducing reserve requirements, reducing the loans-to-deposits ratio limit of 90%, or possibly a combination to tackle any shortage of liquidity and reduce the risk of a monetary drag offsetting the announced fiscal stimuli.

- Downside risks to our outlook are the possibility of a trade war between the US and China that can take place due to the escalation of rhetoric and the announcements of tariffs and counter-tariffs. The political rhetoric between the US and North Korea remains hostile despite the scheduled meeting between US President Donald Trump and North Korea's leader Kim Jong Un. Looking forward, myriad geopolitical concerns pertaining to Iran and North Korea will remain hanging clouds on the global economy as well as Saudi's economic performance.

Business Cycles in KSA



Sources: SAMA and NCB

2018 and 2019 Projections

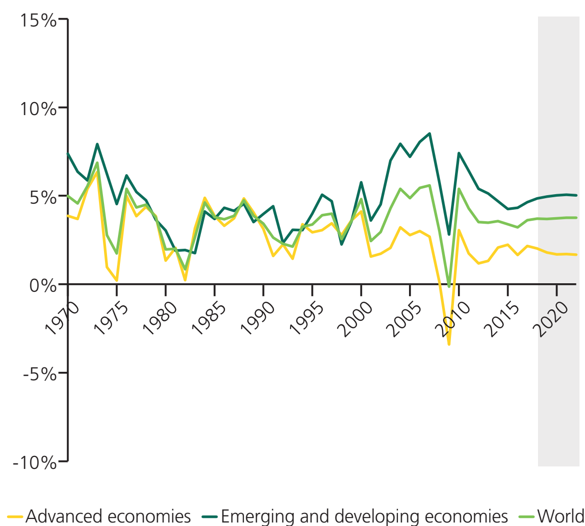
Key Macroeconomic Indicators	2013	2014	2015	2016	2017	2018F	2019F	Latest	Date
Real Sector									
Weighted Average KSA Crude Spot Price, Arab Light, USD/BBL	106.4	97.2	50.2	40.9	52.5	62.7	60.7	66.2	4M18
Average Daily Crude Oil Production, MMBD	9.6	9.7	10.2	10.5	10.0	10.0	10.2	9.9	4M18
GDP at Current Market Prices, SAR billion	2,799.93	2,836.31	2,453.51	2,418.51	2,564.35	2,708.35	2,785.89	-	-
GDP at Current Market Prices, USD billion	747.6	757.4	655.1	645.8	684.7	723.2	743.9	-	-
Real GDP Growth Rate	2.7%	3.7%	4.1%	1.7%	-0.9%	1.8%	2.7%	-	-
Oil Sector GDP Growth Rate	-1.6%	2.1%	5.3%	3.6%	-3.0%	0.5%	2.0%	-	-
Non-oil Sector GDP Growth Rate	6.4%	4.9%	3.2%	0.2%	1.0%	2.8%	3.2%	-	-
Population, million	30.0	30.8	31.5	31.8	32.6	33.1	33.7	-	-
Population Growth Rate	2.7%	2.6%	2.4%	0.8%	2.4%	1.6%	1.9%	-	-
GDP /Capita, USD	24,926.2	24,613.3	20,784.1	20,316.0	21,035.1	21,875.4	22,079.3	-	-
CPI Inflation, Y/Y % Change, Average	3.5%	2.7%	2.2%	3.5%	-0.2%	3.0%	2.0%	2.8%	Mar-18
External Sector									
Merchandise Trade Balance, USD billion	222.6	184.0	44.3	55.8	101.7	133.8	146.1	-	-
Oil Exports, USD billion	321.9	284.6	152.9	136.2	170.2	204.7	208.2	-	-
Non-oil Exports, USD billion	53.8	57.7	50.3	46.6	50.3	57.8	67.8	-	-
Merchandise Imports, USD billion	-152.1	-157.2	-156.5	-125.8	-117.0	-128.7	-129.9	-	-
Invisibles Trade Balance, USD billion	-87.1	-110.2	-101.0	-79.6	-86.5	-87.0	-89.5	-	-
Net Factor Income, USD billion	13.6	16.5	17.3	15.7	11.8	10.5	9.4	-	-
Net Unilateral Transfers, USD billion	-35.9	-38.7	-44.7	-42.3	-39.5	-35.6	-33.8	-	-
Current Account Balance, USD billion	135.4	73.8	-56.7	-23.8	15.2	46.8	56.6	-	-
Current Account Balance/GDP	18.1%	9.7%	-8.7%	-3.7%	2.2%	6.5%	7.6%	-	-
Net Foreign Assets with SAMA, USD billion	717.7	725.2	609.7	529.3	489.5	463.2	442.1	486	Mar-18
Fiscal Sector (Central Government)									
Budgeted Expenditure, SAR billion	820.0	855.0	860.0	840.0	890.0	978.0	1,006.0	-	-
Actual Revenues, SAR billion	1,156.4	1,044.4	615.9	519.4	696.0	863.8	911.0	-	-
Actual Expenditure, SAR billion	976.0	1,109.9	978.0	830.0	926.0	978.0	1,006.0	-	-
Expenditure Overrun, %	19.0%	29.8%	13.7%	-1.2%	4.0%	0.0%	0.0%	-	-
Total Revenues/GDP	41.3%	36.8%	25.1%	21.5%	27.1%	31.9%	32.7%	-	-
Total Expenditure/GDP	34.9%	39.1%	39.9%	34.3%	36.1%	36.1%	36.1%	-	-
Overall Budget Balance, SAR billion	180.3	-65.5	-362.1	-310.6	-230.0	-114.2	-95.0	-	-
Budget Balance/GDP	6.4%	-2.3%	-14.8%	-12.8%	-9.0%	-4.2%	-3.4%	-	-
BreaL-Even Oil Price	82.6	100.1	82.6	61.6	68.9	71.9	70.4	-	-
Financial Sector									
USD/SAR Exchange Rate	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	Mar-18
Growth in Broad Money (M3)	10.9%	11.9%	2.5%	0.8%	0.2%	6.6%	7.5%	0.2%	Mar-18
Growth in Credit to the Private Sector	12.1%	11.9%	9.8%	2.2%	-0.9%	4.9%	6.5%	-0.7%	Mar-18
Average 3M SAR Deposit Rate	1.0%	0.9%	0.9%	2.1%	1.8%	2.3%	3.0%	1.9%	3M18
Average 3M USD Deposit Rate	0.3%	0.2%	0.3%	0.7%	1.3%	2.0%	2.8%	1.9%	3M18
Spread, in Basis Points, SAIBOR-LIBOR	68.7	70.4	56.4	133.8	54.7	30.0	20.0	3.1	3M18

Sources: Thomson Reuters, SAMA, General Authority for Statistics, and NCB

A. Global Economic Developments

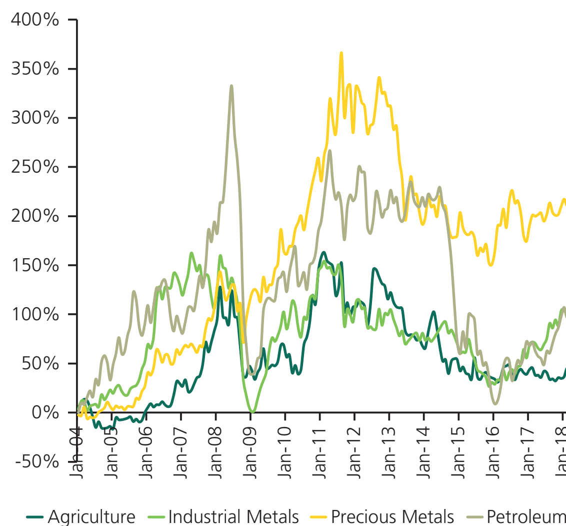
The global economic outlook improved during the second half of 2017 owing to synchronized growth across the world. Global output rose by 3.8% in 2017 according to the April update of the IMF's World Economic Outlook and is expected to inch up to 3.9% in 2018 and 2019. Advanced economies are expected to grow by 2.5% Y/Y, with US economic growth getting a boost from tax policy changes in addition to the Eurozone becoming more stable on the back of resilient domestic and external demand. Emerging markets also enjoyed a stronger momentum due to an improved outlook on commodities and manufacturing activity. The IMF expects China, the world's second largest economy, to beat its 6.5% growth objective again in 2018, especially that the country is adamantly implementing its transitional policies towards a service-based and consumer-focused economy.

1. Global GDP Growth
(Annual % change)



Sources: IMF

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

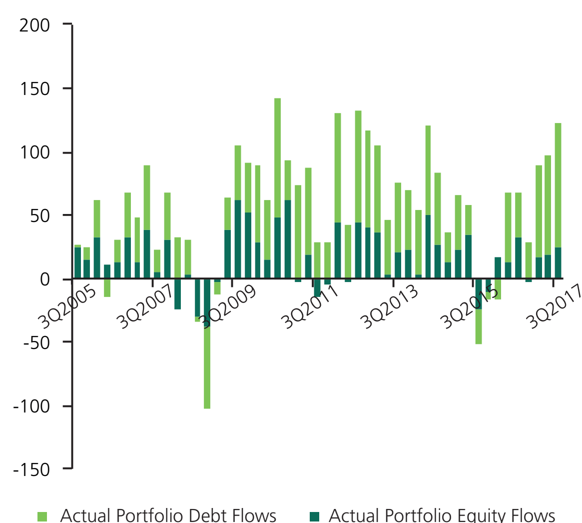


Sources: Thomson Reuters

Monetary policy divergence between advanced economies will remain in place in 2018. The improvement in US macroeconomic indicators and higher inflationary prospects will underpin the normalization drive by the Federal Reserve. The IMF had recently revised US economic growth upwards to 2.9%, a multi-year high. Also, inflation in the US is close to target, with core PCE registering 1.9% during March, thus nearing the 2% target. In contrast, the ECB and BOJ might remain relatively accommodative, with their growth lagging behind that of the US at 2.4% and 1.2% and with their inflation well below the 2% target at 1.3% and 0.5%, respectively. The two central banks do have a long way to go before breaking from their negative interest rate policies, and as such we do believe that interest differentials will continue to widen in favor of the USD. A stronger USD and rising energy prices will most likely push global inflation higher in 2018 compared to last year. Even though the IMF is expecting a marginal increase in inflation to 3.5%, we do believe that an upside revision is appropriate given these recent developments. While most of the inflationary pressure is stemming from emerging and developing economies at around 4.6%, developed economies' inflationary prospects have improved, with the expectation to rise to 2% this year.

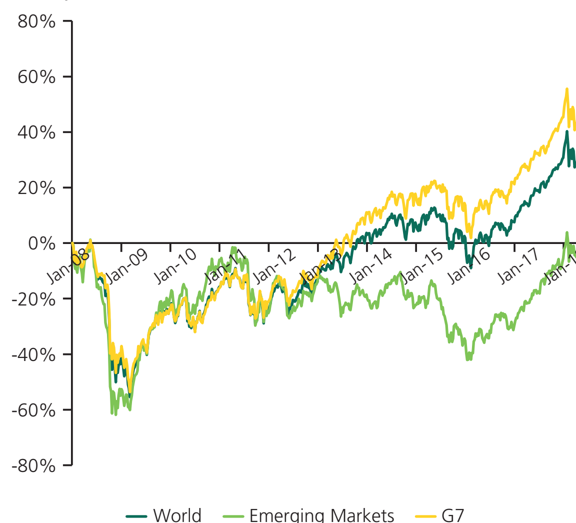
Global equities maintained their upside momentum in 2017. The benchmark indices for the world, G7 and emerging markets, respectively, registered Y/Y gains in 2017 of around 20%, 13% and 34.3%, according to the MSCI World indices. In 2017, US equities marked the best return since 2013 with the S&P 500 ending the year 19.4% higher despite overvaluation concerns. Putting the US equity market into perspective, it had taken the Dow 14 years to climb from 10,000 to 15,000, but just three and a half years to reach 20,000 in 2017, and less than a year to reach 25,000 in 2018. This reflects the recovery of the global economy and the financial system, positive investor sentiment regarding the Fed's macro-prudential policy, and the tax reduction policy's impact on corporate profitability. Moreover, the S&P500 breaking 39 records during 2017 also raises the specter of a market correction given the rising valuations. Hence, it is unlikely that 2018 will register the same double-digit bull-run it had last year. On the other hand, emerging markets still have room for upside momentum.

3. Emerging Market Economies: Portfolio Inflows
USD billion



Sources: IIF

4. Global Equity Markets
(January 2008 = 100)

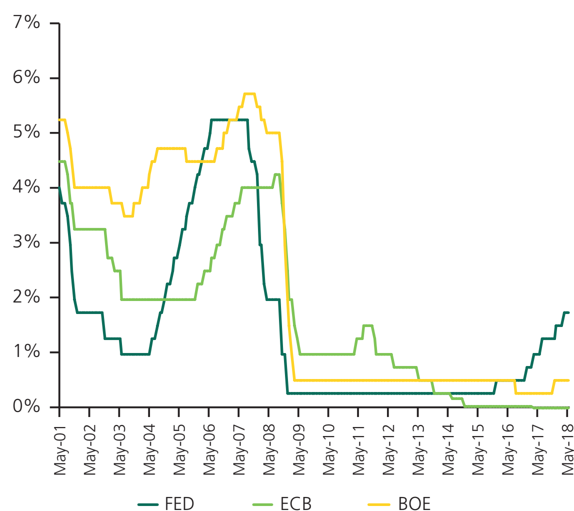


Sources: Thomson Reuters

The year 2017 saw a continued divergence between industrial and agricultural commodities. Industrial metals were strongly supported by a mix of improving economic conditions in developed economies and an environmentally driven reduction in China's smelting capacity. Meanwhile, agricultural commodities face supply abundance and record crops, which did not bode well for some commodity-based currencies. The unwinding of the commodity super-cycle is still on-going, and headwinds to investment include geopolitics in North Korea and the Middle East, US fiscal reforms, terms of trade shocks, accumulation of private debt, and policy uncertainty in major economies. By the end of December 2017, the Thomson Reuters CRB index ticked down by 1.7% Y/Y. Despite average metal prices being at relatively low levels compared to last year, credit stimulus in China combined with supply and environmental constraints sent prices higher. The closure of older, inefficient smelters in China, had a profound impact on prices as China accounts for over 50% of global consumption of industrial metals. Moreover, China's economic transition coupled with an industrial reform and environmental concern will likely create more investor demand, pressuring prices upward. On an annual basis, copper prices rose by 30.9% in 2017, closing at USD7,247/ton on falling inventories and expectations of higher demand. Despite supply growth in new producing countries in the coming years, strong demand from China and more closures and supply disruptions will underpin the red metal. The growing industrial use of aluminum had proven its versatility as it surged 34% Y/Y by the end of last year, standing at USD2'268/ton. Strong global demand, rising production cost, and bauxite export bans have carried aluminum prices upwards. However, downward risks include Indonesia's decision to roll back on its bauxite export ban, in addition to new Chinese low-cost smelting capacity becoming operational.

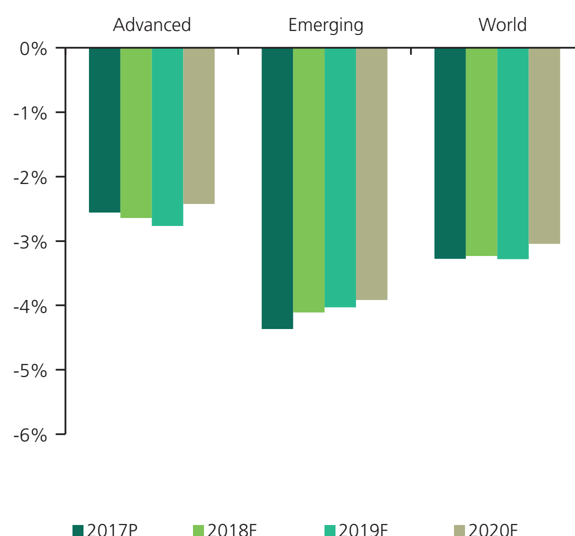
Rising real interest rates in the US have not impacted gold prices as widening interest rate differentials between the US and Europe did not warrant arbitrage. The spot price of a troy ounce of gold closed 13.2% Y/Y by the end of December, reaching USD1,302.6, indicating a moderation from August and September's levels but higher than 1H2017 levels. Physical gold demand was generally weak last year, and in particular; India and China. The Indian government is curbing illicit cash stock by removing cash note denominations of 500 and 1000 rupiahs out of circulation in order to shift savings into financial assets and away from physical assets, notably gold and real estate. In China, demand for gold declined as consumer preference shifted towards leisure activities and other goods in response to higher income. In 2018, we expect gold to maintain an upward momentum, probably breaching the USD1,400 level, as the equity market correction takes place. According to the Goldman Sachs agriculture index, soft commodities inched down 2.4% Y/Y by the end of December. Upward price pressure was conceived in the first half of the year due to an El-Nino induced scare that pushed the index as high as 9% since the beginning of the year. However, higher than expected crop yield coupled with weaker global demand and a relatively stronger USD rendered soft commodities faltering. According to the Chicago Board of Trade, wheat prices erased gains made this year, returning back to 409.3 cents/bushel, whereas corn prices declined by 2.9% YTD, standing at 341.7 cents/bushel.

5. Central Bank Policy Rates



Sources: Thomson Reuters

6. Fiscal Deficits
(in % of GDP)



Sources: IMF

Box 1: Oil…Rebalancing is Around the Corner

OPEC-led strategy to reduce global crude inventories to the industry's five-year average and thus rebalancing the markets is close to being achieved during 2H2018. Oil benchmarks that have been range-bound since the beginning of 2017, contained within the USD40-55/bbl range, entered a bull market since September. The three benchmarks, WTI, Brent and the Arabian Light ended last year in the positive territory, rising by 12%, 23%, and 19%, respectively. Notably, Brent traded at the USD80/bbl level in May for the first time since 2014. Fundamentals and geopolitical factors are being supportive, with an improvement in global economic outlook, mainly from China, high compliance levels by OPEC members and the OPEC/non-OPEC production cuts scheduled till the end of 2018.

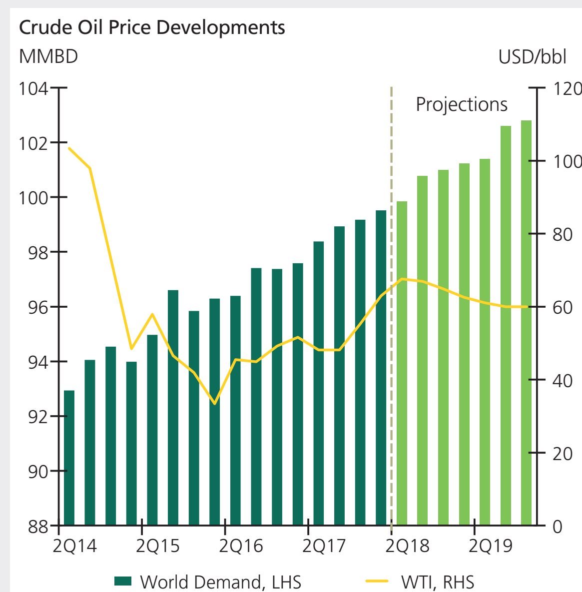
The resilience in oil demand was underpinned by a buoyant Chinese economy that is evident from the higher than expected headline GDP growth rate of 6.9% in 2017, which was above the government's annual target of 6.5% as well as being the first annual acceleration in economic growth since 2010. Accordingly, the IMF, in its January 2018 World Economic Outlook update, had yet again revised growth for the World's second-largest economy upwards by 0.1% in both 2018 and 2019, bringing the total upside revisions since the end of 2016 to 0.6% and 0.4%, respectively. Generally, emerging markets are also expected to grow by 4.9%, which is higher than last year's 4.8%, supported by rising commodity prices and dissipating of fears from Chinese economic moderation and monetary policy reversal by the Federal Reserve as they turned to be over exaggerated.

On the supply side, declining global inventories and production disruptions continue to underpin the elevated price levels witnessed since last year. OECD's commercial crude and refined product stocks fell in December by 55.6 MMbbls, the largest decline in more than seven years, which kept aggregate stocks below 3 billion barrels, the glut level benchmark, to stand at 2.851 billion barrels. As of March, the OECD commercial stocks stood at 2.83 billion barrels, just 9 MMbbls above the five-year average, from 340 MMbbls above the average in January 2017. Oil supply disruptions in Nigeria, Libya, and Venezuela although erratic and unpredictable have been supportive to prices. Venezuela, in particular, had been critical to OPEC's compliance story since its production continues to plunge, reaching around 1.5 MMBD in April, that is well below the agreed upon production level of 1.97 MMBD, a trend expected to remain in place given the insurmountable economic and financial bottlenecks.

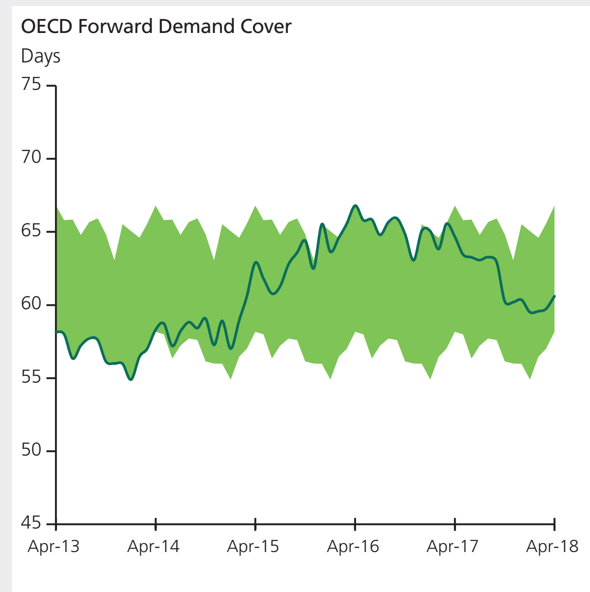
Looking forward, myriad geopolitical concerns pertaining to Iran and North Korea will remain hanging clouds on oil prices. US president Trump had pulled out of the Iranian nuclear deal by refusing to sign another waiver of sanctions this May, which as a result will re-impose them on the Islamic Republic. Trump was adamant to rewrite much of the 2015 agreement, a campaign promise, which he believed "was the worst deal ever." We do believe that such action can raise the specter of geopolitical tensions in the Middle East, a volatile region with numerous hotspots. The political escalation, more of rhetoric to begin with between the US and North Korea, remains hostile despite the scheduled

meeting between US President Donald Trump and North Korea's leader Kim Jong Un, raising concerns over the region's stability and prospects of complete denuclearization.

Nevertheless, these elevated oil prices are propping up US production that had recently reached an all-time high of around 10.7 MMBD as well as higher exports that registered 1.73 MMBD by the end of October, a multi-year high. The fact that US shale is expected to grow by around 1-1.3 MMBD this year coupled with a decline in the demand for OPEC's crude, the 'call on OPEC' by an estimated 250-390 thousand barrels per day, underscores the challenges that might face an exit strategy from the production cuts. Recently, oil rigs in the US rose to 825, the highest level since March 2015, and increased for the whole of April. Therefore, we do believe that these factors can cap future price gains and as such remaining above the USD75/bbl level is highly unlikely, with our Saudi crude export price projection standing at USD63/bbl. A downside risk to this outlook is the start of a trade war between the US and China that can take place due to the escalation of rhetoric and the announcements of tariffs and counter-tariffs.



Sources: EIA



Sources: EIA

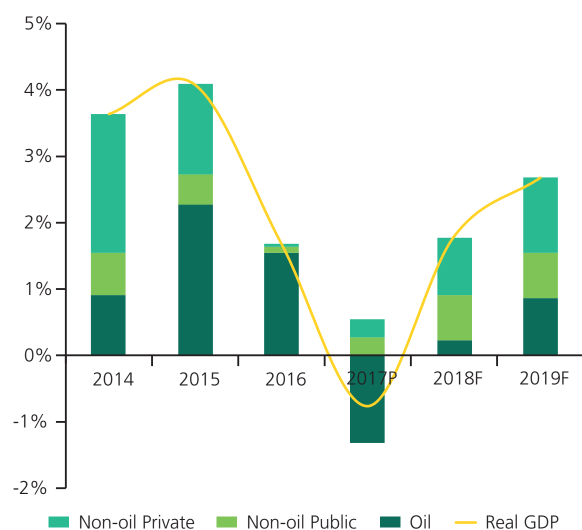
B. Saudi Economic Developments and Outlook

I. Real Sector

The economic overhaul coupled with oil market developments resulted in a contraction of the Saudi economy in 2017, however, 2018 will be the turning point. The seemingly impossible task of stabilizing an inherently volatile commodity has been challenging, to say the least, for OPEC members. As prices bottomed in 2016, OPEC and non-OPEC producers struck an agreement to cut production levels and tackle the oversupplied market. Accordingly, Saudi reduced oil production by 5.1% in 2017 to an average of 9.96MMBD, which contributed to a contraction in oil GDP by 3.0% in real terms. In addition, the fiscal adjustment had pressured the non-oil sector, which registered a modest 1.0% gain on an annual basis, resulting in a contraction in real GDP by 0.9% last year. In 2018, Saudi Arabia continues to lead by example as over-compliance is expected to maintain average oil production at 10MMBD. Ostensibly, real GDP is projected to grow by 1.8% this year as non-oil GDP is also expected to support the economy by increasing 2.8% on an annual basis. Given the rise in oil prices, nominal GDP is expected to rise by 5.6% this year to reach SAR2.7 trillion. As we move on to 2019, the expiration of the oil production cut agreement will contribute to an acceleration in real GDP by 2.7% and, conversely, nominal GDP growth will moderate to 2.9% as the increase in supply will pressure oil prices downwards.

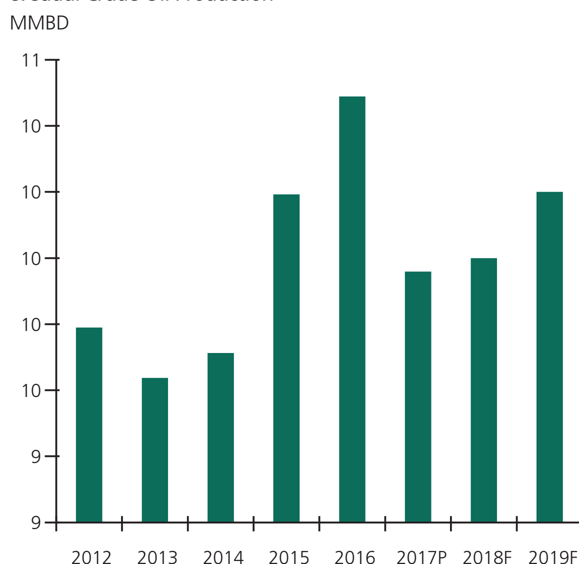
Following the withdrawal of the US from the Iranian nuclear agreement, upside risks to oil prices will act as a catalyst for the Saudi economy. The government is progressing with its diversification plans as six of the twelve vision realization programs have been announced thus far. A key element is to reduce the reliance on oil as the main source of revenues for the government spending. However, oil prices have maintained an upward trajectory and the inflow of revenues can accelerate and soften the impact of the transition. Restoring sanctions on Iran following President Trump's decision to cease participation in the JCPOA will include a wind-down period of 90 and 180 days to disengage with Iranian activities contra to the sanctions relief of the JCPOA agreement. As such, we expect oil prices to remain supported over the short term. According to our baseline scenario for 2018, we conservatively assume oil prices to average USD63/bbl, which will raise revenues to SAR574.8 billion, 30.6% higher than 2017. While Saudi production is expected to average around its quota of 10MMBD as any possible raise in production from OPEC and non-OPEC will likely be gradual during the second half of 2018, which will result in real oil GDP registering a gain of 0.5% on an annual basis. On a medium-term note, elevated oil prices might negatively impact the growth momentum of the global economy. In addition, US shale formations hold a substantial share in reserves, which will enter the market when break-even levels are met.

7. Real GDP Growth, Contribution



Sources: SAMA and NCB

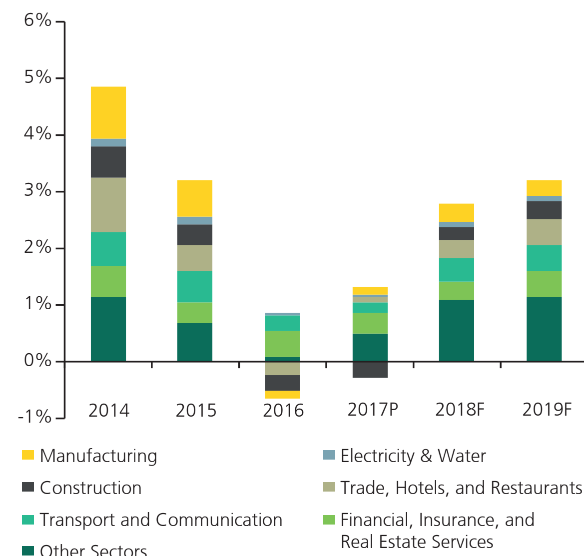
8. Saudi Crude Oil Production
MMBD



Sources: OPEC and NCB

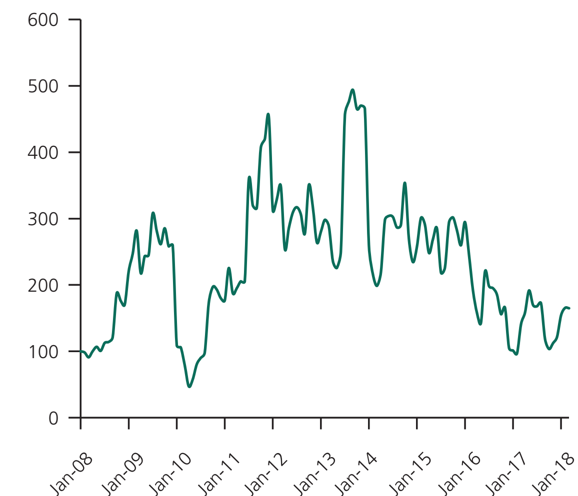
Developing the non-oil sector remains a cornerstone of Saudi Vision 2030, yet, the economic transition has proven challenging given the withdrawal symptoms from decoupling an ageing dependency. In the past, diversification efforts were continually skewed in a vertical sense as the petrochemical industry became one of the largest in the world. Ostensibly, the non-oil sector has been heavily impacted by the oil collapse, which resulted in the rationalization of government expenditure. In real terms, government non-oil GDP's growth of 1.7% in 2017 masked the sluggish growth in private sector non-oil GDP, which registered a relatively benign 0.7% increase Y/Y. The sentiment is reflected by the decline in corporate lending activities which fell by 2.6% on an annual basis last year, the first annual contraction since 2009. On the other hand, consumer activity, gauged by Point of Sale (POS) and cash withdrawals have been supported by a spike in pre-VAT sales towards the end of the year coupled with a cashless system drive by SAMA. In 2017, POS transactions' value reached a record SAR200.5 billion, growing by 9.7% on an annual basis, while the number of transactions witnessed the largest expansion since 2002 at 35.0% to conclude a record 708.1 million transactions. During the first quarter of 2018, POS transactions and values registered Y/Y growth rates of 42.5% and 11.0%, respectively. However, cash withdrawals from ATMs recorded the second consecutive annual contraction by the end of last year, declining by 3.3% Y/Y to settle at SAR728.5 billion. While consumer sentiment has faltered recently, the recent Royal decree announced a financial package in January, estimated at SAR58 billion, is largely aimed towards citizens to minimize the effect of the fiscal consolidation on consumption expenditure levels. Accordingly, we expect private non-oil GDP growth to accelerate, reaching 2.2% in 2018, which will drive total non-oil GDP to register a growth of 2.8% in real terms.

9. Non-oil GDP Growth, Contribution



Sources: SAMA and NCB

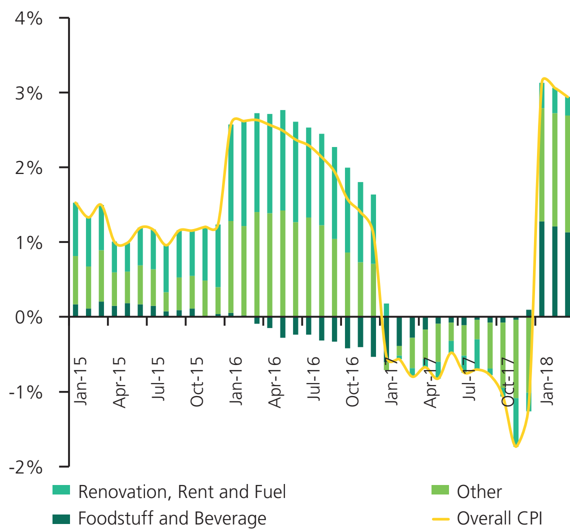
10. NCB Construction Contracts Awards Index



Source: NCB and MEED Projects

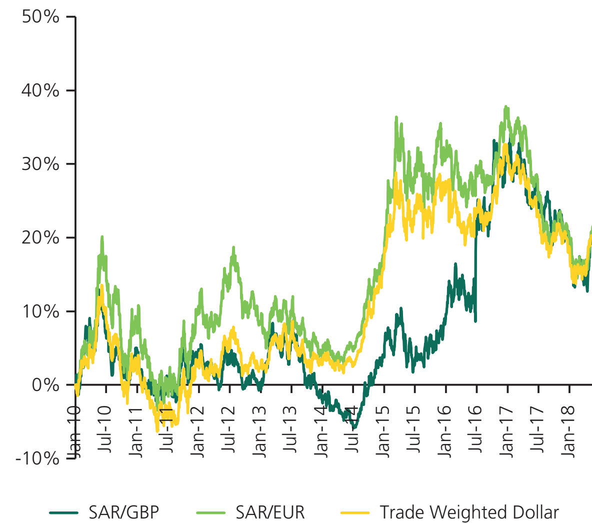
The revised Fiscal Balance Program aims to extend the reduction in energy subsidies timeline until 2025, which softens the impact on the economy and allows for a more gradual rise in consumer prices. Initial energy price hikes were scheduled in July 2017, however, the government postponed any changes till 2018, resulting in a decline in the consumer price index by 0.9% for 2017. Lately, the inflation index has been rebased to 2013 and the consumer basket has been revised to reflect recent consumption behaviors. The food and beverages sub-index, representing 18.8% of the total index, registered a decline of 0.9% in 2017, while maintaining an upward momentum that has been witnessed in the second half of 2017, a reflection of the Food and Agriculture Organization of the United Nations' food price index given the heavy reliance on imports for consumption. In addition, we believe that the economic slowdown coupled with the expatriates' dependents levies have resulted in the departure of foreigners as the latest labor market report reveals a drop of 585'454 in expat employees during 2017, prompting rental prices to decline. Following the 2018 energy price hikes on households, King Salman announced a decree to disperse SAR1'000 on a monthly basis for all public sector employees, SAR500 for pensioners, SAR5'000 for military personnel engaged on the southern border, and a 10% raise to student stipends in order to ease inflationary pressures during 2018 as they are time-bound till the end of the year. Accordingly, we expect inflation to average around 3% this year. Meanwhile, we expect the pace of inflation to decelerate in 2019, yet upside risk movements will be supported by rising commercial input-cost, which will result in cost-push inflation.

11. Drivers of Inflation



Sources: SAMA

12. Imported Inflation
(January 2010 = 100)



Sources: Thomson Reuters

Box 2: From Fiscal Consolidation to Economic Stimuli

There is no denying that the fiscal consolidation drive by the government since 2016 had reduced the deficit from double-digits to a single digit, yet the transition costs coupled with lower oil production had weighed on the Saudi economy, which contracted in real terms by 0.9% in 2017, the first time since 2009. Commendably, policymakers in the Kingdom realized the negative spillover effects that manifested themselves in the form of higher unemployment, deflation, reduced appetite for credit and hence a below 1% average growth in the non-oil private sector during the last two years. As such, the government had opted towards a more gradual approach in reducing subsidies, with the timeline to link all products to international reference prices extended towards 2025 and the balanced budget goal pushed back to 2023 instead of 2020. Recent announcements underscore adamancy on the part of the government to utilize the realized savings from streamlining expenses towards stimulating economic growth, which is apparent from elevated budget allocations to capital expenditures, the National Transformation Plan (NTP) stimulus, the PIF medium-term strategy, and government support measures notably to low and middle-income brackets.

In what had been dubbed an NTP2.0, the government had revised all of its budget-related targets up until 2020, adopting a targeted fiscal expansionary policy that tilts more towards capital expenditures. Expenditures in the modified NTP will be respectively higher by 5%, 6% and 10% during 2018-2020, reflecting the measured and orderly fashion in which fiscal policy is being conducted. More specifically, capital expenditures will edge above the SAR200 billion mark during the abovementioned time-frame in contrast to SAR134 billion and SAR180 billion outlays seen over the last two years. We do believe this inflection could also reflect that the Spending Rationalization Office (SRO) is close to finalizing its two-phase CAPEX review process of a significant SAR1.4 trillion worth of projects to ensure economic and social viability. The government might be comfortable with the list of projects at hand especially that the first phase was extremely successful and saw cost savings of around SAR100 billion, 45% from reviewed projects worth SAR220 billion. By the end of last year, the King had also approved a stimulus package targeting the private sector that amounts to SAR72 billion, which in essence is part of the SAR268 billion NTP initiatives budget announced in 2016. This stimulus package will support 13 initiatives, notably SAR21.32 billion for subsidizing housing loans, SAR13.87 billion for efficient home design, SAR10 billion for project financing and SAR5 billion will be used in setting up an export-import bank to incentivize exports. To promote job creation, the government will also support the SMEs by reimbursing fees worth SAR7 billion over a four-year period.

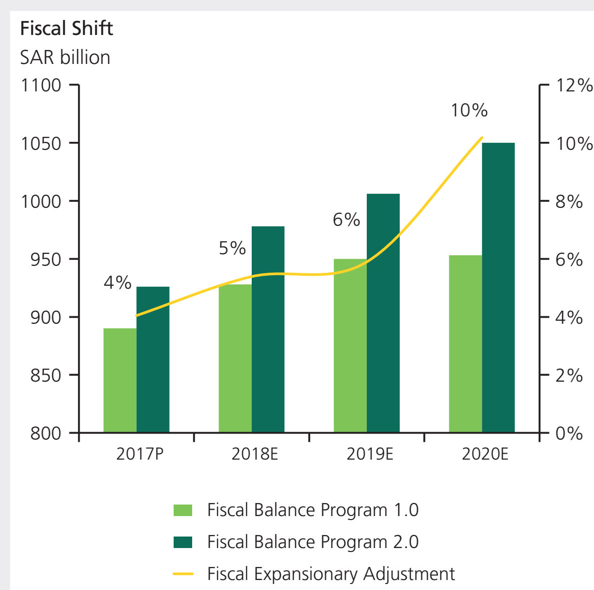
The Public Investment Fund (PIF), the de facto sovereign wealth fund, and a major player in the structural transformation drive has announced its strategy for 2018-2020 that is more active investment-wise and tilts towards new sectors that are related to high-tech. The PIF's four objectives and KPIs were as follows; (1) growing the assets under management from SAR840 billion to SAR1.5 trillion, (2) increasing the share of assets in new sectors to 20%, (3) raising the share of assets in international investments from 5% to 25% and (4) localizing cutting edge technology by investing SAR210 billion in R&D during 2018-2020. The aforementioned strategy reflects adamancy not only to shift away from hydrocarbons

dependency, but the vision towards a digital economy. Accordingly, the fund had established numerous companies and entities, notably a national military industries company, SAMI, an entertainment investment firm as well as two companies to enhance religious tourism in Mecca and Madinah, known as Rou'a Al Haram and Rou'a Al Madinah.

Additionally, the government had introduced temporary and permanent support measures to mitigate the impact on citizens from economic restructuring, namely the 5% value-added tax (VAT) and the hike in fuel and electricity prices. According to our estimates, the temporary measures will at least total SAR58 billion in the form of higher cost of living allowances and a salary increase for public sector employees as well as bearing VAT for all citizens benefiting from private education and private health. On the permanent measures side, the Citizen's Account takes center stage in trying to protect low and middle income households by rationally distributing cash allowances that cover the direct and indirect impact of reforms to families based on size, age and income, thus, eliminating the unsustainable "subsidies for all" model. According to the budget allocations for this year, the Citizen's account will distribute SAR32 billion.

The institutional and regulatory front is also complementing the aforementioned myriad stimuli, with the newly established National Center for Privatization (NPC) implementing a huge program of Public-Private Partnerships (PPPs) and privatization as well as preparing a PPP law, which once passed will garner greater confidence in the upcoming complex deals. There are big-ticket PPP infrastructure projects, which include power plants, airports, seaports, roads, water treatment plants, schools, and hospitals. It is estimated that there are USD29 billion worth of PPP projects planned or underway in the Kingdom, which represents great opportunities for the private sector. Importantly, the Council of Ministers had approved the long-awaited bankruptcy law, which will undoubtedly support investment by mitigating uncertainties pertaining to financial reorganization, liquidation, and preventive settlement. The comprehensive law also makes a critical distinction between bankruptcy procedures for large companies and SMEs.

In our opinion, shifting from fiscal consolidation to economic stimuli was necessary given the fact that signs of a fiscal drag were not only looming, but was starting to impact the business environment. Fiscal consolidation was not a goal in and by itself, but a stepping stone to a more sustainable and balanced economy. Ostensibly, fiscal consolidation had succeeded in moving away from the historical tendency to post double-digit budget overruns, an average of 25% per annum during 2003-2014. Nevertheless, most stakeholders had misunderstood the signals as a government pullback from economic activities rather than a new role that is more concerned with creating an enabling environment where a competitive private sector can flourish. Hence, the timing was right to announce these packages in order to reverse business and consumer sentiments.



Sources: NCB and MOF

2018-2020 Stimuli and Support Measures

SAR billion		2016	2017	2018	2019	2020
Govt. Stimulus	National Transformation Program (NTP)	9	42	72	145	
	National Development Fund (NDF)			50		
Govt. Budget	CAPEX (Central Government)			205	218	228
PIF Stimulus	Public Investment Fund (PIF)			83		
Govt. Support Measures	Citizen's Account			32		
	Royal Decrees (January 2018)			58		

Sources: NCB, MOF, PIF and NDF

II. Fiscal Policy and Economic Implications

The Kingdom is undergoing a period of rapid transformation trigerred by the decline of oil prices since 2014. However, prior to this collapse, high oil prices over the period between 2004 and 2014 have enabled the Kingdom to generate substantial oil revenues, pursuing expansionary fiscal policies, with yearly budget overruns of nearly 25%. Generating excess oil revenues above the budget also have allowed the government to retire its public debt substantially, with its ratio to GDP falling from 63% in 2004 to nearly 1.6% by 2014. In addition, excess revenues have enabled the government to build its foreign reserves, reaching SAR1.4 trillion at its peak in October 2014. Following the fall of oil prices in late 2014 and attributed to the need for financing large fiscal deficits over the past three years, foreign reserves have declined sharply to SAR571 billion in March 2018. This, therefore, proves that the government's foreign reserves are only a short-term cushion and demonstrates that the Kingdom's fiscal policy is highly dependent on oil revenues. Given the lack of revenue diversification and apparently slow recovery of oil prices, the potential depletion of government reserves is a major concern for fiscal sustainability over the medium-term.

Judging by the performance of the last three decades, the future path of oil prices and in turn oil revenues does not indicate sustainable high rates of growth. To ensure a sustained fiscal policy, the government found it imperative to implement fiscal reforms for the prospect of diversifying its finances away from continued reliance on oil revenues. It looks a plausible objective and the policy measures so far introduced would potentially be effective, bearing in mind undesirable transition costs on the economy. In 2016, a number of rationalization measures have been implemented to restrain the growth of government expenditure, which were followed by further fiscal measures introduced in 2017 and 2018. The aim is to finance government spending and potentially eliminate persistent budget deficits. These measures included excise tax, value-added tax, expatriate levies, and energy price reform. Under these revenue measures, the extended Fiscal Balance Program projects the Kingdom will balance its annual budget in 2023, after gradually reducing deficits in the period between 2018-2022.

According to the Ministry of Finance (MOF), total revenues are estimated at SAR783 billion in 2018 and projected to rise at an annual average growth of 9.3%, reaching SAR909 billion in 2020, achievable given the improved outlook for oil prices. Excluding taxes, other revenues, including oil revenues, are projected to reach SAR641 billion in 2018, rising by 7% over 2017, and expected to reach SAR 720 billion in 2020. Moreover, factoring in the fiscal impact of energy price reform to be aligned with reference energy prices, oil revenues are projected to increase by 11.8%, reaching SAR492 billion in 2018. This implies that the average implicit oil price in 2018's budget is USD51 a barrel. However, so far during 2018, oil prices have risen by around 26%, averaging USD66 a barrel, mainly pushed by supply factors with the last being the re-imposition of US sanctions on Iran. We forecast oil prices to average USD63 a barrel, thus increasing oil revenues by 31% over 2017 to reach SAR575 billion, resulting in expected total revenues to rise to SAR864 billion. Under this scenario of expected oil price, the fiscal deficit for 2018 is estimated to decrease by nearly 40% than the initial projection, amounting to SAR114 billion.

Upon implementation of fiscal consolidation measures, total taxes are projected by MOF to increase sharply by 46%, reaching SAR142 billion in 2018, and gradually rise over the following two years to reach SAR189 billion in 2020. Based on MOF's expectation of improved growth, taxes on income, profit, and capital gains are projected to increase by 10.4%, reaching SAR15 billion in 2018 and rising to SAR18 billion in 2020. The value-added tax and excise tax are projected to generate revenues of SAR23 billion and SAR9 billion, respectively, in 2018. Expatriate levies revenues are projected to reach SAR28 billion in 2018. As more expatriate workers are leaving the Kingdom either due to rising cost of levies directly on them and on their employers, the gradual increase in levies collected by the government might be offset by declining foreign population.

Taxes on international trade and transactions are optimistically projected to increase by 17% in 2018, amounting to SAR25 billion and to reach SAR28 billion by 2020, assuming improved economic growth and also due to the implementation of new customs duties and post-clearance auditing as noted by MOF. Similarly, on anticipation of improved economic growth, other taxes including Zakat are projected to record MOF's target of SAR17 billion in 2018, increasing by 10.8% over 2017, and to rise to SAR20 billion by 2020. As some of the fiscal measures are accelerated over the coming years, diversification of budget revenues will surely continue to improve, but may fall short in the expatriate levies or in VAT, hence due to declining base of expatriate workers, or to slower economic growth because of the tax's negative multiplier effects.

The primary pressure facing the Kingdom's budget is the rising level of operational expenditure, which is comprised mainly of "Compensation of Employees," "Use of Goods and Services," and "Social Benefits." Total allocation of operational expenses as projected by MOF in 2018 budget are SAR773 billion or 79% of total spending, rising by 3.6% compared to 2017. Compensation of employees are estimated at SAR438 billion, accounting for 44.8% of total expenditure, nearly unchanged from its actual level of 2017. In this aspect, there is very little flexibility to

rationalize compensation due to the large size of government sector employment with 3.3 million employees, of which 1.2 million are civilian and 2.1 million are in security and defense. In addition, the ratios of 'Use of Goods and Services' and 'Social Benefits' to total expenses have constituted 14.6% and 6.7%, respectively. While removal of fuel, electricity, and water subsidies is gradually progressing, though had been revised to an extended pace, new forms of social and business subsidies have been recently introduced. Spending on subsidies is estimated to rise by 102% to SAR14 billion, as a result of the implementation of the new stimulus packages, which aim to enhance private sector participation, as well as to support the industrial sector. Moreover, "Social Benefits" expenses are estimated to increase by 48.1% to reach SAR65 billion, resulting from the allocation to the Citizen Account program, which could reach SAR32.4 billion in 2018. Accordingly, the Kingdom will face successive years of fiscal deficits up till 2022, as forecasted in the Fiscal Balance Program 2023.

The government needs oil prices around USD70 a barrel to balance its budget given the current oil production level of 9.9MMBD. However, the medium outlook for oil prices are around USD50-60 a barrel, lower than the fiscal break-even oil price. Moving forward, the financial challenge for the government will be to fund its projected fiscal deficits and to service growing public debt. Financing Expenses in 2018, according to MOF, are estimated at SAR14 billion, up by 57.1% compared to 2017, led by the increase of prospective bond and Sukuk issuances. The yearly fiscal deficits, which will persist, yet declining from SAR195 billion in 2018 to SAR58 billion in 2022, will have to be financed by additional reserve withdrawals and more issuances of local and foreign bonds. Government reserves, which stood at SAR589 billion in 2017, are projected to reach SAR271 billion by 2023. In addition, total public debt, which amounted to SAR438 in 2017, is projected to reach SAR854 billion by 2023. Therefore, debt-to-GDP ratio would rise from 17% in 2017 to nearly 27% in 2023. Moreover, total fiscal deficit financing from foreign reserve withdrawals and bond issuances for the period 2018-2023 will amount to SAR729 billion. Although issuances will enable the government to implement its Vision 2030 initiatives and programs and the expansion of physical and social infrastructure, declining foreign reserves, and rising public debt will represent key financial challenges in the long-term not only to the government but the overall economy in multiple ways.

13. Government Revenue and Expenditure Balance

SAR billion	2016	2017	2018 Budget	2018 Forecast
Total Revenue	**519**	**696**	**783**	**864**
Oil	334	440	492	575
Non-Oil	186	256	291	289
Total Expenditure	**830**	**926**	**978**	**978**
Current	696	746	773	773
Capital	134	180	205	205
Deficit/Surplus	**(311)**	**(230)**	**(195)**	**(114)**

Sources: MOF and NCB

Most notable impact due to financial challenges is the sovereign credit rating of the Kingdom. Stressing on fiscal challenges, Moody's already cut the Kingdom's sovereign rating by one notch to A1 and Fitch also downgraded Saudi's credit rating to A+ from AA- in 2016. In the case of an unfavorable oil outlook, further downgrades cannot be ruled out in the medium term as foreign reserves will be pressured coupled with the building up debt. Another point of impact is the lower growth levels of liquidity, which will be a key challenge for banks, as has been witnessed over the last three years. To a great extent, banks are dependent on the trickle down effect of government oil revenues for their depositary base, especially in the form of non-interest demand deposits. With stagnating growth in demand deposits, impacting the supply side and weaker economic growth affecting the demand side, private sector credit contracted. As the rise of interest rate, and in turn net interest margin, is not widening sufficiently to compensate for the reduction in volume, the banking sector will possibly face downside risks on profitability growth. In addition, sovereign bond and Sukuk issuances will continue to see high subscription by banks because of attractive yields and their risk-free nature, therefore, crowding out lending to the private sector.

The rising pace of crowding out will continue to impact the private sector, as witnessed in 4Q 2016 with SAIBOR peaking at 2.38%, surpassing the 2% repo rate at the time. This jump in rate urged SAMA to intervene, bringing the SAIBOR back below repo rate. Given the nature of the Saudi economy, with many companies, directly and indirectly, dependent on government spending for projects, any payment delay, as happened in 2015-2016, affects working capital for companies. Moreover, as part of austerity measures introduced in 2015, advance payments for projects have been reduced from 20% to 5% of contract value. Since corporates access banks for most of their short-to-medium

funding requirements, funding will become difficult given the pressures banks face resulting from liquidity concerns. Moving forward, raising funds by the private sector not only will be difficult but will become increasingly expensive, especially in the current interest rate hike cycle due to the expected FED tightening decisions this year and next. Even debt markets, which may be an attractive source of funding for governments, it is not the case for corporate sector due to wider spreads demanded by lenders. In addition to the financing issue, the introduction of VAT and expatriate levies, which will lessen domestic demand and increase production cost, will ultimately impact private sector's profitability, particularly SME's.

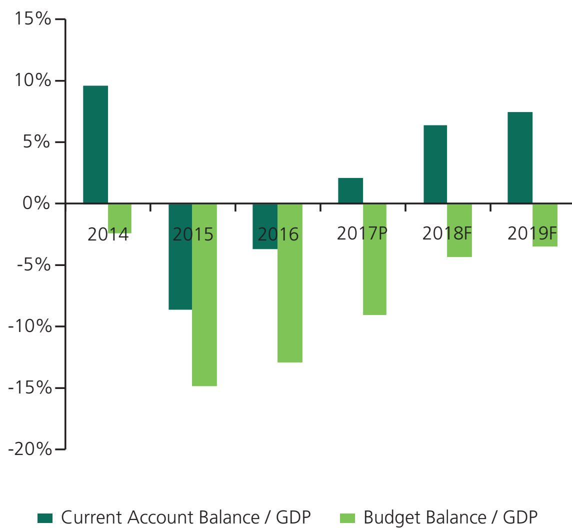
As far as the financial impact on households, it will be manifested in different ways. Firstly, the cut in government subsidies, especially for highly subsidized public services, which include gasoline, electricity, and water. In addition to the direct impact of the gradual removal of subsidies on households, indirectly, the removal of subsidies will lead to added production costs across all good and services, thus contributing to higher inflation, which already rose to 2.8% in March 2018. Moreover, households will have less access to financing options from banks as borrowing costs increased. Given tightening market conditions along with declining purchasing consumer power due to higher inflation, the debt defaults will likely worsen, already rising from 1.1% in 2015 to 1.4% in 2017. As a consequence of the fiscal measures, private sector experienced low growth below 1% over the last two years and expected to improve only marginally in 2018 and 2019. This led to limited job generation, with Saudi unemployment rate rising to 12.8% by the end of 2017. This adverse development comes at a time where the government intends to rationalize spending and restrain public sector employment.

In order to reduce the impact of fiscal measures on the economy, these fiscal reforms need to be internally consistent and to be complemented by relevant economic, legal, and institutional reforms. As oil prices are expected to remain around USD60-70 a barrel and fiscal measures are difficult to implement without negatively impacting economic growth, the government reinstated cuts on public sector salaries and allowances in June 2017. Accordingly, fiscal deficit to GDP, though declined from 2016's double-digit, was still high at 8.9% to GDP in 2017. Given the recent improvement of oil prices, we forecast oil prices to average USD63 a barrel in 2018, up from its average of USD52 a barrel for 2107, on the back of extended OPEC production cuts agreement until the end of 2018 and the recent US decision to retreat from Iran's nuclear agreement. With oil prices still accounting for nearly 63% of total government revenues in 2017 even at low oil prices, the Kingdom's fiscal position remains dependent on changes in oil prices.

These challenges facing the Kingdom can be deemed as opportunities, hence increasing public debt will induce financial discipline, reduce wasteful expenditure and accordingly lead to higher productivity. Moreover, the current economic conditions will also encourage both the government sector as well as the private sector to automate and digitize in order to reduce the cost of service offerings. Companies, including SME's, will focus on efficiency and productivity gains and start to align expansion plans with well researched future market needs. The development of the debt market, as currently driven by government bond and Sukuk issuances, will contribute to establishing of a yield curve, and creation of alternative financing options for companies such as bonds. There are also expectations of an increased appetite for mergers and acquisitions in order to grow and to mitigate current market developments. This transition period, yet challenging, will force the government and the private sector to adapt to new realities needed to achieve fiscal and economic sustainability.

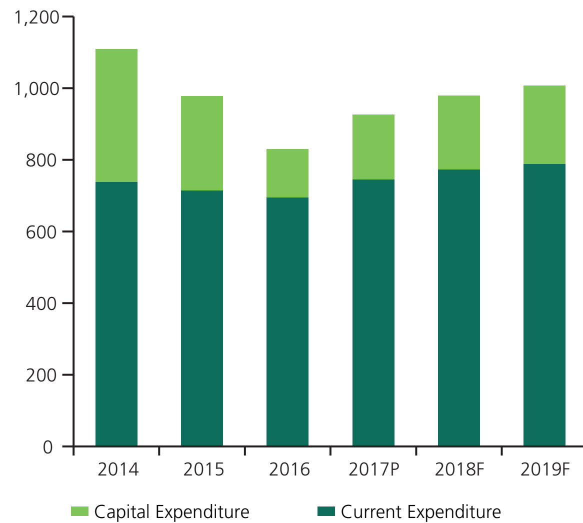
Given the improvement in oil markets, the current account surplus is expected to widen to 6.5% of GDP in 2018. The government revealed that the current oil production capacity of around 12.5 million barrels is ample enough considering the oil market dynamics. The priorities are shifted towards vertical diversification and increasing the Kingdom's refining capacity to capture higher revenues from the petrochemical value chain. Due to the oil accord between OPEC and non-OPEC countries, oil production averaged 10 million barrels in 2017, which resulted in oil export revenues totaling USD170.2 billion. We expect oil export revenues to increase by 20.2% Y/Y to reach USD204.7 billion this year as oil prices average higher despite production remaining somewhat leveled. Total non-oil exports are expected to reach USD57.8 billion in 2018 with petrochemicals and plastics constituting over 60%. On aggregate, total exports are forecasted to record USD262.5 billion, rising by 19.0% on an annual basis in 2018. On the other hand, total imports registered the third consecutive annual decline last year due to the government's rationalization efforts that heavily impacted the projects market. Total imports for the Kingdom settled at SAR438.1 billion, 7% lower than 2016's SAR471.2 billion. However, as the country remains largely dependent on imported goods for domestic consumption, we expect a rebound in 2018 by 10.0% to reach SAR482.0 billion. On a long-term note, the government is aiming to increase localization, a case in point is in the military sector, as the newly established Saudi Arabian Military Industries company recently signed a joint venture agreement with Boeing to localize 55% of military aircraft maintenance, repair, and overhaul services. We believe these and other measures could limit significant growth in imports, in turn, allowing exports to increase and generate higher revenues for Saudi's balances.

14. Twin Deficits



Sources: SAMA and NCB

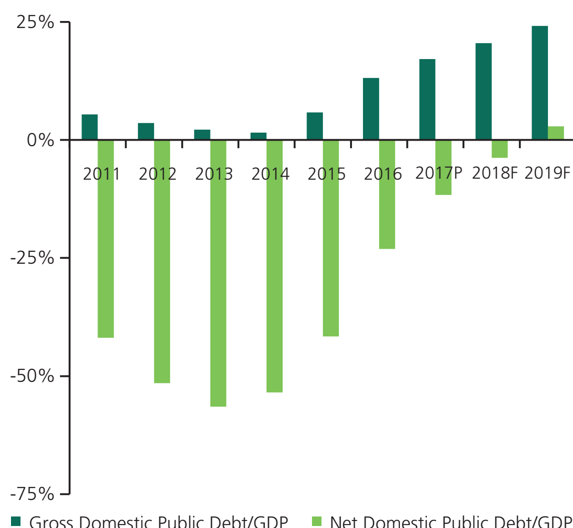
15. Government Expenditure
SAR billion



Sources: SAMA and NCB

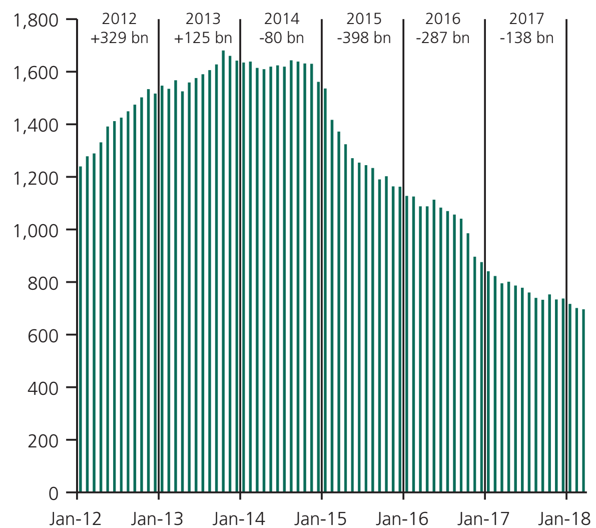
Investment grade ratings have facilitated the utilization of the Kingdom's debt capacity and reduced the reliance on net foreign assets to plug the fiscal deficit. The oil crisis resulted in economic and fiscal difficulties for Saudi Arabia, triggering a transformative strategy which disrupted the status quo. Consequently, the three rating agencies downgraded the Kingdom's sovereign rating on multiple occasions over the past three years. However, as the macroeconomic backdrop stabilized, coupled with an improvement in the government's finances, S&P, Moody's and Fitch affirmed Saudi's rating at A-, A1, and A+, respectively, with a stable outlook. Given the investment grade ratings, international debt issuances received strong investor appetite. The government issued USD21.5 billion worth of dollar-denominated debt in 2017, bringing total public debt to SAR438 billion by the end of last year, representing 17.1% of GDP. In 2018, the Debt Management Office (DMO) raised USD11 billion worth of bonds with maturities ranging from 2025 until 2049. In addition, the DMO increased 2016's USD10 billion syndicated loan by USD6 billion with a 30% reduction in the margin as confidence in the government's reform prospects improved. We expect debt levels to continue rising to 20.5% of GDP, equating to SAR555 billion by the end of 2018. The pace of net foreign assets (NFA) drawdowns has reduced significantly, decelerating from a staggering USD115.5 billion drop in 2015, followed by USD80.4 billion in 2016 and USD39.8 billion in 2017. The recent pick up in oil prices will provide support for Saudi's NFAs, yet, we expect a decline of 6.5% by the end of the year.

16. Domestic Public Debt



Sources: SAMA and NCB

17. Government Deposits at SAMA
SAR billion

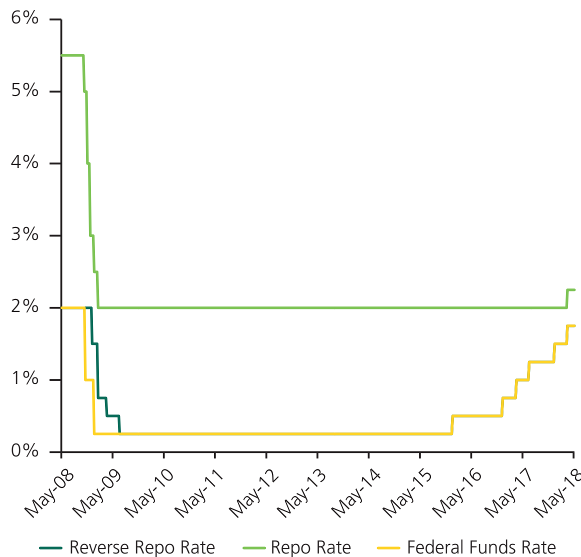


Sources: SAMA

III. Monetary Developments

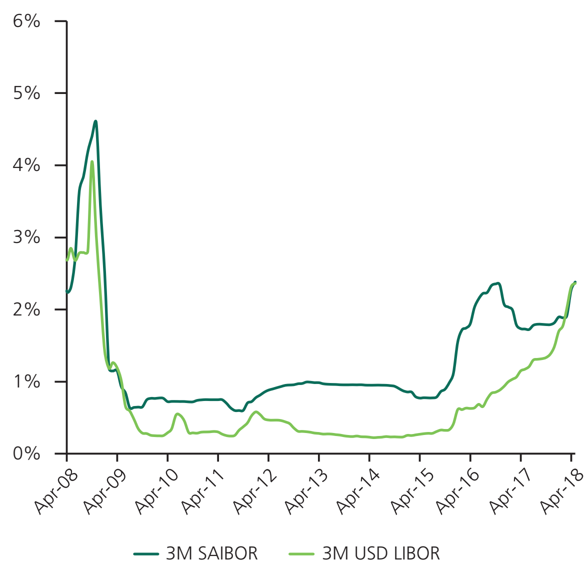
Monetary policy constraints await SAMA as maintaining the currency peg will create a challenging framework for 2018 and 2019. At least three 25 basis point rate hikes are expected in the US this year and an acceleration in consumer prices would entail an even more hawkish US policy. The market priced-in a rate hike, which lifted the 3-month US Libor rate above 2% in February. As the US Federal Reserve continues with its normalization of the benchmark interest rate, the central bank is mitigating capital flight risks by actively raising SAIBOR to remain above LIBOR through allowing some deposits with domestic banks to mature. Furthermore, SAMA preempted the first US hike of 2018 by raising the reverse repo rate to 1.75%, the first time since 2009, and raised the repo rate by 25 basis points to 2.25% to avoid capital outflows. A corridor of 50 basis points constitutes a narrow margin that will require attentive assessment going forward. In the past, SAMA opted to use open market operations to limit the effects of increased or reduced liquidity. However, the recent sovereign debt issuances have prompted banks to allocate funds from T-bills towards government bonds. Local banks' T-bills dropped to SAR10.9 billion by the end of March, a significant contrast to the SAR235.8 billion record reached in May 2014, while government bond holdings reached SAR262.2 billion, rising over 400% during the past three years. Going forward, the central bank needs to monitor the liquidity situation closely to alleviate possible risks. As demand for credit is expected to progressively rise, we believe SAMA might resort to either direct liquidity injections, reducing reserve requirements, reducing the loans-to-deposits ratio limit of 90%, or possibly a combination to tackle any shortage of liquidity and reduce the risk of a monetary drag offsetting the announced fiscal stimuli.

18. SAMA and US Federal Reserve Policy Rates



Sources: Thomson Reuters and SAMA

19. Interbank Market Rates



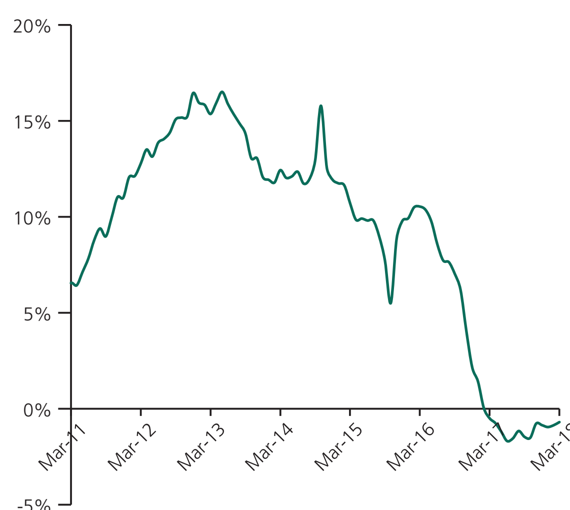
Sources: Thomson Reuters

External debt issuances, privatization programs, and foreign investment will reduce the reliance on the domestic monetary system as the sole provider of funding needs. The government's fiscal consolidation and newfound discipline had constrained the monetary system as capital expenditure is scrutinized to achieve higher efficiencies, while operating expenditures are contained amidst the current fiscal deficits. The broadest measure of money (M3) settled at SAR1.79 trillion by the end of 2017, registering a marginal increase of 0.2% on an annual basis, an inflection from two consecutive annual declines in 2016 and 2015. By the end of March, M3 remained flat with a 0.2% Y/Y gain, supported by a rise in demand deposits which reached above SAR1 trillion, rising by 1.5% on an annual basis. Given the spending mode of the government, time and savings deposits continued on a downward trend, settling at SAR430.1 billion by the end of the first quarter of 2018, posting a decline of 7.4% annually. Furthermore, SAMA's reserve assets have halted a downward trend with net foreign assets stabilized around the SAR1.8 trillion level as debt issuances have eased pressures on foreign asset depletion.

20. Growth in Money Supply

Sources: SAMA

21. Growth in Private Sector Credit



Sources: SAMA

IV. Financial Sector

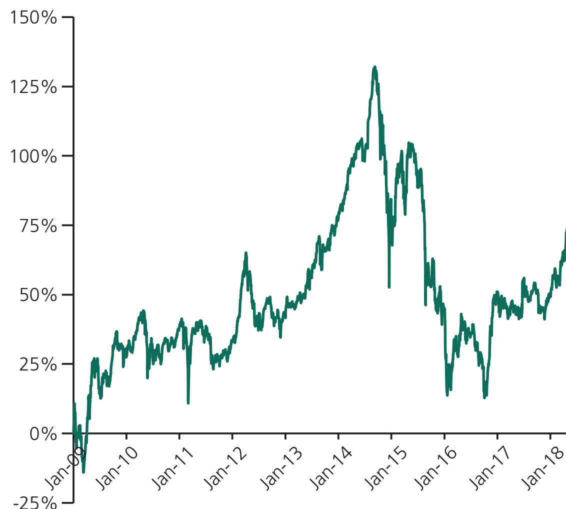
Rising interest rates are feeding into bottom-line profits for the banking sector despite the contraction in credit. Saudi's fiscal consolidation efforts reduced the flow of government capital expenditures over the past couple of years, which pressured the business environment. However, rising interest rates increased banks' margins, which resulted in net profits rising to a record SAR45.0 billion, an annual increase of 8.7%. Profitability was largely attributed to a considerable gain in net income from the consumer segment, registering an increase of 27.2% annually to reach SAR16.7 billion. Meanwhile, the treasury segment's net income recorded a 4.1% Y/Y gain, while the corporate segment net income rose by 1.5% Y/Y. Given the subdued activity in the equity market, which posted an average daily trading value at SAR3.3 billion in 2017 compared to 2016's SAR4.6 billion, the others segment, which includes brokerage activities, registered a decline in net income by 36.8% on an annual basis. As for balance sheet items, the depositary base increased by a marginal 0.1% Y/Y by the end of 2017. The government has raised their demand deposits by 73.7% Y/Y, while their time and savings deposits remain on a downward trend as the economic situation altered the government's "savings mode" to "spending mode" given the lackluster private sector. The interest-bearing deposit base recorded a decline on an annual basis, falling by 8.9% to settle at SAR447.8 billion. Meanwhile, the loans market contracted by 1.0%, the first decline since 2009, settling at SAR1.39 trillion by the end of 2017. Given the aforementioned, the loans-to-deposits ratio fell to 85.6% to remain comfortably below SAMA's guidance limit of 90%. The challenging macroeconomic backdrop is feeding pipeline risks as past due but not impaired loans have increased by 36.8% Y/Y, indicating future strains on the banking system. Non-Performing Loans (NPL) reached SAR20.4 billion, 1.4% of gross loans by the end of 2017, an annual rise of 15.5% that is mostly concentrated in the construction and manufacturing sectors. We do expect NPLs to continue rising due to the transition costs affiliated with economic reforms. Accordingly, a provisioning cycle has been triggered to preempt possible defaults with varying degrees across different sectors. By the end of 2017, provisions for possible credit losses have increased by 3.5% on an annual basis, bringing the accumulated stock for provisions to SAR33.0 billion. We expect the banking sector to benefit from 2018's capital expenditure budget allocation of SAR205 billion coupled with government stimuli initiatives including the Public Investment Fund's SAR83 billion, and the National Development Fund's SAR50 billion spending plans.

The promotion of the Saudi equity market to Secondary Emerging market status by FTSE Russell raises the expectation for inclusion to MSCI indices in June. Representing almost 50% of total GCC market capitalization, the largest market in the Middle East joins the likes of China, India, and Russia with a weighting of 2.7% in the FTSE Emerging Index and 0.25% in the FTSE Global Equity Index Series following two years on its watch list. As recent as 2015, Tadawul was mostly inaccessible for foreign investors, however, Tadawul and the Capital Market Authority (CMA) have implemented a wide range of reforms over the past years to attract investments and adhere to global best practices. Initially, opening the market to Qualified Financial Investors (QFI) has been somewhat below expectations as stringent requirements limited the flow of foreign investments. Accordingly, the CMA had twice eased requirements from the original USD5 billion minimum for assets under management to the current USD500 million. In addition, the settlement cycle has been increased from T+0 to T+2, common practice in European markets, which was also adopted by US markets in 2017. Tadawul also reclassified sectors according to GICS standards, launched the parallel market

NUMO as a less stringent market for companies to go public, introduced real estate investment traded funds (REIT) among other reforms that will enhance the market's depth. The Saudi stock market carried its momentum into 2018 as anticipation of the decision was reflected in stock prices, which rose 8.9% during the first quarter. Another catalyst to the positive trajectory was the announcement of corporate profitability, which climbed back up again above the SAR100 billion threshold in 2017. The FTSE inclusion inflows are estimated to reach USD5 billion over the inclusion timeframe based on the Saudi weightings and the market capitalization of the abovementioned indices. The larger MSCI pool will offer USD30-40 billion if Tadawul and CMA's efforts are enough to merit an inclusion next month.

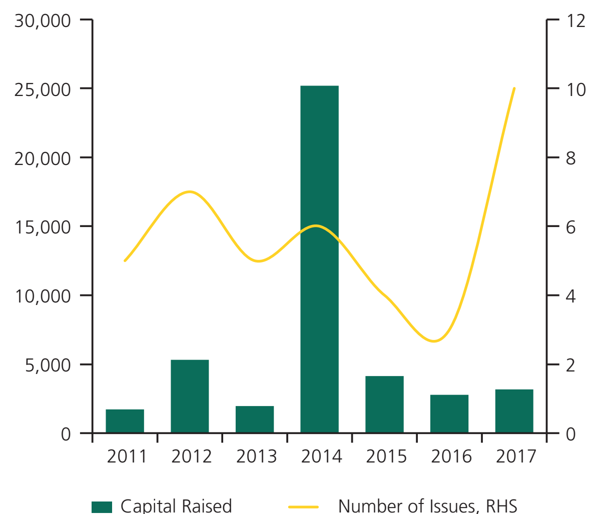
Tadawul's primary market has been dominated by REITs as nine funds were offered during 2017, seeking a total of SAR2.9 billion. Further four REIT funds were introduced during the first quarter of 2018 with a total offered value of SAR1.9 billion. There are currently a total of 12 REITs in the market and we expect a few more initial public offerings for such funds in 2018. Meanwhile, only one company turned public last year with an offered value of SAR229.5 million. The recent announcement to list and trade sovereign debt instruments will enhance the secondary market's development. Floating rate, fixed rate, and sukuk instruments with a total value of SAR204.4 billion have been approved, allowing non-institutional investors to diversify their portfolios. In addition, government entities and banks holding of such assets will have the opportunity to offload them in the market to manage liquidity levels and grasp other investment opportunities. Numo's primary market concluded nine initial public offerings with a total value of SAR752.3 million. The economic slowdown has limited the flow of companies going public despite CMA's objective of increasing listed companies.

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



Sources: Tadawul

23. Saudi IPO Issuance
SAR million



Sources: Tadawul

Saudi government's record USD9 billion sukuk issuance in 2017 underpinned a significant development in the global Islamic finance market. The global Islamic financial market is projected to have reached USD2.4 trillion in 2017 according to Thompson Reuters' Islamic Finance Development Report. Islamic banking constitutes almost three quarters of total assets, while sukuk, the sharia-compliant bond version which are asset-based rather than asset-backed, represented around 16% by the end of 2016. Additionally, the report forecasts the global Islamic financial market to reach USD3.8 trillion by 2022. By the end of 2016, Saudi Arabia was the second largest market with USD472.7 billion worth of Islamic finance assets. Global sukuk issuances accelerated in 2017, reaching USD97.9 billion according to Standard & Poor's, rising 45.3% compared to 2016. Malaysia remained the top issuer of sukuk at USD36.5 billion, followed by Saudi Arabia in second place with total issuances reaching USD31.7 billion, providing alternative investment opportunities for international and domestic investors. While corporate issuances such as Saudi Aramco's USD3 billion took place, sovereign issuances dominated the Saudi market. Given the government's funding needs, Saudi tapped the international sukuk market during 2017 with a record issuance worth USD9 billion for 3, 5, and 10 year tenors, receiving orders in excess of USD30 billion, which reflects investors' appetite for such financial instruments. Domestically, sukuk issuances totaled SAR58.5 billion last year. In 2018, the government already secured USD11 billion from international markets and the Head of DMO signaled that further government funding needs will be financed domestically through smaller sized issuances. Thus far in 2018, the government raised nearly SAR18 billion riyal-denominated sukuk.

V. Risks

Economic and financial risks are slowly abating as the government reflected dynamism in its transformation plan coupled with a steady rise in oil prices. The Kingdom's foreign reserve depletion rate has decelerated significantly, net foreign assets only dropped by 7.5% last year compared to a drop of 13.2% in 2016. By the end of March, net foreign assets stood at USD486.2 billion, a significant buffer for tackling further shocks to the domestic system and provide around 50 months coverage of imported goods. While domestic interbank lending rates have been creeping higher, the banking sector registered record profits last year with ample capital buffers well above Basel III requirements. The capital adequacy ratio (tier-1) stood at 18.4%, a substantial improvement from 2016's 17.5% given the financial challenges for the Saudi market. Additionally, the economic slowdown which hindered the flow of government projects and impacted the private sector raised NPLs, yet the increase was marginal at 1.4%. Furthermore, the NPL coverage ratio provides a comfortable buffer at 161.5% by the end of 2017. Meanwhile, monetary policy remains a concern as the US Fed's normalization policy will act as a challenge for Saudi policy decisions given the commitment to the USD-SAR currency peg. Figure 26 below depicts key macro and banking sector vulnerability indicators of Saudi Arabia between 2012 and 2017.

24. Key Systemic Macro and Banking Sector Risk Indicators

	2010	2011	2012	2013	2014	2015	2016	2017
1. Macro Risks								
Overall Budget Balance/GDP	4.4%	11.6%	13.6%	6.4%	-2.3%	-14.8%	-12.8%	-9.0%
Gross Domestic Public Debt/GDP	8.5%	5.4%	3.6%	2.1%	1.6%	5.8%	13.1%	17.1%
Net Domestic Public Debt/GDP	-41.8%	-41.9%	-51.5%	-56.5%	-53.5%	-41.6%	-23.1%	-11.7%
Net Banking Sector Claims on the Government (SAR bn)	(931.6)	(1,140.4)	(1,474.2)	(1,591.9)	(1,507.6)	(1,076.4)	(697.0)	(483.3)
Overall Current Account Balance/GDP	12.7%	23.6%	22.4%	18.1%	9.7%	-8.7%	-3.7%	2.2%
Net Factor Income/Merchandise Imports	7.3%	8.1%	7.8%	8.9%	10.5%	11.0%	12.5%	10.1%
Net Foreign Assets/Imports of Goods and Services	254.3%	272.0%	302.9%	313.7%	281.4%	249.3%	269.9%	252.6%
Net Foreign Assets/M2	178.8%	188.2%	200.5%	199.8%	176.2%	144.6%	121.2%	113.2%
Merchandise Import Coverage (1YR ahead imports, in months)	54.8	54.0	55.3	56.6	55.4	46.7	50.5	50.2
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%	82.8%
Minimum Risk Assets/Total Assets	34.9%	33.8%	32.7%	31.4%	31.8%	29.1%	28.9%	28.4%
Cash and Balances with SAMA/Total Assets	11.1%	11.7%	12.5%	10.6%	9.5%	6.8%	10.8%	10.6%
Tier 1 Capital Adequacy Ratio	16.6%	16.1%	15.8%	16.4%	16.2%	16.2%	17.5%	18.4%
Non Performing Loan (NPL) Ratio	2.9%	2.3%	1.9%	1.4%	1.1%	1.1%	1.2%	1.4%
NPL Coverage Ratio	115.7%	133.2%	145.3%	157.4%	182.9%	171.9%	178.3%	161.5%

Sources: Financial statements of commercial banks, SAMA and NCB

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