Executive Summary

For the Kingdom of Saudi Arabia (KSA), 2017 proved to be an eventful year, as the plan for the way forward was formulated. It is projected that 2018 would mark the start of the execution and implementation process for the major reforms laid out in 2017. All these efforts would eventually push the nation closer to ‘Vision 2030’.

The 2018 budget focuses on non-oil expansion, reflected in the form of higher capital allocations for non-oil sectors such as transport, construction, and utilities. The economy is also marching toward privatization, as the government announced several reforms to lure private players, including a SAR 72bn stimulus with a focus on housing, exports, and manufacturing.

The three pillars driving ‘Vision 2030’ are listed below. The government’s major reforms, announced until 2017, revolve around these very pillars.

• **Fiscal outlook:** The target to achieve the fiscal balance has been pushed to 2023 from 2020, while subsidy rationalization will continue this year. The government had increased prices of some fuels as of December 31, 2017. It may announce additional price hikes in the near future to remain on track with its fiscal roadmap. By unveiling the largest budget in the Kingdom’s history, the government has clearly indicated its aggressive expansion plans. GDP growth slowed in 2017, largely driven by a decline in the oil sector’s contribution. However, non-oil sector seems to be the rescue gate as the GDP growth in the near future will increasingly depend on it, especially with the introduction of several new taxes and levies.

• **Capital market:** The Saudi equity market is likely to benefit from generous government spending in 2018, in terms of capital and current expenditure (in the form of special allowances). Increased expectations of KSA’s inclusion in MSCI and FTSE indices in 2018 are set to attract foreign institutional investors to domestic equity markets. Moreover, the probable listing of Aramco in 2018 could be a landmark event.

• **Reforms leading to social integration:** The Kingdom took a major stride forward socially by allowing Saudi women to drive and be a part of sports and other forms of entertainment initiatives, starting 2018. Moreover, the Kingdom is expected to begin issuing tourist visas to foreign travelers and allow cinema halls to open this year. These progressive reforms will bring Saudi women into the economic fold and boost the tourism, automobile and entertainment sectors.

Overall, 2018 signals good news for the Saudi Arabian economy, starting with generous government spending after last year’s constraints. The government is now working positively toward its fiscal target. Simultaneously, the adverse impact of price increases on consumption will be partially subdued by government allowances and aids in the form of beneficial policies, made possible by higher crude oil prices. Capital markets are set to outperform if the announced capital/current expenditure is realized and probable inclusions materialize. Moreover, social reforms are expected to groom the economic environment that could help the Kingdom transform from an oil-dependent nation into a diversified market for investors.
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2017: The Year Gone By

KSA announced its ambitious agenda of ‘Vision 2030’ in 2016. The foundation of major refurbishments was laid in 2017. The decline in oil prices forced the Kingdom to rethink its economic strategy. The government progressed toward privatizing key state assets and stimulating investments, which reportedly are a part of its long-term plan to diversify the economy away from dependency on oil revenues.

KSA’s 2018 budget, its largest ever, contributed to the plans of broadening the economy’s base. The government indicated this by increasing public spending and slowing of austerity.

Turnaround story: After a dramatic 2017, KSA is looking forward to a flourishing 2018. Most of last year saw subdued growth, as oil prices were submissive. The government continued to tighten its grip on spending, with expenditure for the first nine months of 2017 increasing only 0.4% YoY. Conversely, the private sector held back on investments, which further reflected in credit growth. The economy advanced at a moderate pace of 1.7% in 2016 and continued its weak momentum in the first half of 2017. However, the second half of 2017 witnessed a major turnaround in oil prices, which started moving up riding on supply-side constraints such as continued OPEC production cut, a nationwide strike in Nigeria, the pipeline blast in Libya, the North Sea pipeline outage, and shrinking US stockpiles. Moreover, the KSA government accelerated spending in Q4 2017 (36% YoY increase), thus leading to the bullish Saudi budget forecast.

The unemployment rate for KSA nationals rose above the 12% mark and was expected to remain high for several years amid low oil prices and the absence of upbeat recovery in non-oil growth.

Key reforms: In 2017, the authorities obliged to last year’s OPEC deal by reducing oil production and introduced major reform initiatives. Although the Kingdom continued to face economic challenges in 2017, its reforms and measures that were set in the fiscal balance agenda within Vision 2030 have demonstrated a positive effect, contributing to an increase in non-oil revenues. Most of its fiscal consolidation efforts in 2017 were aimed at improvements in the short-to-medium fiscal outlook that was attained at the expense of growth.

Revenue initiatives for 2017 were crucial with reforms such as adjustment of visa and municipality fees, implementation of the expat levies, and application of excise tax on some products such as tobacco and its derivatives, soft drinks, and energy drinks. In addition, the government introduced 5% value-added tax (VAT) on most goods and services. Although the amount of revenue generated through VAT would be modest, such steps have laid the foundation to move forward. The government further reduced fuel subsidies, increased electricity tariffs and domestic oil prices.

Several capital market reforms took place in 2017 such as the launch of the Nomu parallel market, reclassification of sectors, and introduction of the T+2 settlement cycle. In June 2017, MSCI added Tadawul to a watchlist for potential inclusion in the MSCI Emerging Markets Index, which was a major milestone and reflects the Kingdom’s significant progress in capital market reforms. The authorities also had plans to enable foreign investors to participate in share floats, and introduce new rules to ease out the issuance of debt securities.

Overall, the Kingdom continued to make progress in creating a stronger and more diversified economy by building dependency on oil and non-oil sectors.
Fiscal Outlook

2018 Budget Key Highlights
The world’s top oil producer indicated that it is ready to escalate spending in 2018 as it revealed the largest-ever budget for 2018. The announced budget is about SAR 978bn (USD 261bn), with projections of revenues for this year totaling SAR 783bn (USD 209bn). The target to balance the budget has been pushed to 2023 from 2020, following the IMF’s advice to curb austerity measures to boost growth.

Expenditure Plans
The budgeted expenditure is projected at SAR 978bn. Moreover, allocations from the sovereign wealth fund (SAR 83bn) and the national development funds (SAR 50bn) bring up the total to SAR 1.1tn. The total expenditure forecast increased 11.5% YoY from SAR 926bn in 2017. Capital spending increased 13.6% YoY to SAR 205bn, while projected spending on the cash transfer program has been capped at SAR 32bn.

Sector-wise Allocation
In terms of sector allocation of the budget funds, the defense portion of the military and security took away the largest piece for the first time in 2018. Around a third of the budget is allocated for military and security combined (SAR 311bn), lower than actual spending in 2017 (SAR 334bn). Other sectors with a significant share include education (SAR 192bn), health (SAR 147bn), and economic resources (SAR 105bn). Furthermore, SAR 54bn would be allocated for the infrastructure and transportation sector to develop roads, ports, railways, airports, housing, communications and information technology and postal services.
Revenues

The Kingdom is attempting to generate more revenue through the introduction of new taxes and fees, including VAT, extra fees on expats working in KSA, and reducing the fuel subsidies.

The forecast for oil revenues increased to SAR 492bn in 2018 from SAR 440bn in the previous year, largely driven by expectations of higher oil prices. Non-oil revenues have been estimated at SAR 291bn in 2018, up from SAR 256bn. Thus, total revenues would reach SAR 783bn, an increase of 12.6% YoY. Moreover, the government expects revenues to reach SAR 909bn in 2020, expanding at a CAGR 9.3%.

Tax revenue is budgeted at SAR 142bn for 2018 (up 46%), significantly higher than 2017 (SAR 97bn) and 2016 (SAR 82bn). Moreover, tax revenues are expected to reach SAR 189bn by 2020 (up 24.9% CAGR). VAT is expected to generate SAR 23bn, while expatriate tax is expected to bring in SAR 28bn for the government in 2018.

Expected Revenues

Source: Ministry of Finance – Budget Statement 2018
Fiscal Deficit

With its revised target, the Kingdom now aims a deficit of SAR 195bn in 2018; down from SAR 230bn registered in 2017 (exceeds from planned deficit in 2017 budget of SAR 198bn). The higher deficit in 2017 came in despite several reforms being introduced by the government to drive non-oil revenues, rationalize expenditures, reduce the budget deficit and control public debt growth.

In 2018, the budget deficit is expected to reach 7.3% of the GDP, which is 1.6% lower than the budgeted deficit for 2017 and considerably lower than the 2016 budget deficit of 12.8% of the GDP. The decline in estimate is the result of a 12.6% rise in total revenues; however, this could be offset by a 5.6% increase in spending, including the 13.6% rise in capital spending to fund Vision 2030’s projects and initiatives, including infrastructure development, to stimulate economic growth and generate more jobs.

Fiscal Balance (SAR bn)

Fiscal Policy

KSA’s medium-term fiscal policy has been developed strategically to achieve the plans specified in Vision 2030. In view of the economic developments and growth targets, the timeframe of the Fiscal Balance Program was delayed and the goal to achieve fiscal balance has been moved to 2023 from 2020. This was followed by IMF’s advice to Saudi authorities to adopt fiscal consolidation gradually to ensure that economic growth is not adversely affected.

Overall, the policy is aimed at developing capital expenditure and infrastructure; and the former has been projected at SAR 205bn (21% of total expenditure) in 2018 budget. The ratio is further projected to rise to 22% in 2020 from 19% in 2017. The government’s total expenditure is expected to average 4.3% over 2018–20, while growth of capital expenditure over the medium term is pegged at an average 8.3%.

Public debt has been projected at SAR 555bn (21% of GDP), higher than SAR 438bn (17% of GDP) in 2017. Debt issuance in 2018 has been capped at SAR 117bn compared to SAR 134bn in 2017, largely to fund some portion of the expenditure in 2018.

Funding of 2018 Budget
Economic Outlook

GDP Growth

Contribution from Oil and Non-Oil Sectors

KSA’s GDP growth was slowed by 0.74% in 2017 compared to 1.7% growth in 2016. This negative growth can be largely ascribed to a decline in real oil GDP (negative growth of 3% during 2017). The non-oil sector, however, proved to be a breather, as it grown by 0.7% in 2017 (as compared to actual growth rate of 0.6% in the first half).

In 2018, the government expects real GDP to grow 2.7%, supported by a strong non-oil GDP growth rate of 3.7%. The private sector will play a major role in non-oil GDP growth. Furthermore, the IMF revised KSA’s GDP growth outlook to 1.6% in 2018 compared to its previous estimate of 1.1%, although the pace of expansion remains below government estimates. Moreover, the ministry estimates that real GDP growth rate will surpass 2.8% in 2020, driven by the real non-oil GDP growth (expected to register a 3.2% increase in 2020).

It has been a challenging task for the government to shift the overall focus from an oil-centric economy to a diversified platform. However, with revolutionary reforms and tactical steps, the government managed to deliver, as non-oil sector outperformed in most of the parameters. The contribution of non-oil sectors towards KSA’s GDP has increasingly strengthened over the years. Non-oil revenue rose to a staggering share of 36.8% (SAR 256bn) in 2017 from SAR 102.6bn (8.2% of the total revenue) in 2012. Furthermore, the trend is expected to continue going forward, with 2018 non-oil revenue estimated at SAR 291bn (37.2% of the total revenue expected).

Oil and Non-Oil Revenue Contribution
Economic Sentiment

Saudi Arabia's Non-Oil Private Sector PMI edged up to 53.2 in February of 2018 from 53.0 in the preceding month. Business sentiment hit its highest in 46 months and employment increased for the 47 month in a row. Meanwhile, new orders grew at the slowest pace on record and output growth was at the second slowest since survey began in August 2009. At the same time, new export orders fell for the first time in seven months. Firms cut selling prices by most in survey history in an attempt to stimulate client demand after domestic fuel price was hiked and the value-added tax was imposed at the start of the year.

The January reading came in lower, as business activity and new order growth witnessed a slowdown over the last couple of months amid initial uncertainties, following the introduction of VAT to the system (starting this year). However, the private sector remains optimistic, with staff hiring picking up gradually to its strongest level since August 2016 and business optimism touching its highest since May 2017.

With higher fuel and energy costs and VAT in the background, 2018 may seem to be a challenging year; however, the macro picture still seems better than the one for 2016 and 2017.

PMI Index

Money Supply (SAR bn)

Monetary Policy

The Saudi Arabian Monetary Authority (SAMA) has been seeking to adopt a policy that can achieve price stability and support various economic sectors. Moreover, it aims to assist domestic banks to encourage domestic lending and maintained the threshold of weekly subscription to treasury bills for domestic banks at SAR 3.0bn in Q4 2017.

The narrow money (M1) has grown by 17.2% over last four years, largely driven by 16.7% increase in Demand Deposits from 2013. On the other hand, M2 has increased by 20.4% due to a substantial rise in Time & Savings deposits (29.8%). The considerable rise of M1 and M2 over the years contributed majorly to the Kingdom's broad money supply, resulting in 15.9% growth in M3 since 2013.
Inflation

The Kingdom's inflation declined throughout 2017, as consumer inflation remained in the negative territory for 10 successive months until October 2017. According to latest data, Saudi Arabia inflation rate stood at 3.0% at the end of January, an increase from 0.4% in December. This is as a result of the implementation of VAT and reforms in utility and fuel prices during the month. However, the introduction of VAT and reforms related to electricity and fuel prices are expected to boost inflation, which is set to rise to 5.7% in full year 2018 from a negative 0.15% last year. As part of additional measures, KSA announced several new allowances and tax breaks for state employees, military personnel, and some citizens, in an attempt to curb rising inflation.

Credit Growth

The value of loans in KSA dropped 1.0% YoY in December 2017. Loan growth in the Kingdom averaged 13.8% from 2001 until 2017, reaching an all-time high of 44.3% in October 2004 and a record low of -1.8% in October 2017.

Bank loans to the private sector edged lower (down 0.9% YoY in December), while it witnessed an all-time peak of 47.2% in October 2004 and lowest of -1.7% in June 2017 (during 2001–17). Sluggish growth since the start of 2017 shows that private sector held back fresh investments ascribed to an economic slump amid subdued oil prices and government austerity measures.

Although the Saudi banks’ ratio of non-performing loans to gross loans is expected to marginally increase from the current level of 1.8% after the implementation of IFRS9; Saudi Arabia's banking outlook is expected to stabilize during 2018, as the economy will return to growth in 2018. Furthermore, lending growth is expected to gradually recover supported by recovery in corporate activity along with strong demand from residential loans. However, higher interest rates can hinder credit growth, as the Federal reserve has shown strong intention of sticking with the current Monetary policy. Any further hike in rates will potentially have a positive impact on banking sector earning (60.1% Non-interest bearing deposits), however given the negative credit growth experienced in 2017, credit growth can only pickup from here, especially due to the easing of ADR ratio calculation and strong economic recovery, due to recovery in oil price, Higher fiscal inflows (VAT, expat fee, lower subsidy,) and higher contribution from non-oil revenue.

Bank Lending Growth

Source: SAMA
**TASI Outlook**

The Tadawul All Share Index (TASI) managed to hold its ground in the last couple of years after falling to levels as low as 5,416 points in October 2016. The index saw the largest fall after reaching high levels of 11,149 in September 2014. The plunge in oil prices and the subsequent setback in liquidity in the market largely resulted in weak investor confidence. The TASI witnessed subdued closing at the end of last year (at 7,226 points, edging 0.2% higher from 2016) due to recovering oil prices since end-2017, further leading to increased activity.

Total market capitalization at the end of March-2018 increased to SAR 1,860bn (almost 4.0% CAGR over the last five years), whereas Index performance increased by 8.5%YTD. Overall, with the upbeat budget announcement, positive economic sentiment, and recovering oil prices, one may expect trading interest to be revived in 2018.

MSCI and FTSE Russell have considered upgrading Saudi Arabia to the Emerging Market index. The decision is yet to be taken, but Saudi stocks have performed brightly on the expectation of such upgrades. FTSE Russell’s decision on Saudi’s inclusion is due at the end of March, 2018. If the decision comes out to be positive, the probability of MSCI EM inclusion will be at an all-time high. The possible weight to be assigned in MSCI and FTSE indexes is estimated to be around 2%-2.5%, which could bring around USD 9.0-12.0 bn of foreign inflows into the market.

**TASI Index vs Volume**

![Graph showing TASI Index vs Volume]

**Market Capitalization (SAR bn)**

![Graph showing Market Capitalization]

**Sectoral Performance**

In terms of the number of transactions during 2017, insurance emerged as the most active sector, representing 19.7% of total trades during the year. It stood third in terms of the total value of shares traded. The materials sector (the largest sector in the TASI) stood second on both metrics with 4.20 million trades (value traded at SAR 192.7bn). In terms of value traded, banks dominated the market with SAR 194.9bn in value (23.3% share) and 2.12 million in volume.

In terms of sectoral performance in 2017, the media industry outperformed posting a 51% increase, followed by retailing (15%) and food and staples (11%). Conversely, the pharma sector was a laggard during the year (down 26%), with consumer services (down 24%) and transportation (down 21%) declining.

**Performance of Industry Group Indices – 2017 (YoY)**

![Graph showing Performance of Industry Group Indices]

Source: Tadawul
Conclusion

The most recent data suggests that the non-oil economy was hit hard by the introduction of VAT as PMI recorded its lowest levels of 53.0 during Jan-2018, since the inception of the survey back in 2009. However, impact on non-oil revenues is believed to be temporary as the glitch occurred due to strong order flows prior to policy implementation. Having said that, the prospects still seems bright as businesses continued to increase their staffing levels at the strongest rate since August 2016 and business sentiment achieved its 46 month high.

Overall, the economic outlook appears optimistic, as oil reached a three-year high in January 2018, indicating a solid start to the year. Rising oil revenues and the implementation of VAT is firmly believed to fill the fiscal gap by offsetting a fiscal deficit created by a more expansionary budget this year. With some upbeat forecasts such as 2.7% GDP growth, increase in revenue share of the non-oil sector (37.2%), the fiscal deficit’s gradual contraction, and inflation entering a positive territory after a long downturn, the current overall picture seems interesting and dynamic. Moreover, potential inclusion of the TASI in the MSCI and FTSE indexes and a possible IPO of Aramco in 2018 would open the domestic market. These landmark events are being closely followed by fund managers and foreign investors, which would drive the equity market backdrop in KSA.

Moreover, the new social reforms such as permitting women driving, opening of cinema theatres, and launching of tourist visas seems revolutionary as these could get other economic sectors to gain their share in the overall economy. However, it will be interesting to see how these reforms will play out in the Saudi landscape.

The progressive reforms adopted by the Kingdom have been acknowledged globally, with IMF raising its economic growth forecast to 1.6%, an upward revision from its previous estimate of 1.1%. Moreover, growing confidence in Vision 2030 is clearly visible among international rating agencies, as the Kingdom’s credit rating continued to improve despite falling oil prices in the recent past. In November 2017, Fitch Ratings issued its Long-Term Foreign-Currency Issuer Default Rating (IDR) at ‘A+’ with a stable outlook. On similar lines, S&P Global Ratings affirmed the Kingdom’s rating at ‘A-/A-2’ with a stable outlook.

With the host of new reforms and developments implemented so far and a few already in the pipeline, KSA is a captivating prospect. With the nation already attracting the attention of economists and investors all over the world, it would be interesting to see how the story unfolds in the near future.
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