February 25, 2020
Approval: 3/3/20

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 18/66-2

11:10 a.m., July 16, 2018

2. Saudi Arabia—2018 Article IV Consultation

Documents: SM/18/172 and Correction 1; and Correction 2, and Supplement 1; SM/18/174, and Correction 1

Staff: Callen, MCD; Duttagupta, SPR

Length: 51 minutes

Executive Board Attendance

T. Zhang, Acting Chair

Executive Directors	**Alternate Executive Directors**
M. Mkwezalamba (AE)	
	M. Raghani (AF)
	G. Lopetegui (AG)
	G. Johnston (AP)
A. Tombini (BR)	
	P. Sun (CC)
	T. Gonzalez (CE)
N. Horsman (CO)	
M. Erbenova (EC)	
	P. Chotard (FF), Temporary
	K. Merk (GR)
S. Gokarn (IN)	
	M. Psalidopoulos (IT)
	Y. Saito (JA)
J. Mojarrad (MD)	
H. Beblawi (MI)	
	V. Rashkovan (NE)
	K. Virolainen (NO)
A. Mozhin (RU)	
H. Alogeel (SA)	
J. Agung (ST)	
	P. Inderbinen (SZ)
	O. Haydon (UK), Temporary
M. Claver-Carone (US)	

C. McDonald, Acting Secretary
H. Malothra, Summing Up Officer
J. Acheson, Board Operations Officer
M. McKenzie, Verbatim Reporting Officer

Also Present
Finance Department: Ali Jassim H Alsadig. Legal Department: Clifford Frank Blair, Jonathan Talusan Pampolina, Gabriela Rosenberg. Middle East and Central Asia Department: Mansour K Almalik, Ali Manea M Alreshan, Botirjan Baltabaev, Nabil Ben Abdelwaheb Ben Ltaifa, N. Ben Ltaifa, Timothy Callen, Aasim M. Husain, Bikas Joshi, D. Kirti, Divya Kirti, Anta Ndoye, Stephane Roudet, S. Roudet, Tucker Norris Stone, Juan

Pedro Trevino. Monetary and Capital Markets Department: Abdul Naseer, A. Naseer. Strategy, Policy, and Review Department: Rupa Duttagupta. Western Hemisphere Department: A. Alsadig, A. Husain. Alternate Executive Director: M. Siriwardana (IN). Senior Advisors to Executive Directors: W. Abdelati (MI), B. Alhomaly (SA), Y. Danenov (SZ). Advisors to Executive Directors: X. Cai (CC), D. Fadhel (MI), T. Manchev (NE), T. Persico (IT), K. Hennings (BR).

2. SAUDI ARABIA—2018 ARTICLE IV CONSULTATION

Mr. Alogeel submitted the following statement:

The bold socioeconomic reform program under Vision 2030 to transform and diversify Saudi Arabia's economy is bearing fruit. The contribution of non-oil private sector is increasing and is expected to strengthen further over the medium term, and the employment of nationals, particularly women, is improving, while the budget deficit is declining rapidly.

Going forward, my authorities remain committed to continue the implementation of their wide-ranging reforms with the objective of, inter alia, achieving a budget balance by 2023, further modernizing the fiscal framework, promoting financial development and inclusion, and improving the business environment. Saudi Arabia will also continue to play its stabilizing role in the global oil market, for the benefit of both producers and consumers, including recently through its leading role in the OPEC to increase oil production.

Fiscal consolidation efforts are progressing well. As a result, the fiscal deficit was rapidly reduced from 17.2 percent of GDP in 2016 to 9.3 percent of GDP in 2017 and is projected to further decline in 2018. This sustained reduction has been possible by the authorities' landmark decisions on diversification of budget revenue, including through the introduction of VAT, containment of expenditure, and rationalization of subsidies.

My authorities recognize the uncertainty associated with the future path of oil prices and are determined to adhere to the medium-term spending targets. We consider that recent oil price increases offer an opportunity to further rebuild buffers while providing scope for additional high-priority spending to accelerate growth-enhancing reforms. In the medium term, the authorities view staff projection of oil revenue as pessimistic and consider that the oil price forecast is below consensus. Having said that, the authorities stand ready to implement, if needed, already identified contingency measures to achieve the balanced budget target by 2023.

Despite limited experience in taxation and important administrative challenges, the authorities successfully introduced VAT in January 2018. The initial results on VAT compliance and collection are encouraging. Because of the very large number of taxpayers, mostly small businesses, the authorities cautiously set the initial registration threshold at a high level to ensure high compliance. They are committed to reduce the threshold to the GCC-agreed level in 2019.

Efforts on reviewing capital and current spending to enhance efficiency and better align spending with policy priorities will continue. The Ministry of Finance has launched new initiatives, which seek to strengthen performance management mechanisms to ensure government entities' compliance with their spending ceilings. The Bureau of Spending Rationalization continues to work closely with entities to review their spending and improve their procurement practices. In addition, the National Project Management Office is strengthening its efforts to ensure that investment projects are meeting clearly identified needs and are in line with Vision 2030 objectives. Further efforts have been made to contain compensation and improve productivity in the public sector. In this regard, the government has recently approved the updated civil service regulations that link wage premia to performance and provide clear guidelines on job termination.

Energy price reforms are continuing and will constitute an important source of fiscal revenue. Gasoline and electricity prices were further increased in 2018. As detailed in the 2018 budget, additional gradual adjustments to energy and water prices are planned over the medium-term.

My authorities continue to be attentive to the social impact of reforms. They note with satisfaction the successful introduction in December 2017 of a cash transfer mechanism under the Citizen's Account Program, covering one-half of the Saudi population, which has been helpful in providing targeted financial support to low- and middle-income households to compensate for the costs of reforms. The authorities will continue to safeguard the welfare of needy families and communicate to the public in a timely manner to sustain public support for reforms.

As part of their reform program, the authorities have continued to strengthen the fiscal framework and promote fiscal transparency, with a particular emphasis on improving expenditure management, building on the successful launching of the Etimad portal to reinforce budget implementation and controls and monitoring of spending, avoid recurrence of arrears, and further enhance transparency. The Macro-Fiscal Policy Unit is now fully operational and is contributing to better inform the Fiscal

Committee on fiscal developments and policy options. Starting with the 2018 budget, more detailed information is being provided and quarterly fiscal reports are being published. In addition, the central government budget is now published in the GFS 2014 format. The authorities are committed to meet the Open Budget Index standards for fiscal transparency.

The Public Investment Fund (PIF) is contributing to domestic economic development while expanding its international assets. While the authorities understand the risk of crowding out, it is important to note that the PIF program is an important catalyst for the launch and development of new sectors. Indeed, PIF complements, enables, and partners with the private sector by creating new opportunities through its investments in giga-projects and developing large-scale infrastructure. To achieve its objectives, PIF has adopted a governance and operating model that builds on global best practices. In addition, a Sovereign Asset Liability Management Framework is being developed by the Debt Management Office to determine target balance sheet composition under various parameters.

The external position has strengthened substantially. The exchange rate peg continues to serve the Saudi economy well. Important progress has been made in strengthening the financial sector. SAMA has continued to implement the recommendations of the 2017 FSAP to strengthen banking oversight, further improve liquidity management, expand financial safety nets, and advance the use of macro-prudential tools to safeguard financial stability while promoting lending to SMEs.

In the same vein, the authorities launched in April 2018 the Financial Sector Development Program (FSDP), one of the most important Vision Realization Programs (VRPs), to guide the reform efforts in the period ahead to realize a fully developed and inclusive financial sector while safeguarding financial stability. Some of the objectives of the FSDP are the development of the debt, capital, and insurance markets, the advancement of financial inclusion and literacy, and the promotion of Fintech. In line with the goals of the FSDP, a primary dealer system has been recently launched to foster the development of the primary and secondary markets and support the debt financing strategy of the government. The recent inclusion of Saudi Arabia in the FTSE Russell and MSCI EM indices is an important milestone in the development of the capital market and would help in expanding the investor base.

Important progress has been made in implementing structural reforms embedded in the VRPs. More recently, the increase in public and private investments, including in untapped sectors such as the tourism and entertainment sectors, have contributed positively to economic diversification and employment creation for nationals, particularly women. Among the most relevant reforms, now in the final stage of the legislative process, we would like to mention laws on competition, public procurement, franchise, and companies. Further improving governance, building on the initial actions by the high-level anti-corruption committee, is also high on the authorities' agenda.

The authorities have recently launched the Privatization Program to further strengthen the role of the private sector in the economy. To this end, the National Center for Privatization and Public-Private Partnerships published in early July the draft of the Private Sector Participation Law for public consultation. Notably, privatizing selected government services will help further improve the quality of services and realize productivity gains. Given the synergies between this program and the other VRPs, the Privatization Program is expected to foster a more conducive environment for private sector-led growth and attract new foreign investments. In this context, close engagement and communication with the private sector on the reform agenda has been ensured through developing an internet feedback platform, annual private sector LABs, and monthly open ministerial panels.

On the Selected Issues Papers (SIPs), we would like to share Saudi Arabia's experience in view of the recent Board discussion on SIPs. My authorities greatly appreciate staff's research work in SIPs as it often helps prepare the technical ground for policy discussions and contribute to capacity building. The topics to be covered by staff are selected in close cooperation between staff and the authorities. The authorities view SIPs as a critical contribution to the Article IV consultation since most of them cover, in a more comprehensive way, policy issues relevant to their reform program.

Finally, my authorities would like to take this opportunity to reiterate their appreciation to staff for the valuable policy advice and technical assistance and thank management and the Executive Board for their continued support.

Mr. Rashkovan and Mr. Manchev submitted the following statement:

We thank staff for the comprehensive set of reports and Mr. Alogeel for his informative buff statement. Saudi Arabia's fiscal and external balances have substantially improved since last year given the higher than projected oil prices, progress with the fiscal consolidation, and the reform momentum under the authorities' Vision 2030 and Vision Realization Programs (VRPs). Although the near term-risks are now balanced, the geopolitical tension in the region remains high, which continues to put pressure on defense and security spending, and requires further reforms to mitigate fiscal and development risks in the medium term. In this regard, we welcome the authorities' sound implementation of the 2017 Article IV consultation and FSSA recommendations, and with the remarks below we wish them all the success with the implementation of their agenda.

Fiscal Policy and Public Finance Management

Gradual fiscal consolidation should continue given the uncertainty in the global oil price movements and spending pressures arising from the tense geopolitical and regional situation. Saudi Arabia has made important progress with strengthening the country's medium-term fiscal framework through improving the macro-fiscal analyses and increasing budget transparency. These improvements, together with the newly adopted digital platform for public expenditure and wage bill management, provide the authorities with a powerful tool for better focusing the fiscal policy and achieving their development objectives. The authorities' cooperation with the WB should continue to improve cost effectiveness of the civil service. Increasing capital spending in support of Vision 2030 and the VRPs need to be carefully designed to deliver efficient outcomes. In this regard, staff rightly emphasized the need for Saudi Arabia to increase transparency of the debt management and develop an integrated public asset-liability framework. Can staff provide a more detailed information and appraisal on the Saudi Arabia's external lending?

Financial Stability and Inclusion

We commend the authorities' continuous efforts to improve the supervisory framework and implement the macroprudential policy framework. These are important preconditions for a successful implementation of the recently adopted Financial Sector Development Program, which rightly focused on increasing financial inclusion and bank lending to SMEs. Given the recent recovery in oil prices, the banking system has become more liquid and we encourage the Saudi Arabian Monetary Authority (SAMA) to further strengthen the liquidity forecasting toolkit and speedily implement open market operations to better manage money market volatility. SAMA's concerted efforts with the Capital Market Authority should continue to develop the domestic debt market and secondary market for mortgage securities while carefully monitoring the related risks. The SAMA should also enhance monitoring and supervision of the banks' lending portfolios given the increasing market liquidity and recovery of the credit cycle. We welcome the new AML/CTF laws, which have enabled the introduction of the risk-based supervisory framework, and encourage the authorities to progress with the implementation to reduce the use of cash. Can staff brief the Board on the FATF's recent assessment on effectiveness of Saudi Arabia's AML/CTF framework?

Structural Reforms

We welcome the authorities' commitment and efforts to diversify the Saudi economy. The authorities' ambitious plans for job creation, especially for youth and women, should be well-sequenced with the private sector to avoid painful economic adjustments. Going forward, we encourage the authorities to carefully consider staff's suggestion for a comprehensive approach to the labor market reform. Reforms to improve the business environment should continue to build on the recent legislation and forthcoming adoption of the new laws on competition, franchise and insolvency. These reforms should also speed-up privatization, and facilitate public-private partnership transactions and recovery of the FDIs. In this regard, staff's further comments are sought on the effects that increased oil production might have on implementing future reforms and how a possible slower implementation pace may influence the foreign investment and business environment? We also note that key components in the authorities' reform agenda will be the measures to improve governance and tackle corruption, and would welcome if staff can provide any non-perception-based estimates for the corruption cost in Saudi Arabia, and quantitative estimates for the near- and long-term growth effects of the proposed anti-corruption measures in paragraph 34.

Finally, we encourage the authorities to promptly subscribe to the IMF Special Data Dissemination Standard, and especially to consistently broaden coverage of the government finance statistics beyond the central government operations in line with the well-established international practice.

Mr. Lopetegui and Ms. Moreno submitted the following statement:

We thank staff for the reports and Mr. Alogeel for the useful buff statement. We commend the authorities for the impressive advances made since the last report, showing a high degree of implementation of staff's recommendations. Reform momentum remains strong and higher oil prices improve fiscal and external balances. Nevertheless, the high reliance on oil prices has two faces, as it allows for the buildup of buffers when they are high, but as staff remarks, may put at risk the continuation of reforms. We agree with the thrust of the staff appraisal and offer some points for emphasis.

Growth declined because of lower oil prices, but non-oil growth is expected to strengthen. We wonder if sectors like tourism, entertainment, and non-oil services, which were identified as potential drivers of growth, are effectively helping boost the economy.

We agree that the prioritization and sequencing of structural reforms is key. The authorities have made ample efforts in many significant areas such as the financial system, legal framework (like the new bankruptcy law), business environment (the authorities recently launched the Privatization Program, and have improved the framework for local firms). Efforts to increase foreign direct investment are also commendable as they will permit technological transfer, among other benefits. Allowing for qualified institutional investors to acquire full ownership (versus a cap of 49 percent) will also attract foreign participation in the local securities market.

Historically, fiscal developments have been dominated by oil prices, resulting in a highly procyclical fiscal policy, as the volatility of oil revenues makes government spending volatile as well. Implementing a fiscal rule to manage resource revenue will be beneficial, though its application may take some time until the fiscal framework is further strengthened. We encourage the authorities to assess possible alternatives and decide on the rule that may best serve the country. This said, we commend the authorities for the introduction of the VAT, a key step in diversifying the revenue base. We also welcome progress in improving domestic energy pricing, with focused transfers to compensate low and middle-income households.

Labor market developments have improved with respect to the last report but challenges persist. We see merit in the authorities' efforts to improve educational and training outcomes to support medium term growth. Policies to create jobs for nationals, particularly women, should focus on gradually leveling the playing field between Saudis and expatriates.

The financial system is on average healthy, with Basel III regulation in place for all banks. While progress in developing capital markets is important, increasing financial development and inclusion would help private sector growth prospects. We encourage the authorities to enhance macroprudential regulation and ensure effectiveness of the AML/CFT framework.

We encourage the authorities to continue efforts related to data compilation and closing data gaps.

With these comments, we wish the Saudi Arabian authorities and their people the best in their future endeavors.

Mr. Merk and Mr. Maluck submitted the following statement:

We thank staff for the informative set of reports and Mr. Alogeel for his helpful buff statement.

We broadly agree with the thrust of the staff's appraisal. Growth rates of the Saudi Arabian economy declined slightly in 2017 due to a drop in oil-related activity. While the necessary fiscal consolidation continued, the authorities made further progress in advancing their wide-ranging economic and social reforms. Total employment for nationals, particularly women increased and the external balance significantly improved. Supported by a strengthening in oil prices, growth is expected to pick-up this year and the economic outlook for the next years is rather positive. However, rising oil prices might lead to reform fatigue, which could pose a threat for growth over the medium term. Therefore, a continuation of fiscal consolidation and structural reform implementation is crucial for a sustainable macroeconomic development and strengthening of non-oil growth.

We strongly encourage the authorities to focus their fiscal policies on delivering the targeted adjustment over the medium term based on conservative projections of oil price developments in the budget. We take note of staff's assessment that strong fiscal buffers and readily available financing allow for a gradual pace of fiscal consolidation over the medium term. However, we also notice staff's projections that the authorities will miss the target of a balanced budget in 2023 and end up with a deficit of 3.6 percent. Moreover, we take note that staff does not project the debt and net financial asset trajectory to stabilize in the baseline. Against this background and bearing in mind the generally high volatility of commodity prices, we agree that it will be crucial to ensure that spending remains sustainable in different oil price environments. This will also help improve inter-generational equality. In this light, we encourage the authorities to base their budget on prudent assumptions about future oil price developments. Additional windfall revenues could be used to rebuild policy buffers that have been depleted since 2014 rather than used for an acceleration of spending. Regarding fiscal revenues, we welcome the recent introduction of the VAT and the planned continuation of the gradual increase in energy prices and encourage the authorities to further broaden the tax base.

We agree that there is a need to further improve the fiscal framework. In particular, the expenditure management could be strengthened, given the budget overrun of 5 percent of GDP and continued accumulation of payment arrears. Moreover, we encourage the authorities to improve fiscal reporting, as well as the transparency and coverage of fiscal data. As ARAMCO and the PIF are undertaking quasi-fiscal spending on behalf of the government, in our view they should be taken into account when assessing the governments' fiscal balances. Additionally, we encourage the authorities to develop an integrated asset-liability management framework, in order to be able to fully assess how different investment commitments will be financed and how the different institutions involved interact and are linked within the asset-liability framework.

We welcome the progress in the implementation of the structural reform agenda and encourage the authorities to maintain their reform commitment and continue the implementation in consultation with the private sector. Given high unemployment and the growing working age population, the authorities need to further improve employment creation for nationals, in particular underrepresented groups in the labor market, i.e. youth and women. Initial reform efforts are welcome but we stress the importance of further incentivizing entry into the labor market. Moreover, the authorities should strive to discourage a crowding out of employment in the private sector by government agencies or state-sponsored companies. While we take positive note of initial reforms to improve the business environment, we encourage the authorities to enhance their efforts to facilitate private sector-driven non-oil growth. Tackling corruption and improving governance will be key in this respect. We encourage the authorities to carefully assess risks and benefits of large investment projects.

Regarding the external sector assessment, we would welcome further comments by staff. In particular, we take note of a policy gap of -3.4 percent and current account gap of -2.4 percent in the EBA-lite approach and a much larger policy gap of -8.2 percent but smaller current account gap of -1.6 percent in the EBA-oil approach. Could staff provide additional comments on what explains the different results and how the staff assessed CA gap is computed? On a more general level, we understand that the EBA models do not include Saudi Arabia. How does this square with multilateral consistency of the results presented in the ESR?

Lastly, we encourage the authorities to consent to the publication of the staff report.

Mr. Jin and Ms. Lok submitted the following statement:

We thank staff for the informative set of papers and Mr. Alogeel for the useful buff statement. We are pleased to note that the comprehensive reform program under Vision 2030 is bearing fruit. Going forward, we encourage the authorities to maintain this positive momentum, and sustain their reform efforts to promote sustainable and inclusive growth. We broadly agree with the thrust of staff's appraisal, and would like to make the following comments for emphasis.

The availability of fiscal space allows time and room for a well-sequenced, carefully-planned fiscal adjustment. The work of the Bureau of Spending Rationalization and the National Project Management Office, as well as the Etimad portal could help ensure resources are well allocated to productive uses and projects and strengthen overall fiscal management. While staff and the authorities have different projections of oil revenue going forward, we take comfort from the fact that the authorities stand ready to implement contingency measures, if needed, to achieve the balanced budget target by 2023. In the meantime, raising non-oil revenue is also critical to the authorities' fiscal consolidation efforts. The introduction of the VAT in 2018 is a key step for putting

Saudi Arabia’s fiscal position on a more sustainable, less oil-dependent path. We note the encouraging results so far in terms of compliance and collection, and look forward to a successful reduction of the registration threshold next year.

In the process of fiscal adjustment, it is crucial to ensure that the vulnerable remains adequately protected. We are encouraged by the authorities’ attentiveness to the social impact of their policies, and their assurance that the Citizen’s Account Program has been helpful in compensating low- and middle-income households for the costs of reforms.

Structural reforms are essential for supporting growth and employment. Reform efforts continue to proceed in various areas including reducing costs of doing business, improving governance, making the FDI regime less restrictive, and strengthening the role of the private sector. These efforts are important for promoting private-sector led growth, diversifying the economy, and generating growth dividends. Labor reforms, including measures to increase female labor participation, would help further unlock the economy’s potential. As the authorities continue to pursue structural measures in different directions, it is important to remain mindful of possible costs to businesses and ensure that measures are carefully paced and clearly communicated.

Greater financial development and inclusion efforts will lend further support to the economy. A developed, stable, and accessible financial sector is vital to the healthy growth of an economy. Thus, we are encouraged by the establishment of the Financial Sector Development Program (FSDP) this year with the objectives to develop financial markets, advance financial inclusion and literacy, and promote Fintech. The efforts of financial development should be complemented by appropriate safeguards to financial stability. We take positive note from staff’s scenario analysis in Appendix II that Saudi Arabian banks can withstand various asset quality and liquidity shocks. Nevertheless, in face of potential risks including the tightening global financial conditions, geopolitical uncertainties, and oil price volatility, we encourage the authorities to continue to strengthen its supervisory and regulatory frameworks, supported by well-calibrated macroprudential measures. Could staff shed light on the reasons behind the recent increase in the LTV ratio for first-time owners to 90 percent?

Overall, the authorities are making notable progress in pursuing reforms on multiple fronts, and we wish them every success in their policy endeavors going forward.

Mr. Beblawi and Ms. Abdelati submitted the following statement:

We thank staff for a well-prepared set of reports and Mr. Alogeel for an informative buff statement. We commend the authorities for sustaining the reform momentum under their Vision 2030, and for continuing to roll out new reform initiatives. We note the rising contribution to growth of non-oil private sector activity, which reflects the gains from these reforms. We commend the improvements in the employment of nationals, particularly women. We encourage the authorities to consider the prospect of higher oil prices as an opportunity to continue reforms rather than to defer them.

We support the authorities' objective of achieving a budget balance at a slower pace by 2023, which will require continuing with the implementation of reforms, especially in terms of the containment of spending, rationalization of subsidies, and diversifying budget revenues. Actions already implemented in these areas, including the successful introduction of the VAT, have contributed to reducing the budget deficit markedly from over 17 percent of GDP in 2016 to less than 10 percent of GDP in 2017, and a projected 4½ percent of GDP in 2018. The deficit is further expected to narrow to below 2 percent of GDP in 2019. We note that staff calls for any revenue over performance to be saved, while the authorities see scope for additional high-priority spending to accelerate growth-enhancing reforms. In principle, the low debt and need to accelerate non-oil-based activity suggest there is fiscal scope to do so.

Sizable spending/on-lending is planned outside the budget by transferring government deposits amounting to 1.7 percent of GDP to specialized credit institutions, while the Public Investment Fund is also planning to invest another 2.8 percent of GDP domestically. We note the commendable progress that has been made in strengthening the budget process, developing medium-term fiscal framework, increasing transparency, and improving macro-fiscal analysis, as noted in the staff report and in the buff. Consistent with this strengthening of the fiscal framework, we agree with staff on the importance of broadening fiscal coverage to get a fuller picture of the impact of fiscal policy on the economy. We also agree with the importance of developing an integrated asset-liability management framework.

The authorities consider staff's medium-term oil price projection as pessimistic and below consensus. We recognize the uncertainty of forecasting oil prices and the prudence of being conservative. But at the same time, oil prices are a key assumption for a country like Saudi Arabia and can significantly affect the baseline medium-term projection. We seek staff clarification of whether the systemic oil exporters are consulted in the process of formulating the Fund's oil price projections and the implications for Saudi Arabia of using the consensus forecast.

Attentiveness to the social impact of reforms is critical to sustain public support for the reforms and contain the cost borne by low- and middle-income families. The successful introduction of the Citizen's Account Program in December 2017, with coverage of 50 percent of the Saudi population is very impressive. Continuing to communicate to the public in a timely manner is also important to sustain public support for the reforms.

We agree that the exchange rate peg has served the Saudi economy well and note SAMA's decision to raise its policy rates ahead of the Fed as a sign of commitment to the peg. We welcome the strengthening of the external position with the rise in oil prices. SAMA's reserves have recovered and remain high by Fund metrics.

We take note of the continued implementation of the recommendations of the 2017 FSAP. SAMA is working to strengthen banking oversight and further improve liquidity management. It is also working to advance the use of macro-prudential tools to safeguard financial stability, while promoting lending to SMEs, a topic we return to below. The financial sector development plan (FSDP) includes wide ranging and ambitious reforms to realize a fully developed and inclusive financial sector. We welcome the recent launching of the primary dealer system in order to support the development of a primary and secondary market. We also congratulate the Saudi authorities on the recent inclusion of Saudi Arabia in the FTSE Russell and the MSCI EM indices, which will help build the investor base.

Wide-ranging initiatives are under way to increase the role of the private sector and contribute to economic diversification. We take note of the substantive legislative agenda in the final stages of preparation, including the laws on competition, public procurement, franchise and companies. The recent launching of the privatization program and public consultations surrounding the Private Sector Participation Law should also pave the way to encourage private investment. In the next Article IV reports, we would like to hear more about progress in these areas and the experience with planned close consultations through the internet feedback platform, the annual private sector LABs, and monthly open ministerial panels.

The Selected Issues Paper (SIP) chapter on How to Develop an Inclusive Financial Sector in Saudi Arabia provides useful benchmarking and country comparison with peers. We found useful staff's description of the state of SME development and the box on Government support to SMEs, which account for 95 of registered businesses and 38 percent of jobs. We agree with the recommendation to address institutional constraints to SME lending. We would welcome staff views on the effectiveness of the SME support program and what lessons are there for other countries wanting to support SME growth.

Given the usefulness of SIPs and their important role in the consultation discussions with Saudi Arabia, we support their continuation. We also appreciate the close consultations on topics that are relevant for the reform program. All three topics selected are highly relevant and include detailed staff analysis that is useful for policy formulation.

We wish the authorities continued success in realizing their Vision 2030.

Mr. Mozhin, Mr. Palei and Mr. Potapov submitted the following statement:

We thank staff for a set of insightful papers and Mr. Alogeel for his informative buff statement. Saudi Arabia is implementing ambitious policy reforms aimed at promoting economic diversification, reducing oil dependence, and increasing the role of the private sector, while achieving a balanced budget by 2023. Staff believe that reform momentum remains strong under Vision 2030 and risks to the outlook are broadly balanced. The key strategic reforms are bolstered up by sizable fiscal buffers that provide considerable cushion against potential shocks. Higher oil prices over the past year have also contributed to improvements in the fiscal and external positions. We broadly agree with staff's recommendations in the report and would limit our comments to the following points.

Following last year's contraction, GDP growth is expected to pick up in 2018, supported by the on-and off-budget fiscal stimulus and higher oil prices and output. As staff pointed out, the successful implementation of structural reforms could boost non-oil growth by around 2 percent over the projection period. We would appreciate staff's additional elaboration on sectoral growth prospects in Saudi Arabia.

In line with the recommendations made during the 2017 Article IV consultations, the authorities have recalibrated the pace of fiscal consolidation, pushing back the target of a balanced budget from 2020 to 2023. This policy change is intended to reduce the impact of the necessary fiscal adjustment on growth and employment, while providing time for growth-enhancing structural reforms to take hold. At the same time, we note a substantial divergence between the authorities' (a balanced budget by 2023) and staff's fiscal projections (a deficit of 3.6 percent of GDP by 2023) over the medium term. We would appreciate staff's comments on the key reasons behind this divergence.

We welcome the authorities' fiscal adjustment measures, which have led to the non-exported oil primary deficit reduction from 44.6 percent of non-oil GDP in 2016 to 38.6 percent in 2017. Important progress has been made in strengthening the budget process and developing the medium-term fiscal framework. The VAT introduction in the beginning of this year was a remarkable achievement in strengthening the tax administration and raising non-oil revenues. We agree with the authorities that further ambitious fiscal consolidation, accompanied by fiscal structural reforms, is needed to put public finances on a more sustainable footing. Priority should be given to reducing the high wage bill and operational expenditures, while creating room for social and capital spending. Progress on energy sector reforms, including the sale of an equity stake in Aramco and future energy price adjustments, will also be critical in supporting the fiscal adjustment. At the same time, we agree with staff on the importance of avoiding a procyclical fiscal policy and welcome the very useful analysis of a possible fiscal rule in Saudi Arabia in one of the SIP chapters.

Improving fiscal transparency and better integrating the Public Investment Fund (PIF) and Aramco in the fiscal reporting would be instrumental in strengthening the budget process. In this context, we welcome the authorities' objective to improve general budget score in the Open Budget Index (OBI) and to subscribe to the SDDS. We also support their plans to develop a sovereign asset-liability management framework, which will improve public investment management and contain fiscal risks.

While a more flexible exchange rate could have helped to adjust to external shocks, we agree with staff and the authorities that the exchange rate peg to the U.S. dollar remains broadly appropriate for Saudi Arabia, given the structure of the economy and the predominant role of oil in export. At the same time, it is recognized that the peg may constrain the authorities' plans aimed at facilitating economic diversification. Under such circumstances, we find it useful to review the peg over the medium term, subject to progress on structural reforms.

Despite the pressure on public spending and overall growth contraction in 2017, banks remain generally in good shape. We welcome the results of stress tests update presented in Appendix II of the report. This exercise concludes that most banks are resilient to severe economic and liquidity shocks. We welcome the authorities' efforts aimed at strengthening further the liquidity management framework and the macroprudential framework. Improving the effectiveness of the AML/CFT regime and developing the financial and domestic debt markets are also among the authorities' key priorities.

Acceleration of structural reforms is needed to improve the business environment and promote the private sector's development. One of the key challenges facing Saudi Arabia is to create enough jobs for its growing labor force and reduce existing unemployment, which remains high among Saudi nationals. In this context, we welcome the authorities' efforts aimed at implementing the labor market reforms and, at the same time, agree with staff that the pace and design of these reforms should take into account potential negative implications on economic activity. We encourage the authorities to remain focused on reducing remaining barriers to female labor force participation. The authorities are also well advised to further strengthen education and training, support the SME sector, and reduce the attractiveness of employment in the public sector.

With these remarks we wish the authorities further success.

At the same time, we would like to make special remarks on the exclusive emphasis on the third-party indicators (TPIs) on governance and corruption in the report (Box 7). In our opinion, staff's approach is not consistent with the recently adopted Framework for Enhanced Fund Engagement (FEFE). While staff rightly highlighted the risks associated with weak fiscal transparency, the report lacks the detailed assessment of how the governance vulnerabilities are macroeconomically critical and affect the state functions most relevant to economic activity, i.e. the main areas described in the policy adopted by the Board. Did staff discuss with the authorities any existing governance vulnerabilities that are macro-critical in line with the FEFE? In the absence of such analysis, staff's findings on corruption are linked entirely to the perceptions-based indicators of inferior quality. The use of four such indicators instead of one does not add any useful information, as they all are based on perceptions and similar information.

We do not believe that the ICGR indicator is based on expert opinions. This indicator is lacking reliability and transparency, and it is provided by a private company PRS Group. We find it inappropriate for the IMF to endorse such indicators or to promote the sales of the PRS Group products. We regret that it is the case now, as the site of this company states: "Our results are consistently and independently back-tested for relevance and accuracy by such organizations as the IMF and by scholars at leading universities, including the Fuqua School of Business and the National Bureau of Economic Research."

According to the FEFE, TPIs could be used to complement but not displace the analysis by the IMF staff and other international organizations, including the World Bank. Moreover, we note that the report does not include a disclaimer about substantial shortcomings of these indicators, especially those provided by private companies and perception-based. The quantitative assessment of a potential impact of reducing corruption on GDP growth in Saudi Arabia lacks credibility, as it leaves out the unique features of the economy and is based on unreliable data.

Mr. Psalidopoulos and Mr. Persico submitted the following statement:

We thank staff for the comprehensive set of papers and Mr. Alogeel for the informative buff statement. We support the staff's appraisal and would like to provide the following comments.

Saudi Arabia makes good progress in reform implementation. Nonetheless, growth declined and unemployment remained high calling for further interventions. The country is exposed both to external and domestic risks. For this reason, the authorities should avoid any slippages in the reform agenda, moving forward in the implementation of the envisaged Vision 2030 plan. Moreover, we invite the authorities to continue the ongoing accomplishment of Staff recommendations, in particular on the reduction of the government wage bill and the labor market reform. In this context, structural reform efforts to support stronger non-oil and private-led growth should continue. At the same time, the authorities should be ready to take advantage of eventual favorable oil prices to increase savings and rebuild the depleted policy buffers.

Saudi Arabia should continue a gradual fiscal adjustment. We commend the authorities for the effective deficit reduction of the last year and the good progress in fiscal reforms, namely the introduction of the VAT and the increase of energy prices. As this chair stressed in the past, the fiscal consolidation should provide some fiscal space to support the implementation of the most needed structural reforms. In this regard, we welcome the slower pace of fiscal consolidation announced in the 2018 budget and the delayed budget balance. The authorities should intensify their efforts to address the remaining fiscal weaknesses increasing transparency and coverage of public-related entities such as the Public Investment Fund Program (PIF) and Aramco. In this regard, also considering the new domestic role of the PIF as a catalyst for the development of new sectors, crowding out risks should be carefully monitored.

With the current peg arrangement fiscal policy remains the only absorber of external risk. In the occasion of the last Article IV discussion we expressed our doubt on the appropriateness of the peg regime. Now, we welcome staff's suggestion for a greater flexibility. We wonder if this option could be recalled also in the staff appraisal. Staff's comments are welcome. As the external position was weaker than consistent with desirable medium-term settings and oil prices remain a key driver of the external outlook, a more flexible exchange rate could support both fiscal revenues stabilization (with the exchange rate following oil prices) and non-oil sector development. Moreover, a flexible exchange rate regime could allow a more independent interest rate policy. At the same time, while increasing financial inclusion, the authorities should strengthen the macroprudential framework and the AML/CFT regime according to the MENAFATF standards.

Unemployment and a persisting gender gap remain a key issue as well highlighted in the Selected Issues paper. Staff analysis, as recognized also by the authorities, covered in a comprehensive way several relevant policy issues: among them, there is the key challenge to create jobs in the private sector for Saudi nationals. Data on increasing unemployment, especially among women and the young, are concerning. We invite the authorities to step up their efforts to increase female labor participation. Indeed, while Saudization measures and expatriate levy – as pointed out by staff's model – could potentially undermine the growth trend (creating also excessive burden for the private sector), an increased female participation will impact positively both growth and consumption. In this regard, we would appreciate more details on youth unemployment and the impact of the related measures.

Mr. Gokarn and Mr. Siriwardana submitted the following statement:

We thank staff for their well-written set of reports and Mr. Alogeel for his informative buff statement. Saudi Arabia is progressing in the implementation of its ambitious economic and social transformation agenda under Vision 2030 aimed at becoming a less oil-dependent economy. Although growth was negative in 2017, the economy has improved with relatively higher oil prices in the recent past, which has propelled the oil sector while leading to greater fiscal space and strengthened external position. We commend the authorities for their strong commitment to the reform agenda. However, given the uncertainty surrounding oil prices, which are key drivers of the fiscal and external outlook, continuation of the adjustments to strengthen the fiscal framework and diversify the economy is vital to withstand large commodity prices swings in the future. Hence, the relatively high oil prices at present provides excellent leeway to continue growth friendly structural reforms in a more gradual, focused and sequenced manner with clear governance and effective coordination to minimize their negative impact on growth and the social system, and further build buffers. We broadly agree with the staff's appraisal and wish to offer following remarks for emphasis.

Fiscal adjustments should remain as the cornerstone of the reform agenda. We commend the authorities for introducing a VAT in January 2018, which is a landmark achievement, and encourage them to implement other planned reforms, including the reduction of VAT threshold, to improve the non-oil revenue. Sustainability of expenditures is also important in reducing the vulnerability of the budget to oil prices. We note the divergence between staff and authorities on the timing of achieving budget balance, mainly due to the assumption on oil prices. Staff comments are welcome on the significant divergence in the oil price assumptions and its broad impact on the pace of implementing fiscal reforms. In this light, we support the staff's call for developing contingency scenarios to face future uncertainties of oil prices. While recognizing the need for gradual adjustment in domestic energy prices, we highlight the importance of continued compensation to low and middle-income households from the reform impact through initiatives such as the new Citizens' Accounts Program. On the question of introducing fiscal rules, we concur with staffs' recommendations, elaborated in an SIP, that improvement of the fiscal framework would be appropriate at present compared to a formal fiscal rule, given the need for improving institutions to support the latter.

We agree with staff that given the structure of the economy, the exchange rate peg serves Saudi Arabia well. The recent increase in inflation, reflecting the impact of VAT and energy price hikes, warrant close monitoring, given higher oil prices, ongoing domestic energy price reforms and the gradual closing of wage gaps.

Saudi Arabian banks remain liquid and relatively well developed. However, fluctuations in oil prices could expose the system to shocks, including their profitability. Hence, we commend the authorities' commitment to undertake continuous reforms, including the recent Financial Sector Development Program (FSDP), to safeguard the financial stability while strengthening financial inclusion. We agree with staffs' suggestion to develop a National Financial Inclusion Strategy, focusing on women and remotely located populations. The authorities' proactive approach to capitalize on opportunities in fintech is a welcome development. We also encourage the ongoing measures to develop the domestic debt market, including the planned establishment of a Primary Dealer System, which will increase flexibility in the pricing of government debt issuances and attract private investments.

We welcome the authorities' strong structural reform agenda entrenched in the Vision Realization Programs (VRPs) to further diversify the Saudi Arabian economy and reduce vulnerability to oil price shocks. The progress accomplished in improving the business environment, developing capital markets, reforming the legal system and, more broadly, limiting government's role in the economy will promote private sector investments and activities. The recent launch of the Privatization Program is also important to further strengthen the role of the private sector in the economy. In effectively continuing these new policies, we concur with staff that empowering institutions is important. Measures to improve productivity in the public sector will complement these moves. We note the expectation of increasing employment opportunities to Saudis, which however has been largely prevented by the wage gap between expatriate and national labor, as highlighted in an SIP. While we concur with staff on the proposed multi-pronged approach to address the wage gap, could staff comment more on the implications of proposed reform measures in expatriate labor policies to address this?

The authorities' push to open-up and include more women to play a greater role in the economy is particularly commendable. The recent policies to increase labor force participation of women, including the expansion of childcare facilities, transportation subsidies and allowing women to drive as well as continued emphasis on female education, are reassuring and will help spur potential growth rate of the non-oil sector. Staff comments on further measures to open-up the labor market for women are welcome.

We note the growth dividends that Saudi Arabia could obtain by tackling corruption and improving governance (Box 7). In this context, we commend the recent initiatives to ensure credible and strong institutions towards reducing corruption. We concur with staff that further efforts are needed to reduce the opportunities for corruption, together with the enhancement of AML/CFT framework.

With these remarks, we wish Saudi Arabian authorities all the very best in their future endeavors.

Mr. Saito and Mr. Ozaki submitted the following statement:

We thank staff for the comprehensive papers and Mr. Alogeel for his informative statement. Oil prices have risen over the past year and are positively affecting fiscal and external balances. Fiscal consolidation continued in 2017, and the current account returned to surplus (2.2 percent of GDP). As the government is continuing to implement wide-ranging economic and social reforms under Vision 2030, we commend the authorities for making good progress in implementing their reform program. On revenue side, major progress has been made in implementing new revenue initiatives, in particular, the authorities successfully launched the VAT on January 1, 2018 with very limited exemptions. Having said that, while higher oil prices provide an opportunity for the reforms, we need to bear in mind that higher oil prices might also lead to a risk of complacency. As we broadly concur with the thrust of the staff's appraisal, we will limit our comments to the following points:

Fiscal Policy

Saudi Arabian authorities should focus on strengthening fiscal framework and fiscal institutions, and develop the tools for budgetary implementation and monitoring to strengthen budget execution at this stage, admitting that important progress has been made in strengthening the budget process. The fiscal deficit is projected to narrow to 4.6 percent of GDP in 2018, and reduce further in 2019. However, the fiscal deficit would widen modestly thereafter in the medium term. It seems to remain unchanged that the government's ability to achieve its fiscal objectives will importantly depend on the future path of oil prices. In this regard, we note that the projection of future oil prices diverges between the Fund staff and the authorities, and the authorities' path is more optimistic than the staff, while both parties agreed with the importance of targeting budget balance by 2023. We encourage the authorities to be ready to implement previously identified contingency measures to still achieve the balanced budget target by 2023, if oil prices turn out to be lower than in the budget.

As for a fiscal rule, while the eventual introduction of a fiscal rule could potentially help the government achieve its fiscal policy goals, strong institutional framework for fiscal policy is key to successfully implement a fiscal rule, as the experience with fiscal rules in resource rich countries has been mixed owing to flawed design and weak institutional arrangements. Therefore, the focus of reforms should be to continue to strengthen the fiscal framework at this stage.

Regarding capital spending (investment), we put emphasis on the importance of establishing comprehensive framework, including PIF, Debt Management Office, and SAMA's reserve management strategies. In introducing Public-Private Partnerships, the authorities should develop internal capacity to handle them.

Compensation for low and middle-income households is essential to support the reform. In this regard, the introduction of the Citizens' Accounts is welcomed. The figure on page 64 in the staff report illustrates that, in the citizen account cash transfer scheme, as the income of the households increase, the amount of entitlement decreases. We also note that one-half of the population are covered under the program. However, regarding the appropriateness of the compensation level, staff observe that it is difficult to assess due to the lack of data and methodology underlying the calibration of the benchmark compensation level. In this context, we concur with staff's view that the details of the Citizens' Accounts compensation and its adequacy should be made public and broadly communicated through examples to ensure the credibility of the Citizens' Accounts.

Financial Stability

We welcome the authorities' focus on financial development and inclusion as set out in the recent Financial Sector Development Program. We appreciate authorities' approach to remove the underlying constraints and impediments that deter financial institutions from entering new markets or developing products, rather than requiring them to lend to certain borrowers. Regarding the measures to maintain financial stability, efforts to strengthen liquidity management and to use macroprudential tools countercyclically by SAMA are welcome. However, we have some concerns with the recent increase in the LTV ratio for first-time home owners to 90 percent (from 85 percent), which is quite high by international standards, at a time when retail mortgage lending is growing strongly. While we note that authorities judge that financial stability risk from the change of the LTV ratio is deemed to be limited, we would ask staff's view on the risk of overheating housing market.

Structural Reform

We welcome the progress made in implementing structural reforms in wide range of areas. In this vein, we positively note that the authorities have introduced policies to boost female labor force participation and employment (FLFP), including transportation subsidies, covering childcare costs, expanding childcare facilities and encouraging telework. We would appreciate it if staff would give comments on whether these measures are effective enough to facilitate FLFP, and if not, what kind of additional measures the authorities should take further.

Ms. Erbenova and Mr. Dogan submitted the following statement:

We thank staff for the comprehensive report and informative selected issues paper, and Mr. Alogeel for his insightful buff statement. We note the authorities' commitment to the multi-pronged economic and social reform efforts under Vision 2030, which have the potential to significantly transform the economy. The recent increase in oil prices and fiscal consolidation measures are conducive to economic growth and the rapidly declining fiscal deficit. While Saudi Arabia's medium-term economic outlook appears favorable, we note the difference of the authorities' and staff's estimates of future oil prices. Regardless, the current environment provides a good opportunity to build buffers and support further development of the non-oil sector. We broadly agree with the thrust of staff's assessment and would like to offer the following comments for emphasis.

Fiscal adjustment should be accompanied by strengthening the medium-term fiscal framework (MTFF). The authorities' plan to balance the budget by 2023 is appropriate, if fiscal reforms are not compromised. In this regard, a strong MTFF would serve as an effective anchor for revenue mobilization and expenditure control. Moreover, applying a comprehensive asset-liability management framework would be beneficial. We concur with the need for the contingency measures outlined in the staff report to prepare for the oil price uncertainties. The VAT which was introduced in 2018, is a paramount step to increase and diversify budget revenues and we welcome the reduction in the registration threshold to increase the number of VAT payers starting in January 2019. Could staff comment on the initial tax compliance experience since the introduction of the VAT? The pace of further increases in energy and water prices should be gradual and commend the authorities for their citizens' accounts initiative to offset the financial burden on the lower income groups of the population. In this regard, we encourage the authorities to share the data on compensation system and its calibration to facilitate further analysis by staff. Could staff inform us whether the authorities intend to change the current compensation program once the planned additional price increases are being implemented? As staff rightly notes, the development of the non-oil sector should significantly involve the private sector, and avoid crowding out effects by overly relying on public sector engagement.

The exchange rate peg continues to serve Saudi Arabia well. We note that the authorities agree with staff's assessment that the peg provides an effective nominal anchor for monetary policy. In line with the staff's assessment, we find it useful to regularly review the peg to ensure that it remains appropriate. In this vein, the authorities should take advantage of the current conditions to develop liquidity management tools.

We commend the authorities for the progress made in enhancing the financial stability, but the resilience of the financial sector still needs to be strengthened. Banks are sound, well-regulated and supervised, while non-performing loans are low. We note the considerable variation of NPLs across sectors but are reassured about the banks' resilience based on staff's asset quality and liquidity analyses. We welcome the efforts to increase financial inclusion, particularly for women, spur financial innovation and the use of technologies, and encourage authorities to further facilitate debt market development. We positively note the authorities' endeavors to remove the constraints in financing access for SMEs, which in turn would support economic diversification and job creation. At the same time, we concur with staff on the importance of reforms to remove the impediments that deter financial institutions from entering new markets or developing products, rather than requiring them to lend to certain borrowers, which could over time undermine the quality of their assets. Regarding macro-prudential policy, we agree with the staff's view that increasing the loan-to-value (LTV) for first-time homeowners from 85 to 90 percent at a time of the strong growth in mortgage volumes could pose risks. We encourage the authorities to continue their efforts aimed at strengthening the AML/CFT framework. Can staff comment on the main conclusions from the recent FATF/MENAFATF Mutual Evaluation Report?

An effective prioritization and sequencing of the far-reaching reforms will help to achieve the Vision 2030 objectives. We welcome the authorities' emphasis on private sector development by easing doing business and improving the investment environment. The labor market reform is an essential part of the overall structural transformation plans, and in particular the reduction of the share of employment in the public sector, addressing wage differences and segmentations, and promoting female labor force participation. Building institutional governance frameworks and fighting corruption are among the major components of the reform agenda. We support the authorities' efforts to streamline relevant government regulations. Could staff inform us about the high level anti-corruption committee's activities?

With these remarks we wish the authorities success in their reform endeavors.

Mr. Inderbinen and Mr. Danenov submitted the following statement:

We thank staff for the comprehensive set of reports and Mr. Alogeel for his informative buff statement. The transformation and diversification of Saudi Arabia's economy is underway, and we note that many of recommendations of previous Article IVs and the recent FSAP have been implemented. Reform momentum remains strong, and higher oil prices have improved the fiscal and external balances. But further reforms are required to mitigate risks to the outlook over the medium term, and tensions in the region are putting upward pressure on security and defense spending. We note the differences of view between the authorities and staff, including on the outlook for oil prices and its implications for the fiscal position.

Growth Outlook

The opportunity offered by the current high oil prices should be used not only to reduce deficits and build buffers, but also to advance toward a more diversified private sector. Although the non-oil and private sectors are growing faster than the oil and public economy, the non-oil output gap remains negative. We agree with staff that the roles of public and private sectors in developing the non-oil economy need to be carefully delineated. A strong private sector will require further progress in improving the business environment and advancement under the authorities' privatization program.

Fiscal Adjustment

We acknowledge the achievements in consolidating the fiscal position. We also note the important step of introducing the VAT, as well as the ongoing efforts to limit the growth of public spending and increase expenditure efficiency. However, the non-oil balance is projected to deteriorate slightly in 2018. We note the divergence between the authorities and staff on the break-even oil price consistent with the authorities' fiscal objectives. Staff correctly emphasizes the need for contingency measures, should oil prices turn out to be lower than projected. It is reassuring to learn from the buff that the authorities stand ready to take such measures if needed. We commend the authorities on the further progress in public expenditure management, in developing a medium term fiscal framework and in increasing transparency.

Monetary Policy and Financial Sector

We note the staff's assessment on the adequacy of the exchange rate peg. We also note staff's take on the longer term benefits of exchange rate flexibility, including for the non-oil export sector. We agree that the authorities would be well-advised to review the exchange rate regime periodically. We note that banks are well positioned to cope with shocks, thanks to low of NPLs and increased risk-weighted capital coverage. We agree that further financial development, with a focus on inclusion, remains important. The priority given to the Financial Sector Development Program is promising in this regard.

Structural Reforms

High oil prices provide an opportunity for maintaining reform momentum under the authorities' Vision 2030 agenda and boosting non-oil sector growth. We would particularly underline the potential benefits of labor market reforms to reduce constraints to the employment of segments with low participation rates. We acknowledge the progress in improving the business climate and encourage the continuation of efforts to this end.

Mr. Johnston and Mr. Khurelbaatar submitted the following statement:

We thank staff for their comprehensive report and Mr. Alogeel for his helpful buff statement. The performance of Saudi Arabia's economy is improving, and is expected to show steady growth in the medium term, depending in no small part on the path for oil prices and volumes, and also on the successful implementation of wide-ranging economic reforms. We commend the Saudi authorities for their comprehensive reform program. We also thank staff for the selected issues papers which provide detailed information on the labor market and an analysis of fiscal policy.

Measures to increase revenue and reduce expenditure will support medium-term fiscal consolidation. The fiscal deficit is narrowing, despite recent measures that will delay the 2019 fiscal balance target, including the reversal of the 2016 decision to reduce government employee allowances and annual pay steps, and the increase in allowances for government employees for 2018. It will be important to contain the wage bill, as this accounts for half the budget, and to consider the sustainability of long-term pension funds, as Saudi nationals retire at a relatively early age compared to some other countries. We welcome the introduction of VAT, and look forward to the lower threshold and broader participation of businesses from 2019, which will help establish a more efficient tax system and a steady revenue stream. Measures to increase the effectiveness of financial management will also contribute to fiscal consolidation, such as a centralized payroll system, single treasury account, improved public procurement law, increase in fiscal transparency and integrated asset-liability management framework.

Unemployment in Saudi Arabia remains high, especially high among women and youth, and we agree with staff that greater participation in the labor market could positively influence domestic consumption, investment and growth. We note staff's analysis that by increasing women labor force participation the economy could grow by an additional 2 percent in five years' time and we support ongoing reforms to encourage this, including in transportation and child care.

Mr. Agung, Mr. Machmud and Mr. Sanoubane submitted the following statement:

We thank staff for their comprehensive report and Mr. Alogeel for his informative buff statement. We laud the Saudi Arabian authorities for progress made in implementing ambitious reform envisaged under the Vision 2030. Fiscal reforms, in particular, have delivered tangible results with a significant decline in fiscal deficits and appropriate path to achieve budget balance by 2023. We also welcome the bold structural reforms, which are shaping the country towards sound business climate, and greater labor participation, especially in women and in turn will help boosting non-oil growth. Yet, in light of uncertainties surrounding the outlook, particularly oil price movements, we emphasize the need to sustain momentum of reforms with a view to achieving fiscal objectives, a more vibrant private sector and job creation. We agree with the thrust of staff appraisal and offer following comments for emphasis.

Continuing fiscal adjustment and strengthening fiscal frameworks are keys to achieve fiscal sustainability in the medium term.

As part of fiscal adjustment on revenue side, we welcome the recent introduction of VAT that partly contributes to the declining projection of fiscal deficit in 2018. While we commend the VAT measure, we see a need to further, but gradual, implementation of fiscal adjustments through other non-oil revenue mobilization, continued energy price reforms and wage bills rationalization in order to achieve fiscal balance in 2023. On capital spending, while we welcome the authorities' continued efforts to enhance capital spending efficiency, we tend to agree with staff that in the midst of oil price uncertainties, capital spending should remain at a sustainable level. Acknowledging the importance of compensation to mitigate the impact of fiscal adjustments, we encourage the authorities to regularly assess the adequacy of Citizens' Account program in protecting the most vulnerable.

On fiscal frameworks, we commend the authorities' significant progress in strengthening the budget process, developing the medium-term fiscal framework, and enhancing fiscal transparency. In this regard, we suggest the authorities to continue their advancement in expenditure management and fiscal reporting beyond central government budget. Given the robust investment activities led by the Public Investment Program (PIF), we look forward to seeing a full picture of its governance and operations as well as the updates on the introduction of Asset Liability Management Framework. On long-term fiscal framework, we note that staff made a good case in Selected Issues Paper regarding the possibility of targeting primary non-oil balance or fiscal rule to limit spending volatility. Could staff share the authorities' preliminary views on fiscal objectives beyond 2023?

We welcome the implementation comprehensive structural reforms to boost growth and employment. We note that the authorities' labor market interventions have been crucial to increase the participation of Saudi nationals in the private sector. Further advancing these efforts will ensure that the 7 percent target of unemployment rate is achievable by 2030. In this vein, we would like to echo staff's recommendation on creating incentives for nationals to work for private sector and improving skills development for Saudi workers. The recently created Labor Market Policy Market Committee should closely monitor the developments in labor market, particularly the higher cost of labor. Meanwhile, we view that ongoing reforms in business environment are key to boost non-oil growth and to offset the impact of higher energy and labor cost arising from other reform initiatives. In this regard, we welcome the update on legal framework and measures to streamline the process of opening a business. Accelerating privatization and PPP program could also help increase government efficiency and enhance the role of private sector.

Safeguarding financial stability and increasing access to finance continue to remain a priority on the agenda. We take a positive note on the regular meetings of National Financial Stability Committee to ensure the stability of financial system. On financial inclusion, we see merit in developing a comprehensive strategy with focus on women and remotely-located population, supported by Fintech and financial literacy program. In this regard, the authorities may consider upgrading regulatory framework to align with financial deepening efforts.

Ms. Horsman and Mr. Williams submitted the following statement:

We thank staff for their comprehensive set of reports and Mr. Alogeel for his insightful buff statement. Helped by higher oil prices and profound reforms under the Vision 2030 initiative, Saudi Arabia's fiscal and external balances have improved considerably. We take positive note of the authorities' steady progress in implementing key recommendations from the last AIV consultations and the FSAP. Nevertheless, the country remains vulnerable to volatile oil prices. Against this backdrop, the authorities are advised to capitalize on the favorable macroeconomic environment to press ahead with their reform agenda to strengthen fiscal and external buffers, induce greater private sector activity and diversify the economy. We broadly concur with staff's assessments and recommendations and will offer the following remarks for emphasis.

Efforts to consolidate fiscal operations should continue with sufficient social protection. We support the authorities' more gradual fiscal consolidation path to balance the budget by 2023 instead of 2019. This will help to garner social buy-in for the reforms, as well as allowing for prudent scaling up of public investment to support growth while keeping debt manageable. However, less reliance on oil revenues will be integral to sustaining fiscal operations and, in this regard, we commend the successful implementation of the VAT in January 2018. Given concerns about compliance, can staff comment on the merits of a phased reduction of the VAT registration threshold? Plans to gradually increase energy prices are also welcomed. Moreover, in light of the authorities' more optimistic forecasts relative to staff's, the identification of contingency measures is warranted, and the authorities should stand ready to implement them, if required. Mindful of the social impact of the reforms, we welcome the recently introduced cash transfer mechanism under the Citizen's Account Program. However, this program covers half the population, and we invite staff's comments on whether there is scope to tighten the targeting of benefits. Relatedly, the public sector remains large, and we urge the authorities to accelerate actions to curb wage costs.

The fiscal framework should be buttressed by PFM enhancements and institutional strengthening. In this context, we underscore the importance of a sound public investment management system, strong budgetary controls, and solid macro-fiscal capacity. The authorities are making noteworthy progress in these areas, including through the introduction of the electronic Etimad platform to strengthen budget implementation, and the full operationalization of a Macro-Fiscal Unit. However, further efforts are critical to enhance transparency. Given the importance of the public investment fund (PIF) in the Saudi economy, we are concerned that its financing is unclear. In this regard, we urge the authorities to press ahead toward developing an integrated asset-liability management framework to guide investment decisions. Additionally, the authorities should establish a clear roadmap for subscribing to the SDDS.

We note the concurrence between staff and the authorities that the exchange rate peg has served Saudi Arabia well given its current economic structure. Looking ahead, as the authorities move to diversify the economic base, and as global financial conditions tighten, a flexible exchange rate regime may have a more prominent role in stabilizing fiscal revenues and strengthening competitiveness in the newly developed sectors. In this regard, we support staff's call for a regular review to determine the appropriateness of the peg. We invite staff's comments on the conditions that would trigger a gradual relaxation or removal of the peg.

Further efforts to implement structural and financial sector reforms will be integral to invigorating and sustaining higher and inclusive growth. Measures aimed at safeguarding the stability of the financial sector and improving the business environment, including through legal reforms and tackling corruption, are well placed to encourage private sector investment. Furthermore, we believe the authorities' focus on generating employment for Saudi nationals in the private sector is appropriate. A streamlining of public expenditure to scale up education and vocational training would help in this regard. We also welcome recent measures to increase female labor force participation, including programs to lower transportation and childcare costs. While social norms have caused limited access to financial services by women, we encourage the authorities to continue with efforts to remove existing barriers.

Mr. Claver-Carone and Ms. Svenstrup submitted the following statement:

We thank staff for a very well-written report and Mr. Alogeel for an informative buff statement. We particularly appreciated staff's two very insightful Selected Issues Papers, which provided in depth analysis and highly relevant policy recommendations.

The Saudi authorities continue to make highly welcome strides in implementing their economic transformation program, "Vision 2030." Two rounds of subsidy rationalization, the rollout of the citizens' account, and increasing the strength and transparency of the fiscal framework were significant achievements. Further work in these and other areas will still be required to stabilize the budget, rationalize government spending, and place Saudi Arabia on the path to more diversified and job-creating growth. We concur with the thrust of staff's policy recommendations and offer a few comments for emphasis.

The authorities' planned gradual pace of fiscal consolidation, as announced in the 2018 budget, is appropriate given available fiscal space and concurrent structural reforms. We agree with staff that any additional revenues from higher-than-anticipated oil prices should be saved to rebuild policy buffers. Going forward, continued focus on improving the budget execution is needed to meet fiscal targets, and we welcome the authorities' notable progress on this front thus far. We also urge the authorities to consider staff's thorough recommendations to strengthen the fiscal framework, including the elimination of off-budget spending. The eventual adoption of a fiscal rule would provide a transparent anchor in line with the authorities' longer-term budget strategy. In the meantime, do the authorities have in place a mechanism to communicate the importance of reform efforts and meeting budget targets, even in the context of rising oil prices?

The authorities face the challenge of growing a private sector that can employ the millions of young Saudis that will enter the workforce over the next ten years. Even with higher oil prices, Saudi Arabia can no longer sufficiently offer public sector employment to its citizens, as the large wage bill already accounts for over half of government spending. In this context, we agree with staff on the importance of clearly communicating the limited prospects for government employment so that new labor market entrants can calibrate expectations and focus on skills acquisition.

The authorities have also rightly taken on an ambitious structural and labor market reform agenda aimed at increasing competitiveness and boosting employment of nationals. Notably, due to highly welcome policy measures and easing of restrictions, employment of Saudi women has increased by over 6 percent since 2016Q4. Staff's helpful Selected Issues Paper clearly shows that Saudization policies will only have a positive impact on growth if there are sufficient of relatively high-productivity national workers willing to work at a wage rate that that reflects their productivity. In this context, we agree that reforms to increase labor supply and private sector demand, while also boosting the skills and competitiveness of workers, will need to be gradually implemented and carefully calibrated. Have staff discussed with the authorities timing and phasing of these reforms?

We concur with staff's analysis that the exchange rate peg remains appropriate at this time and acts as a strong policy anchor. We urge the authorities to continue reforms that would allow for a more flexible exchange rate regime in the future, if it were to become appropriate.

Finally, we welcome the planned IPO of Aramco has the potential to catalyze further efficiencies in government spending, inject billions of dollars of investment into the nascent Saudi private sector, send a positive signal to investors, and take another step in diversifying the government's revenue stream.

Mr. Virolainen and Mrs. Jekabsone submitted the following statement:

We thank staff for the interesting set of reports and Mr. Alogeel for the insightful buff statement. We commend the authorities for the good progress and sustained commitment to wide-ranging economic and social reforms. We encourage the authorities to continue with the ambitious structural reform agenda to ensure consistent, transparent and well-communicated implementation. We broadly share staff's appraisal and would like to offer the following comments for emphasis.

We take positive note of the fiscal consolidation and support policies targeting budget balance by 2023. The successful implementation of the VAT is welcome given the limited experience in taxation and administrative challenges. We urge the authorities to decisively address the remaining challenges and lower the registration threshold as planned. Containing the persistently high wage bill is also critical to achieve fiscal targets. The ongoing civil service review to improve the cost effectiveness in the public sector is a step in the right direction. Furthermore, we welcome the introduction of the new electronic Etimad platform that could be instrumental for better and more transparent expenditure management, constraining the occurrence of arrears, and avoiding budget overruns. Spending by Aramco and the PIF as well as financial links between them and the government should be part of the fiscal reporting.

We recognize the progress achieved and welcome that employment creation in the private sector for nationals, including youth and women, is a key priority. A comprehensive set of policies is important for job creation given the significant number of new entrants into the labor market annually. We agree with staff that gradual the implementation of labor market reforms is appropriate to minimize any adverse impacts on growth and ensure positive outcomes. Moreover, clearly communicated expectations from the government on future public-sector employment are crucial. Private sector jobs need to be made more attractive, and incentives for public employment reduced. Improving the quality of education and outcomes, as well as reducing skill mismatches, are paramount in this context.

We concur with staff that continuous measures to improve the business climate are key for private sector development, fiscal revenues, and the success of labor market. The passing of several important legal reforms is welcome. We encourage the authorities to ensure the efficient and transparent implementation of the new laws to facilitate business creation. Against this backdrop, the authorities should also focus on measures to promote better financial sector access for SMEs and women, and continue strengthening the AML/CFT regime.

Mr. Mkwezalamba and Mr. Abdullahi submitted the following statement:

We thank staff for the comprehensive set of papers and Mr. Alogeel for the informative buff statement.

Economic growth is expected to rebound this year, and the risks to the outlook are balanced in the near term. In 2017, real GDP contracted by 0.9 percent. However, a larger contraction was avoided mainly due to a modest growth in the non-oil sector. The negative output gap in the non-oil sector suggests that with appropriate policies, the sector could play a bigger role in the economy, and contribute to strengthen resilience against uncertainty in oil price developments. In this context, we commend the authorities' steadfast implementation of wide ranging economic and social reforms under Vision 2030. We broadly support the thrust of the staff appraisal, and provide the following comments for emphasis.

Fiscal consolidation efforts should continue even if at slower pace. While we welcome the government's commitment to balance the budget by 2023, we note that under staff's projection, the fiscal deficit will not be balanced by the target date. Given the inherent volatility of international oil prices, we encourage the authorities to adopt more conservative oil price estimates, implement previously identified contingency measures if needed, and deepen reforms aimed at improving non-exported oil revenue. In this regard, we welcome the successful introduction of value added tax (VAT) in January 2018. Given the high mandatory registration threshold of the tax, we urge the authorities to keep their commitment to lower it on

January 1, 2019 to the Gulf Cooperation Council (GCC) agreed level. We welcome staff comments on the implementation progress since the introduction of the measure.

While we commend the authorities' actions to strengthen budget execution, we agree with staff that a better public expenditure management is needed. In this context, the introduction of the new electronic Etimad portal, aimed at improving controls and transparency in the spending process, is commendable. Further, we encourage the authorities to develop a more detailed and integrated medium-term expenditure framework, and expand fiscal coverage to include off-budget expenditure by Aramco and the Public Investment Fund (PIF) on behalf of the government. Finally, to ensure a sustainable fiscal path and to avoid procyclical fiscal policy, it is important to keep government spending at sustainable levels even if sustained high oil prices do not materialize.

We welcome the progress in implementing structural reforms to strengthen labor market performance and improve the business environment. A key objective of the labor market reforms currently underway is to increase employment of Saudi nationals, particularly the youth and women. Efforts to increase labor force participation among the youth and women should be complemented by increasing employment opportunities, particularly in the private sector for these target groups. While recent reforms are expected to improve labor participation and employment of Saudi nationals, to achieve a lasting structural adjustment, a comprehensive set of policies that would address both supply and demand constraints are needed.

Government is taking concrete actions to improve business regulatory environment. The anticipated introduction of the new insolvency, competition, and franchise laws are welcome. We also appreciate the government's efforts to fight against corruption and improve governance. In this regard, we concur with staff 's view that passage of a new public procurement law would be important. Further, the government's continued commitment and desire to strengthen the role of the private sector in the economy through the recent launch of the Privatization Program is step in the right direction. In this connection, we welcome the establishment of the National Privatization Committee and the twelve sector specific committees, and urge the authorities to urgently complete the approval process for privatization and public-private partnership (PPP) law. That said, did staff discuss with the authorities the time-line for completing the approval process for and going into force of the privatization and PPP law?

Finally, although the financial sector in Saudi Arabia is well developed, financial inclusion needs to be strengthened. The government's focus on financial development and inclusion as a key objective under Financial Sector Development Program (FSDP) is appropriate, and should continue. Improvement of access to finance by small and medium-sized enterprises (SMEs) is key to creating employment, particularly considering labor market reforms aimed at increasing labor force participation of Saudi nationals. We agree with the authorities that Fintech and financial literacy would help overcome physical financial access and social norms obstacles. We also support staff's view that tying social assistance programs to opening a bank account could help.

Mr. Raghani and Mr. Diakite submitted the following statement:

We thank staff for the well-written set of papers and Mr. Alogeel for his informative buff statement. We command the authorities for their far-reaching economic and social reforms under Vision 2030 which set the foundations for the Kingdom's economic transformation and diversification away from oil. Going forward, the authorities are encouraged to continue implementing policies in support of this vision, including strengthening the resilience of the macroeconomic framework to oil price volatility, and implementing deep structural reforms to boost the nonhydrocarbon sector and the employment of Saudi nationals, including women. We broadly agree with staff's analysis and policy recommendations and would like to emphasize the following points:

Fiscal consolidation should be pursued while supporting growth in the nonhydrocarbon sector. The authorities have made notable efforts to build strong fiscal buffers which should be preserved to weather the impacts of oil price volatility. However, considering that fiscal buffers are strong, we find appropriate that the authorities see scope for additional high-priority spending to boost growth in the non-oil sector as noted in the buff statement. It will also be important to pursue efforts to increase nonhydrocarbon revenue, notably by expanding the coverage of the value-added tax (VAT) which should be an effective tax instrument to mobilize domestic revenue. As this entails a significant adaptation of the tax administration, we encourage the authorities to pursue their efforts of capacity development in this area.

Efforts aimed at phasing out energy subsidies and controlling the wage bill should continue, as well as improving the efficiency of public investment in the framework of the Public Investment Fund Program (PIF). We note from the buff statement and the selected issues paper (SIP) that Saudi Arabia is making good progress in many PFM reforms including budget preparation and execution, and fiscal monitoring and reporting. We commend the authorities for their progress in PFM reforms under vision 2030 and encourage them to consider further measures outlined in the SIP to help them achieve their fiscal objectives. Could staff indicate if technical assistance programs are envisaged in this regard?

Laying the ground for economic diversification and fostering sustainable growth and employment should remain a high priority of the authorities. In this regard, we recognize the significant reforms being undertaken to improve the business environment, and promote private sector employment creation for nationals, particularly youth and women. In this connection, we encourage the authorities to continue their efforts notably to finalize the new procurement law, and improve the skills of the labor force to rebalance national workers from the public sector to private sector employment. Their support to SME development as a means to bolster growth and job creation is a welcome engagement in this regard.

On the exchange rate, we share the view that the authorities' commitment to the peg is appropriate given the current structure of the economy, as it helps maintain the credibility of monetary policy and avoid higher inflation.

In the financial sector, we note the considerable progress made to increase financial development and inclusion, notably equity markets, and appreciate the authorities' concern on maintaining financial stability at the same time. The framework established to monitor financial stability issues is necessary while the authorities are encouraging SMEs access to finance through the promotion of a variety of instruments such as leasing and venture capital. The efforts aimed at strengthening liquidity management and using macroprudential tools on mortgage loans are also noteworthy. We encourage the authorities to keep on course progress to improving financial sector access and strengthen the AML/CFT framework.

With these remarks we wish the authorities continued success in their endeavors.

Mr. de Villeroché, Mr. Castets and Mr. Chotard submitted the following statement:

We thank staff for a very clear and comprehensive report, as well as Mr. Alogeel for his insightful buff statement. We welcome that the Saudi economy is performing well, both thanks to recent developments in oil prices and to the significant progress in the implementation of the ambitious structural reform agenda. Going forward, we encourage the authorities to remain committed to their transformative agenda aiming at diversifying the economy. We agree with the recommendations made in the staff report and make the following comments for emphasis:

Fiscal Policy

We agree with staff that the more gradual adjustment path to a balanced budget by 2023 is appropriate. We positively note the reduction of the fiscal deficit, already significant in 2017, is expected to be pursued in 2018. We welcome the authorities' decision to follow staff's advice and to implement a more gradual, growth-friendly consolidation plan. Nonetheless, should additional revenues appear in case of oil prices increases, we concur with staff that they should be entirely used to reduce the fiscal deficit.

In addition, we commend the authorities for the successful launch of the VAT reform in 2018 and of the energy price reform. On the latter, we commend the authorities' objective to gradually increase energy prices to benchmark levels by 2025, as well as their efforts to compensate the most vulnerable through the implementation of the citizens' accounts. We thank staff for their efforts to analyze the impact of this cash transfer mechanism, and note that the average compensation offered covers the cost of the reforms. However, we also note that the precise impact on the most vulnerable cannot be assessed due to lack of data and we invite the authorities to allow staff to proceed to a more granular assessment. In addition, we wonder whether this cash transfer mechanism is sufficiently targeted towards low-income households, as 80 percent of the population is covered and 50 percent of the population are expected to be fully compensated under the current system. Staff comments are welcome.

Monetary Policy and External Sector

We share the view that the peg to the US dollar remains appropriate. As for the inflation developments, we struggle however to assess to which extent it is linked to the introduction of VAT. Staff comments are welcome. We also note that the current account balance returned to surplus in 2017, and that it is expected to be the case over the medium term, though it will progressively decline, notably against the background of expected declining oil prices. Lastly, we encourage the authorities to further liberalize their FDI regime, along the lines of the international best practices.

Financial Sector

We positively note that the banking sector is assessed as robust and profitable, and welcome policy actions to strengthen lending to SMEs. We however understand that some financial entities are under the supervision of Ministries, and wonder to which extent it would not be warranted that they become supervised by the central bank. Staff comments are welcome.

Structural Reforms

We commend the authorities for their good progress in implementing their structural reforms agenda, but invite them to deepen certain aspects, notably regarding women participation to the economy. We positively note the numerous achieved and ongoing structural reforms. We support efforts to make private sector jobs more attractive to Saudi nationals, through quotas, temporary subsidies, expatriate levy and efforts to contain the public wage bill. We however wonder whether the recent January Royal Decree, which creates additional monthly allowances for public sector workers, does not undermine this strategy and if it should not be recommended to reverse it. Staff comments are welcome. In addition, whereas experts increasingly forecast massive outflows of expatriate by this summer following the increase in the levy, we wonder about the potential impact of the Saudization strategy beyond the labour market, on the short-term GDP prospects in general and on some sectors in particular, for instance on the housing sector. Staff comments are welcome.

Regarding women participation to the economy, we positively note the efforts undertaken by the authorities, as well as the near doubling of the women's participation rate to the labour market since 2000, from 10.1 percent to 19.4 percent. Saudi Arabia keeps however lagging behind regional countries, and more remains to be done. Could staff detail which policy actions the authorities could usefully take in order to improve women's participation to the economy, with a focus on financial inclusion as it seems that reforms could be implemented there according to paragraph 39 of the report? Lastly, as rightly pointed out by staff, we encourage the authorities to deepen their efforts to fight corruption, notably through the adoption of the new procurement legal framework, and to strengthen their AML/CFT framework. Could staff provide an update on the recent FAFT evaluation and on the prospect for Saudi Arabia to become permanent member of FAFT?

Mr. Tombini and Ms. Hennings submitted the following statement:

We thank staff for the reports and Mr. Alogeel for his statement. After a period of unfavorable oil prices and production cuts, the Saudi economy is rebounding, supported by recovering international oil prices. The country remains committed to a bold and encompassing program of structural reforms which, if successful, will reshape Saudi Arabia's economy and sharply reduce its dependence on oil.

Saudi Arabia faces an improved outlook of stronger growth, declining fiscal deficits, and inflation under control. Public revenues have been recently boosted by the oil prices hike, price increases in gasoline and electricity, and a positive performance of non-oil revenues. While the recent oil windfalls have been important to boost capital spending on structural programs, we caution against extending monthly allowances to public sector workers, retirees, and students considering the objectives of the reform agenda – even understanding that the measure is temporary.

The introduction of a VAT and increases in energy and water prices will affect inflation this year. However, inflation is expected to converge to two percent in the medium term. The exchange rate peg with the dollar strengthening will help keep prices under control – staff concurs that Saudi Arabia's exchange rate regime continues to serve the country well, given the country's very particular circumstances.

Saudi Arabia's Vision 2030 program foresees an impressive array of economic, structural and social reforms. The targeted reforms embedded in the program are very much welcome, but will call for a timely and successful implementation. Some developments so far have been encouraging, such as increasing expenditure efficiency, improving business environment, development of equity markets, and progress in SOEs privatization, among many others. We hope that the more favorable external environment for Saudi Arabia can gather momentum for the country's reform agenda. Could staff elaborate on the role assigned to domestic banks in the Vision 2030?

Beyond the welcome emphasis on fostering the non-oil sector, we underline the importance to develop a labor market for the nationals. We encourage all initiatives to enhance the quality and supply of private sector jobs, reducing the focus on public sector employment. We also welcome the measures taken to increase the opportunities for female participation in the labor force.

We encourage the authorities to persevere on the reform path. Economic and other important changes may require a long period of time to take place, and highlight the importance of transparency and communication. As staff also pointed in the report, the availability and dissemination of accurate and timeliness statistics and information, the transparency of the rules, the clarity in the respective roles of the public and the private sector are cornerstones for the greater involvement of the private sector.

Ms. White and Mr. Haydon submitted the following statement:

We thank staff for their report, and Mr Alogeel for his informative buff statement.

Fiscal and Structural Reforms

We agree with staff's positive assessment of the Saudi economy. We welcome the reforms made to date and the improved economic performance. Much of the latter is a result of improved oil prices, and Mr Alogeel recognizes the uncertainty associated with their future path. We therefore stress the importance of continued diversification and reform to hedge against a future fall in prices.

We support efforts to date on energy reform, but would like to see more details on the next round of reforms. Are staff able to provide any update on when they expect that information will be made available on the next round of energy price reforms?

We welcome the introduction of VAT. It plays a valuable role as an additional source of government revenues. Greater efficiency of the tax administration should help further boost government revenues.

Staff are right to stress that policies to tackle corruption and improve governance could yield growth dividends. Box 7 represents a valuable attempt to quantify the potential economic benefits of such reforms. We welcome the authorities emphasizing that actions in these areas are key components of their reform agenda.

Economic Diversification

The total cost of the Vision 2030 initiative remains unclear, with limited detail disclosed on the delivery of its programs. It is important that increased public-sector spending does not crowd out private investment. This year's expansionary budget has seen a large increase in public investment. Although this helps to stimulate consumption, investments and therefore growth in the short term, private investment remains the key to sustainable long-term growth. Do staff consider the balance between private- and public-sector investment to be appropriate?

We welcome staff's assessment of the improved business environment. We encourage the authorities, however, to continue improving rules and regulations in order to enhance the ease of doing business in Saudi Arabia. Privatisation programmes have also been slow-paced, with limited progress achieved so far.

The relaxation of foreign investment rules may be beneficial for encouraging FDI. Foreign investors are currently allowed to own up to 49 percent of companies listed on Saudi stock exchange. Nationals, however, still retain majority ownership, with any one foreign investor restricted to owning just 10 percent.

Labor Force

Targeted policies giving Saudi nationals preferential treatment for jobs may harm investment and short-term growth. The reforms are aimed at encouraging the private sector to replace expats with nationals, but there remains a high mismatch in skills and salary expectation amongst Saudis. If the private sector fails to suitably substitute expat workers, or costs increase, business investment will be harmed. Additionally, recent data shows unemployment amongst Saudis has increased despite policies to give Saudi workers preferential treatment. Do staff agree with the policies to give Saudi workers preferential treatment? Do staff consider there to be resulting risks to the overall economy?

We welcome the improved female labor force participation rate in Saudi Arabia and appreciate the staff analysis. Recent announcements to improve the mobility of female workers are particularly important. Female labor force participation, however, is still significantly lower than the Gulf Cooperation Council average, and female unemployment remains high.

Further policy changes are required to encourage more women to enter the workforce. High collateral requirements and rising interest rates create barriers to financial inclusion for women. Financial literacy programmes would be key enablers to help women overcome obstacles related to financial access and social norms. Further legal reforms to increase financial autonomy would allow greater female participation. Women also often do not have enough collateral required to get formal loans—micro-financing programmes could be a potential solution to this.

We agree reform to the Kafalah system would encourage mobility of expat workers. In addition to attracting more productive expats, it will also help decrease wage gap between expats and nationals, thereby increasing incentive for greater employment of nationals.

Banking Sector and Financial Services

Bank deposits in Saudi Arabia are not showing much growth compared to pre-2015 levels. Given the substantial reserves at the Central Bank, we do not consider this to be a particularly high risk. What do staff consider to be the reason behind this lack of growth? Is this being acted on?

Mr. Mojarrad and Mr. Sassanpour submitted the following statement:

We thank staff for a well-articulated report and SIP, reflecting a broad collaborative research effort among the Fund staff—drawn from a number of departments—the World Bank staff, and government experts. We agree with Mr. Alogeel—as expressed in his helpful buff statement and also stressed by Mr. Beblawi and Ms. Abdelati—that research on issues identified in advance in close consultation with the authorities are important in facilitating policy discussions and building capacity, and hope that this broad-based research initiative is extended to other countries in the region. We are in broad agreement with the thrust of staff appraisal and limit our comments to a few key issues.

The structural reform program embodied in Vision 2030 is broad and multifaceted. The challenge is that the reforms are prioritized and sequenced properly, are clearly focused on the objectives and have broad public support. The authorities are making progress in the reforms to diversify the economy and correct its internal and external macro imbalances, encourage private sector activity and create jobs, in the process rebuilding buffers and lessening the economy's vulnerabilities to the vagaries of the oil market. Oil is dominant in the Saudi economy and Saudi Arabia plays an important role within OPEC in stabilizing the oil market for the benefit of producers and consumers alike, and we welcome Mr. Alogeel's assurances in that regard. Saudi Arabia's traditional role as the major "swing producer" in the oil market however has weakened considerably in the last decade with the doubling of US oil production—expected by experts to surpass Saudi production as early as next year—and the rise of production in other regions. We also agree with Mr. Alogeel that staff's medium-term oil price assumptions are on the conservative side and wonder what Saudi oil production profile and global demand outlook would be consistent with the higher price scenario. We welcome staff comments, including on the Saudi's spare production capacity to compensate for negative shocks to the oil market.

Saudi Arabia has made important progress is redressing its budget deficit and rebalancing its external position through cost cutting measures, including subsidy reform and wage containment, and new revenue initiatives, notably introducing a VAT and strengthening the tax culture. The energy price reform that is expected to be an increasingly important source of fiscal revenues is rightfully at the core of the fiscal plans, as are measures to safeguard the welfare of the population to maintain public support for the reforms. We support staff in encouraging the authorities to conduct deeper studies to confirm that compensations through the Citizens' Accounts are indeed sufficient for the lower income groups that would be hardest hit. The medium-term balance budget target by 2023 seems appropriate and is consistent with the government objective of containing the central government debt below 30 percent of GDP. Beyond 2023, the focus should be on rebuilding sufficient fiscal buffers to be able to mitigate the potential impact of adverse oil price developments on growth and employment. As proposed by staff, it would be better to formulate fiscal policy targets in terms of non-oil primary balance; staff's concept of "non-exported oil primary deficit" in particular seems appropriate as it properly captures the impact of the ongoing energy price reforms on the domestic economy. Equally important as fiscal consolidation and rebuilding fiscal buffers would be efforts to reinforce fiscal planning and implementation framework and broaden the fiscal coverage beyond the central government, as suggested by staff. As regards the coverage, bringing the Public Investment Fund (PIF) in the consolidated budget would be particularly prudent as the PIF is expanding its quasi-fiscal activity on behalf of the government and is increasingly assuming some sovereign wealth fund functions. We further welcome the steps taken towards fiscal transparency and expect these efforts to be gradually reflected in major improvements in the Open Budget Index ranking, as also indicated by Mr. Alogeel.

The currency peg has served Saudi Arabia well, given the structure of the economy. The peg has anchored policy, has helped deliver low inflation, and has been a major source of confidence. The policy should continue, but reviewed regularly to ensure that it remains appropriate as the economy is expected to undergo major structural changes over the coming years.

We are encouraged by staff and SAMA's assessment that banks are well positioned to withstand negative asset quality and liquidity shock. SAMA has made good progress in implementing the key 2018 FSAP recommendations and we urge the authorities to implement the remaining measures. The financial system needs to support the fledging non-oil activity by mobilizing savings for investment, addressing the major institutional constraints to SME lending, and reducing the role of informal finance—also stressed in the SIP. We would have expected more elaboration on developments and issues in Islamic banking in Saudi Arabia. Staff comments are welcome. We would also like to hear from staff on the outcome of discussions on the FATF/MENAFATF Mutual Evaluation Report following the FATF plenary session in June.

Creating jobs for nationals, especially women and youth, and broadening the scope of private sector activity are two intrinsically interlinked dominant challenges. Reducing the administrative costs of doing business and leveling the playing field for the private sector are priorities, particularly in an environment of rising labor and energy costs tied to other reforms. The effectiveness of reforms also critically hinges on strengthening the institutional and legal frameworks and putting in place strong anti-corruption policies. Could staff clarify the scales in "indicators of corruption" in Box 7 of the report? The labor market has a number of structural distortive features that require a comprehensive set of policies to foster job creation for nationals—as elaborated in the SIP. The recent initiatives to increase female labor force participation (FLFP) and the positive outcomes are encouraging, but meeting the objective of increasing FLFP by 1 percentage point a year by 2030 (from 18 to 30 percent) probably calls for much deeper and bolder reforms in the labor market. Staff analysis shows that almost an additional one million jobs need to be created to accommodate women entering the labor force if FLFP rises by 1 percentage point per year through 2023; extending the projections to 2030 may require creating another 1-2 million more jobs just to accommodate women entering the labor force. We invite staff to comment on how the current active labor market interventions (including Nitaqat, wage subsidies for nationals, and "expat levy") could affect delivering these ambitious objectives.

Mr. Gonzalez submitted the following statement:

We would like to thank staff for its insightful report and Mr. Alogeel for his informative buff statement.

The sharp decline in oil prices had profound effects on Saudi Arabia's economy that helped trigger a necessary wave of reforms. As mentioned in our previous gray, with such a dependence on a single commodity, the shock slowed growth, widened the fiscal and external deficits and made structural problems more visible—especially in the labor market and non-oil sector. The crisis also highlighted the need for a comprehensive reform to modernize the economy, reduce the weight of government and improve overall spending efficiency, all while maintaining a sound macroeconomic framework that recognizes Saudi Arabia's role in global energy markets and the challenging geopolitical environment in the region.

We are pleased to see that the Vision 2030 reform initiative launched for that purpose is progressing well. Last year we praised how ambitious the scope and scale of the reform initiative were, and noted that the key to success rested on recognizing the complementarity between the fiscal and structural components, and on ensuring a coordinated implementation so that the benefits required to sustain it could materialize. Authorities must be commended for the progress so far—albeit with delays in critical components—and for implementing many of the recommendations contained in the Article IV and FSSA reports.

This chair broadly agrees with the analyses and recommendations in this year's report. With a return to positive growth rates and low inflation, efforts must focus on attaining a balanced budget by 2023, while simultaneously providing support for the key structural reforms and space for private sector growth. This will require limiting growth and improving the quality of spending, but also advancing in some of the critical areas emphasized in the report like having a stronger medium-term fiscal framework and creating an integrated asset-liability management framework.

Of the various risks identified, slippages in the reform agenda is the most concerning. The report rightly warns of the risks associated with failing to follow through on fiscal consolidation, delaying the privatization agenda or giving a very large role to government—all of which could be costly in terms of economic activity and jobs, and could weaken reform efforts. But even in the baseline scenario measures seem insufficient as the debt trajectory does not stabilize, and the projected adjustment is assessed to be very large when compared to past international adjustment experiences. Could staff clarify what are the implications of these two conclusions for the size and speed of the required adjustment? Is the full cost of the reform package included in the analysis?

The report also emphasizes the large vulnerability of the Saudi economy to oil prices and encourages identifying measures to deal with adverse scenarios. Specifically, should a negative price scenario materialize, it advises increasing VAT rates, freezing the wage bill and prioritizing investment projects—although it acknowledges authorities could see staff's price projections as overly pessimistic. Could staff explain the large differences in expected prices, why authorities are so confident they can deliver a budget balance in 2023, and their views for adopting these measures should further adjustment be required?

Energy reform is a key component that must be prioritized. Given the fiscal cost of subsidies, energy prices have been increased and a generous compensation package given to households and SMEs that bear most of the burden. However, a slower pace of reform could lead to longer duration in compensation programs than originally expected. Are compensation packages designed to be incentive compatible with reform goals? Are they permanent, or will they be withdrawn once certain targets are achieved?

Finally, on the structural front labor market reforms seem insufficiently flexible. With the aim of tackling unemployment, authorities have pushed forward labor market reforms aimed at creating jobs for Saudi nationals—especially youth and women. But the reforms so far have been focused on restricting competition, forcing local hires and limiting work visas. We therefore agree with staff's proposed measures to make private jobs more attractive to Saudis and Saudi workers more attractive to private firms: in the medium-run it is only through increased competition and productivity that the structural unemployment problems can be tackled. Is there any transition from the current approach to one closer to staff's recommendations envisaged in the current set of labor market reforms? What are authorities' views on these issues?

Mr. Tombini made the following statement:

I thank the staff for the detailed reports and Mr. Alogeel for his helpful buff statement. We issued a gray statement, and I will comment on one issue of great relevance.

The authorities are implementing a bold reform program with the objective of transforming and diversifying the Saudi economy, the so-called Vision 2030. One of the most germane objectives of the program is to increase female labor force participation to 30 percent. Saudi women have a high level of education, but female labor force participation is only 18 percent and is highly concentrated in the education sector, with the health sector in a distant second place.

We understand from the staff reports that these sectors are less segregated by gender. However, a substantial increase in female labor participation will require breaking some of the existing cultural barriers over time. It is a worthwhile effort. Since, unsurprisingly, a staff econometric exercise showed positive results for the economy from increased female labor force participation.

The authorities are pursuing the right policies by fostering private sector development and by working to adjust the education system to address the skills mismatch. Success on this front would have an overwhelming impact, and would redraw the way the Saudi economy works.

Among the ongoing initiatives, sectoral programs such as the Women's Employment in the Retail Sector and the Support Women's Jobs in Factories appropriately provide incentives for both training and hiring. It is unfortunate, however, that apparently there are not sufficient statistics to evaluate the results of these policies. Could the staff present a more substantiated assessment of these programs?

With this, I wish the Saudi authorities success in implementing their ambitious and needed reform program.

Mr. Mkwezalamba made the following statement:

We thank the staff for the informative set of documents and Mr. Alogeel for his buff statement. We have issued a gray statement and wish to make the following comments. First, diversifying the economy away from oil dependence is an important goal. Given the current dominant role that the oil sector plays, the economic fortunes of Saudi Arabia will continue to rest on highly volatile oil prices in the medium term. Therefore, the government's commitment to reforms aimed at increasing the diversification of the economy under Vision 2030 is commendable. In this regard, we are particularly encouraged by the increased investment in untapped sectors, such as tourism and entertainment. However, successful diversification will require sustained efforts over a number of years, and we urge the authorities to stay the course.

Second, maintaining public support for the reforms aimed at expenditure rationalization, particularly energy price reforms, during a period of high oil prices and increasing government revenues is challenging. In this regard, we are pleased to learn from Mr. Alogeel's buff statement that the authorities continue to be attentive to the social impact of reforms. Therefore, the recent successful introduction of a cash transfer mechanism under the Citizen's Account Program, intended to shield low- and middle-income households from the cost of reforms, is a step in the right direction. That being said, we agree with the staff's recommendation for increased transparency and predictability about future energy price changes.

Third, contrary to the recent Board decision, the staff continues to use third-party indicators (TPI) on governance and corruption. In this context, we associate ourselves with Mr. Mozhin's views, as detailed in his gray statement. At the same time, the disclaimer in footnote 2, Box 7 is inadequate, considering the detailed discussion on the cost of corruption based on the results of TPIs.

Finally, we agree with the staff and the authorities that the exchange rate peg has served Saudi Arabia well and is appropriate, given the current structure of the economy. However, we share the views of Directors who have called for periodic reviews of the currency peg to ensure its continued appropriateness as reforms take hold.

Mr. Chotard made the following statement:

> We welcome the fact that the Saudi economy is performing well, thanks to the recent developments in oil prices and to the significant progress made in implementing the ambitious structural reform agenda to diversify the economy. We commend the authorities for that. Going forward, we encourage them to pursue and remain committed to this transformative agenda.
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> In addition, we would like to emphasize two of the points we mentioned in our gray statement. First, on the energy price reform and the compensatory measures, we commend the authorities for their decision to gradually increase prices to benchmark levels by 2025, as this will ensure a more efficient functioning of the economy. At the same time, we welcome the fact that they introduced contingency measures. However, we invite both the authorities and the staff to follow more closely the adequacy of these measures. We understand that the staff cannot currently assess the precise impact on each category of the population, especially on the most vulnerable.
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> Second, on women’s participation in the labor market, we positively note the efforts undertaken by the authorities in this regard, as testified by the near doubling of the female labor force participation rate in 20 years.
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> Saudi Arabia, however, continues to lag regional countries, and more remains to be done. We encourage the authorities and the staff to keep working closely on additional measures warranted to deepen the positive trend observed over the last years. We also encourage the staff to be bolder in their recommendations on this, as the written answers we received to our questions were quite disappointing, with few precise recommendations.

Mr. Claver-Carone recognized the strides the authorities had made in implementing the Vision 2030 economic transformation program. He also highlighted the challenges the authorities faced in growing the private sector and seeking employment for the millions of young people who would be entering the workforce over the next 10 years. That effort would require many structural labor market reforms, and he encouraged and supported the strides being made in that regard.

Mr. Mozhin made the following statement:

We have issued our written statement. We found the report to be comprehensive and of high quality, so we welcome that.

The only point I would make is that it is clear that the treatment of corruption and governance issues in the report is not in compliance with the recently approved framework to enhance Fund engagement. This is recognized by the staff in their written answers, where the staff explained that they did not have sufficient lead time to apply the framework in this the Article IV consultation. I take this explanation as it is, and I understand it. However, what is missing in this whole approach is the discussions with the authorities on governance and corruption issues, the presentation of the authorities' views, and the reliance on TPIs as the primary source of the staff's information about this whole topic. This is recognized by the staff, and I am looking forward to the next Article IV, when I would expect the new framework to be fully applied.

Mr. Gonzalez made the following statement:

We view the scope and scale of the Vision 2030 reform in a good light. We have seen substantial progress on the structural side and on the fiscal side, and in the interaction of the VAT, and controls on spending. Many things, such as the cutting of the deficit, show that great effort has been put into that. However, there is an area which is key to the Saudi Arabian economy, which is energy reform, and we have two points to highlight.

The first one has to do with the energy price reform. We see there is scope for improvement on that, as others have noted. According to the report, prices have been updated. At the time, they appeared to be in line with international prices, but there is no mechanism to adjust prices on an ongoing basis, and with the oil market being as volatile as it is, we might end up in a situation where subsidies continue or may increase.

When one looks at the compensation mechanism, consumption seems to be quite large in per capita terms. Of course, there are particularities in Saudi Arabia, but the per capita consumption that is subsidized in Saudi Arabia is more than three times the U.S. household consumption of energy. The same goes for fuel, it is about 40 or 50 percent above the average consumption of fuel. We wonder if there is an efficiency signal that can be introduced there.

In terms of targeting, the authorities have targeted about four out of every five households in the country. We wonder if there is scope to do more precise targeting so the social objectives can be achieved.

Finally, in the case of electricity, the report shows that electricity production is produced with fuel that is highly subsidized. We wonder if there is also scope for reform in this respect because we do not know how long the subsidy program will be in place, if there are any signals to improve targeting, and because doing so would make it more compatible with program goals.

The second point has to do with the oil prices themselves. The authorities seem to think that the staff is very conservative in terms of the oil price forecasts. The staff provided some information on that in the technical questions. But I was wondering if the staff could elaborate on where the differences are and if the staff has taken into account the heterogeneity of oil prices because, in the end, Saudi Arabia is a very big swing supplier. Perhaps it will have incentives to push prices higher if the fiscal situation and reform progress requires it to do so.

Mr. Sun made the following statement:

We have issued a gray statement and would only like to emphasize one point.

We thank Mr. Alogeel for his informative buff statement, and we thank the staff for the good set of papers. We commend the authorities for the substantial progress made in implementing their reform agenda.

Given the uncertainties associated with the future oil prices, we would like to encourage the authorities to take the current opportunity to further rebuild buffers to accelerate reforms, especially structural reforms. We believe that the energy sector reforms are probably the most urgent and important ones.

The authorities should not be complacent about the achievements made so far and should push forward to make the economy more inclusive and more growth-enhancing for the medium and the long term. In this regard, it is good to note that the authorities have recognized that uncertainties lie ahead and are determined to adhere to their reform policy objectives, especially the medium-term spending targets.

With that, we wish the authorities all the best.

Mr. Psalidopoulos commended the authorities for implementing their agenda. He asked Mr. Alogeel to elaborate on the authorities' possible objections to the publication of the report.

The staff representative from the Middle East and Central Asia Department (Mr. Callen), in response to questions and comments from Executive Directors, made the following statement:[1]

> First, I thank Mr. Alogeel and the staff in the Saudi Arabia Executive Director's office for their support and cooperation during the consultation. I also wanted to thank my team for their hard work and the staff from other Fund departments, the World Bank, and the authorities who worked with us on the reports.
>
> We have provided written answers to all of the questions raised by Directors, so I will focus my comments on three issues: the first one is oil prices, uncertainty with oil prices and fiscal policy; the second one on the exchange rate; and the third one on the labor market reforms and female employment. Then I will pick up the questions raised by Directors in the Board.
>
> Starting with oil prices and oil price uncertainties and the implications for fiscal policy, as many Directors noted, there is a difference between the staff's oil revenue projections and those of the authorities. How much of that is due to differences in prices, differences in assumed quantities of production—we are not sure. That information is not disclosed by Saudi Aramco for reasons of market sensitivity.
>
> What we can say is, if one looks in the near term, there is very little difference between the World Economic Outlook (WEO) oil price baseline and the consensus forecast. Both were around US$70 a barrel this year and in 2019. But that difference opens up over the medium term. While both the consensus and the futures market have oil prices declining over the medium term, the decline is sharper in the futures market, which is the basis of the WEO baseline. It declines to about US$59 a barrel in 2023, whereas the consensus is around US$66 a barrel.

[1] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

The key point is that the oil price outlook is uncertain, and it can change quite quickly. If we go back to when we were discussing the Article IV report last year, futures markets were predicting a price of around US$50 a barrel on average for oil prices this year, and now it is close to US$70 a barrel. It has moved sharply upwards. But at the time of the 2014 Article IV consultation, futures prices for 2015 were about US$100 a barrel; and the outcome was about US$51. The consensus was also off by a wide margin on both of these occasions.

The point we want to emphasize in the report is that fiscal policy needs to remain robust to the oil price uncertainties and should not be unduly influenced by short-term movements in the oil price. Otherwise, volatility will be introduced unnecessarily into the economy.

After the global financial crisis, as oil prices recovered, government spending increased quite sharply, and then had to be cut back sharply in 2015 and 2016 when oil prices declined. We would argue that controlling spending during the oil price upswing is key to rebuild buffers for the next oil price downturn.

We would also note that government spending is already increasing quite sharply this year—our estimate is about 10 percent in underlying terms relative to 2017—and capital spending is high at 8 percent of GDP.

Because there have been many ongoing reforms in terms of the public investment management framework, it is important that the projects are allowed to go fully through the cycle of this new reform framework before spending is really ramped up to ensure that it is increasingly delivering efficient outcomes relative to the early part of this decade.

At the same time, in our fiscal policy advice, we have to recognize these uncertainties, and that is why even though we have still quite a large fiscal deficit projected in 2023, we are not calling for any immediate fiscal measures to rectify that but are, rather, suggesting the government just begin to think about contingencies that could be eventually introduced if the oil price turns out to be lower than the government has expected in its medium-term framework.

Turning to the exchange rate, the staff fully supports the exchange rate peg to the U.S. dollar, believing it continues to serve Saudi Arabia well, given the structure of the economy. Reserves have clearly stabilized. They are now expected to increase to a level more than adequate to maintain the peg over the medium term.

While there would be some benefits of moving to a more flexible exchange rate, particularly over the medium term, these are more than outweighed by the costs that would be involved in moving off the peg. These costs would be borne in the near term at a time when uncertainty is already high because of the ongoing domestic reforms and developments in the region.

We agree with the Directors who have noted that the benefits of the peg should be reevaluated at regular intervals. There are big reforms taking place. The government is aiming to transform the economy to reduce the reliance on oil and expatriate labor. A more diversified economy, where expatriate labor is less readily available, may call for a move to a more flexible regime at some point in the future.

Lastly, on labor market reforms and female employment, clearly, there has been progress in improving female participation and employment in recent years. Improving educational opportunities and outcomes has been one of the factors behind the rise in female participation. Nevertheless, it is still low, and the unemployment rate of Saudi women remains high. The government recognizes that this is a suboptimal outcome and has been introducing policies to boost participation in employment by trying to address some of the constraints that women face when entering the workforce. Some of these constraints are common in many countries, such as a lack of affordable child care. The government has been introducing subsidies on child care but has also been trying to strengthen the child care industry itself to make more supply available.

There are some unique characteristics to Saudi Arabia. Women have only recently been permitted to drive, so transportation has been a constraint in the past. One of the policies the government has taken is to subsidize ride hailing apps, such as Uber and Careem, to try to offset the transportation costs. Social norms still generally require separate workspaces for men and women in the workplace, and that can be quite an up-front, fixed cost for businesses. There are programs—and this goes partly to the retail and the industrial program for women—to help companies, particularly when they are building new factories, and also in terms of providing subsidies to the employers to help them recruit new women. Those are two of the main aspects of these policies.

On a personal note, having visited Riyadh many times, it is noticeable in the retail sector how many more women are working there compared to even a year ago. The evidence is certainly on the ground and in the statistics that the policies are having an impact.

One area where more could be done is to support companies as they revamp their workspace. Particularly for smaller companies, this can be an issue in terms of the up-front costs. That is one thing the government could look at more.

Going forward, we are still seeing positive effects from the improvements in educational participation and outcomes for women. We would expect that female participation will continue to increase going forward. With that, we believe it will go hand-in-hand with greater financial inclusion as well for women.

On the impact of Saudization more broadly, many private sector businesses are very reliant on expatriate labor, and there are, undoubtedly, adjustment costs, as Saudization pushes up labor costs. However, if one looks at the data, the distribution of GDP is very skewed toward capital. In the non-oil/non-government sector, about 80 percent of GDP accrues to capital. It does suggest that as part of the economic adjustment process, we will need to see a redistribution of GDP away from capital and toward labor, as average wages need to rise to attract Saudis into the private sector. What is important is that the reforms are implemented gradually and supported by reforms that help reduce the cost of business in other areas as well.

I would like to pick up on two other issues. One is on the Citizens' Accounts compensation. The government has not yet declared a policy for how it will treat this in the more medium-term timeframe. The concern in the near term was to make sure that the compensation was seen as adequate.

Our estimates are that, on average, it was compensating for the increased costs of the VAT and the energy price reforms. However, there have still been many protests within Riyadh, particularly on social media. It has been important to make sure that compensation is adequate. These are critical reforms. If necessary, we would err on the side of overpaying the compensation in the near term to make sure the reforms are sustainable.

One hope is that the consumption of energy products will decline in Saudi Arabia. It was pointed out that the capital consumption is very high. Part of it is clearly because it is a very hot climate, but there is also, undoubtedly, overconsumption caused by low prices. It will be important that the authorities continue to review the compensation. If the consumption comes down, then the compensation through the accounts can be adjusted. Likewise, if the prices are linked to international prices in the future, there would also be a need to consider how the Citizens' Accounts compensation will be handled.

The government is very focused on energy conservation programs. They have an Energy Conservation Institute that is working on the issue, with quite an aggressive public campaign to highlight the importance of better energy consumption. Over time, that should help reduce consumption.

The electricity company does still get subsidized energy products. As those are adjusted over time—and we understand this is already beginning to happen as part of the process toward the Saudi Aramco IPO—some of these cross-subsidies are beginning to be worked out. But as input costs go up, then clearly electricity prices will also need to go up to maintain the viability of the electricity company.

With regard to coverage of corruption, our discussions with the authorities focused on the public procurement law that is coming in. The authorities have indicated on a number of occasions the costs that they see in the public procurement process and the money that has effectively been lost through the corruption of that process in the past. This is one of the areas they are focusing on. In terms of their reforms, they have established the high-level National Anti-Corruption Commission. They have introduced whistleblower legislation. We have made a few other recommendations of what else they should cover in this area as well. But I wanted to highlight that this was an area of discussion during the consultation that we have tried to highlight in the report.

Lastly, I wanted to alert the Board that the staff is still considering some corrections to the staff report that have been requested by the authorities.

The staff representative from the Strategy, Policy, and Review Department (Ms. Duttagupta), in response to questions and comments from Executive Directors, made the following statement:

I would like to alert Directors to some corrections to the staff report that are still being considered, which were requested by the authorities. Under the Transparency Policy, I would like to list them because then the pre-Board rules would still apply.

There are a few changes to accurately reflect the authorities’ views on the Vision Realization Programs and the role of then Public Investment Fund (PIF). These are on paragraph 21, on page 12. Then there are a number of smaller corrections that fall under the evident ambiguity category—on page 1, there are changes concerning the risks of the reform program and the characterization of the external adjustment, which is also repeated in paragraph 45 on page 25; changes relating to the risks from the regional security environment in paragraph 3; and on the timeline of further energy price reforms table on page 5; and other changes relating to civil service employment in paragraph 23, page 14; the use of privatization proceeds in Box 5; and finally, on the characterization of the Citizens’ Accounts Program in paragraphs 8 and 10. These changes are currently being already considered under the Transparency Policy.

Mr. Alogeel made the following concluding statement:

I will begin by expressing my sincere appreciation to Directors for their recognition of the substantial progress made by the authorities in implementing their wide-ranging reform agenda which, as noted by Directors, resulted in implementing many of the recommendations of last year’s Article IV and Financial System Stability Assessment reports. We also thank Directors for their support and for their helpful policy advice. We would like to emphasize a few points.

On the concern raised by a few Directors regarding the risk of recent oil price developments impacting the overall reform implementation, including possible delays in advancing the structural reforms, let me clarify that oil price shocks are not new for the Saudi economy. Historically, the key policy response to oil price shocks has been to implement fiscal policies to safeguard macroeconomic stability. Now, the vision of the new leadership is to carry out the unprecedented social and economic reforms to transform the Saudi economy irrespective of oil market developments. The government, therefore, remains firmly committed to sustain the positive momentum of the reform implementation, underpinned by the Vision Realization Programs, with the goal of realizing the objectives of Vision 2030.

At the same time, my authorities understand the concern about risks to the fiscal consolidation efforts because of the recent oil price increase. In this regard, they reiterate their commitment to proceed with ongoing fiscal adjustment, rebuild buffers, and further improve the fiscal framework and transparency. The overall expenditure envelope, as planned in the Fiscal Balance Program, will be maintained, while additional non-oil revenue measures will be implemented, if needed, with the aim of balancing the budget by 2023. Here, it is important to underline that fiscal reform measures will continue to be carefully paced and clearly communicated.

Second, the PIF will continue to actively invest to maximize sustainable returns, to be the investment partner of choice for global opportunities, and to enable the economic development and diversification of the Saudi economy. The PIF's oversight is with the Council of Economic and Development Affairs, and the Minister of Finance is a Board member in the PIF and the chairman of its investment committee, which is responsible for reviewing and endorsing the investment activities of the PIF and the asset transfer. The PIF's domestic investment is deemed essential to crowd-in private investment in new sectors, where large, upfront investments are needed.

On the exchange rate regime, my authorities are committed to maintain the pegged exchange rate, as it continues to serve Saudi Arabia well, given the structure of the economy. We agree with the staff that the exchange rate peg will continue to support the reform agenda by providing greater certainty for households, businesses, and investors.

Saudi Arabia will continue to remain an important partner both regionally and globally. Saudi Arabia has provided significant financial support to countries in the region to advance their reforms and help overcome economic downturns. Saudi Arabia will also continue to play its stabilizing role in the global oil market for the benefit of both producers and consumers, including through its important role in the OPEC-plus to increase oil production. Through its continued investment in energy infrastructure, Saudi Arabia maintains substantial spare capacity and can meet oil demand, including in the event of any interruption in supplies, as has been done in the past.

On the issue of publication, we have not received consent for publication yet, but we expect to do that shortly, as we have done in the past.

Finally, I will not be concluding my intervention without thanking the mission chief, Mr. Callen, and his team for their excellent work, candid analysis and policy recommendations, which are greatly appreciated by the authorities.

The Acting Chair (Zhang) noted that Saudi Arabia is an Article VIII member and no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for the progress made in implementing their reform agenda. Directors welcomed the broadly positive outlook and emphasized that higher oil prices should not slow the reform momentum. They agreed that continued commitment to implementing wide-ranging reforms will help achieve the fiscal objectives and promote non-oil growth.

Directors welcomed the ongoing fiscal consolidation efforts and agreed that aiming for a balanced budget by 2023 is appropriate. They emphasized the importance of fully implementing the revenue reforms and limiting the future growth of government spending to achieve this objective. In the event oil prices exceed those assumed in the budget, most Directors recommended saving the additional revenues to begin to rebuild fiscal buffers.

Directors welcomed the new revenue measures, particularly the introduction of the VAT. They encouraged the authorities to continue their preparations to lower the VAT registration threshold in 2019. Directors welcomed the authorities’ intention to continue to gradually increase energy prices, but saw scope for more communication about the future price increases. They emphasized the importance of ensuring that the payments through the citizens’ accounts are adequate to compensate low and middle-income households for the impact of the price increases.

Directors encouraged the authorities to anchor fiscal spending in a medium-term expenditure framework. They supported the ongoing civil service review, which should help identify reforms to contain the wage bill. Directors welcomed recent efforts to strengthen the medium-term fiscal framework, increase fiscal transparency, and develop macro-fiscal analysis, and encouraged further progress in these areas. They emphasized the importance of an integrated asset-liability management framework to guide the government's borrowing and investment decisions.

Directors welcomed the progress in implementing structural reforms, and emphasized that these should continue in consultation with the private sector. They noted the progress with the privatization and PPP plans and believed this program should be accelerated. Directors agreed that the public sector could be a catalyst for the development of new sectors, but emphasized that this should not crowd-out the private sector.

Directors highlighted that policies to create jobs for nationals in the private sector should focus on leveling the playing field between Saudis and expatriates. In addition to the ongoing reforms, they believed that setting clear expectations about employment prospects in the public sector, reforming the visa system for expatriate workers, strengthening education and training, and addressing remaining constraints to female employment would be key.

Directors welcomed the authorities' focus on financial development and inclusion. They agreed that increasing SME finance, improving financial sector access, particularly for women, and developing the debt market are priorities. They welcomed SAMA's efforts to strengthen liquidity management. Directors encouraged the authorities to continue to strengthen the effectiveness of their AML/CFT framework.

Directors agreed that the exchange rate peg to the U.S. dollar continues to serve Saudi Arabia well given the structure of the Saudi economy.

It is expected that the next Article IV consultation with Saudi Arabia will be held on the standard 12-month cycle.

APPROVAL: March 3, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Growth Outlook and Risks

1. We seek staff clarification of whether the systemic oil exporters are consulted in the process of formulating the Fund's oil price projections and the implications for Saudi Arabia of using the consensus forecast.

- The Fund derives its oil price baseline from the futures markets. This is a long- standing practice and one that forms the basis of the projections for country desks, who use the oil price baseline circulated by the Research Department. The use of a common baseline ensures consistency across country projections.

- For Saudi Arabia, we use this baseline and adjust for any historic difference between the Saudi oil export price and the price circulated by RES (which is a weighted average of Brent, Dubai, and WTI). RES has studied whether there are better ways of forecasting oil prices than using the futures market, but has concluded there are not, while noting the futures market is a far from perfect predictor of future prices. Systemic oil exporters are not consulted in the process.

- While there is little difference between the futures and consensus oil price forecast in the near-term, the consensus has a higher price forecast in the medium-term. If this were to eventuate, it would improve the fiscal and current account balances in Saudi Arabia.

2. We welcome staff comments on Saudi's spare production capacity to compensate for negative shocks to the oil market.

- The International Energy Agency (IEA) reports that Saudi Arabia's sustainable oil production capacity is 12 mb/d so this would suggest current spare production capacity of 1.5 mb/d after the increase in production in June 2018 to 10.5 mb/d (up from 10 mb/d in May). There is of course uncertainty around this spare capacity estimate and actual production has not come close to the estimated production capacity. Production reached a recent peak of just over 10.7 mb/d in November 2016.

3. As for the inflation developments, we struggle to assess to which extent it is linked to the introduction of the VAT. Staff comments are welcome.

- With the introduction of VAT and energy price reform in January, the CPI increased by 4 percent month-on-month, with increases close to 5 percent in sectors fully covered by the VAT. This took CPI inflation from -1.1 percent (y/y) in December 2017 to 3 percent (y/y) in January 2018. The overall price increase in January was driven more by the VAT: fuels and electricity have a small weight in the index. There does not appear to have been any second-round effects from the VAT increase, and the underlying disinflation, in place since 2017, has continued and CPI inflation eased to 2.3 percent in May 2018.

4. We wonder if sectors like tourism, entertainment, and non-oil services, which were identified as potential drivers of growth, are effectively helping boost the economy.

5. We would appreciate staff's additional elaboration on sectoral growth prospects in Saudi Arabia.

- Non-oil GDP growth was 1.1 percent in 2017 and 1.6 percent (y/y) in 2018Q1. Growth was comparatively strong in manufacturing outside of refining and financial services; both sectors are targeted by the ongoing reforms.

- While there are some positive indications in other sectors (for example, arrivals for religious tourism increased strongly in 2017), detailed data is not available to evaluate growth performance and prospects of other targeted sectors such as entertainment and tourism.

6. Do staff consider the balance between private- and public-sector investment to be appropriate?

- The government sector accounted for about 40 percent of non-oil and gas investment during 2014-16. While this share has recently declined as fiscal consolidation has continued, there is some risk that the role of the government in the economy may grow with the increasing importance of the PIF and the limited progress so far with privatization. While the public sector can catalyze the emergence of new sectors, it can also crowd-out the private sector. Staff believes the government's role in the economy should be carefully considered and monitored to ensure there is sufficient room for private sector investment.

Fiscal Policy

7. We note a substantial divergence between the authorities' (a balanced budget by 2023) and staff's fiscal projections (a deficit of 3.6 percent of GDP by 2023) over the medium term. We would appreciate staff's comments on the key reasons behind this divergence.

- The difference between the authorities' and staff fiscal projections in the medium- term is largely due to differences in oil revenues.

- The non-exported oil primary deficit path in the staff baseline is broadly in line with that of the authorities', and close to the more gradual adjustment path recommended in the 2017 staff report.

8. Staff comments are welcome on the significant divergence in the oil price assumptions and its broad impact on the pace of implementing fiscal reforms.

9. Could staff explain the large differences in expected prices, why authorities are so confident they can deliver a budget balance in 2023, and their views for adopting these measures should further adjustment be required?

- Staff's oil price baseline is based on futures prices as provided to country desks by RES. The authorities themselves do not release the oil price assumptions they use in the budget due to the market sensitivity of this information. However, staff calculates that to balance the budget in 2023, if the announced fiscal measures are implemented as planned, it would take an oil price of $73 a barrel rather than $59 a barrel in the baseline.

- Differences in medium-term oil price forecasts likely reflect the considerable uncertainties about medium-term supply and demand. Whether lower output in some key oil exporting countries will rebound, the extent to which shale oil production will increase, and the extent to which demand will be affected by the global growth outlook and new technologies are some of the factors creating these uncertainties.

- The fiscal implications are that the authorities should stand ready to take additional fiscal measures to achieve budget balance in 2023 if oil prices turn out to be lower than in the budget. If oil prices turn out to be higher than in the budget, they should save these additional revenues.

- The authorities have said they are committed to achieving budget balance by 2023, so we would expect that they would identify additional measures if oil prices fall short of their forecasts.

10. Even in the baseline scenario measures seem insufficient as the debt trajectory does not stabilize, and the projected adjustment is assessed to be very large when compared to past international adjustment experiences. Could staff clarify what are the implications of these two conclusions for the size and speed of the required adjustment? Is the full cost of the reform package included in the analysis?

- The debt trajectory does not stabilize under the staff's baseline scenario given the budget remains in deficit in 2023. This, however, would not be the case if staff's oil price projections were in line with the authorities'. Staff recommends that the government should stand ready to implement contingency measures, as needed, if oil prices turn out to be below those assumed in the budget so as to achieve a balanced budget and stabilize the net debt-to-GDP ratio by 2023.

- The projected adjustment is very large compared to international experiences, but a similar size of adjustment was achieved in Saudi Arabia in the 1980s/1990s.

- Staff's assessment of the needed pace of fiscal adjustment tries to strike a balance between using some of the fiscal space available to ensure a socially acceptable pace of adjustment, while also keeping an eye on the need to ensure fiscal sustainability over the medium-term and acknowledging that the oil price outlook is uncertain.

- Current estimates of the cost of the reforms to the central government are included in the budget spending numbers. Costs that may be borne elsewhere (e.g. the PIF) are not included.

11. Could staff provide authorities' preliminary views on fiscal objectives beyond 2023?

- Staff has not discussed with the authorities their fiscal objectives beyond 2023.

12. We welcome staff comments on the implementation progress since the introduction of the VAT.

13. Given concerns about compliance, can staff comment on the merits of a phased reduction of the VAT registration threshold?

14. Could the staff comment on the initial tax compliance experience since the introduction of the VAT?

- The government is planning to lower the VAT registration threshold in line with its commitment under the GCC agreement starting on January 1, 2019. Registration of smaller taxpayers has started. More than 30,000 new (small) companies had registered and more than 220,000 had been identified (but not yet registered) by early May 2018.

- The tax authorities have identified engaging with small businesses and verifying their revenue status as among its biggest challenges. A readiness track tool has been launched to monitor taxpayer readiness, and indications are that more more than half of future taxpayers are aware of their filing and payment obligations.

- The decision to initially set a higher VAT registration threshold was taken at the suggestion of FAD experts to overcome the challenge of registering more than

400,000 taxpayers in a very short period of time to meet the target implementation date of Janaury 1, 2018. The higher registration threshold of SAR 1 million set for January 1, 2018 reduced the taxpayer base to 110,000 from more than 400,000 under the GCC registration threshold of SAR 375,000.

- Compliance with both filing and on-time payments has been very high, at over 90 percent. Revenue collections have substantially exceeded expectations in the first half of 2018 according to the Ministry of Finance.

15. Could staff indicate if technical assistance programs (for PFM) are envisaged in this regard?

- FAD has an ongoing technical assistance program with the MoF to support the Macro-Fiscal Policies Unit and to help strengthen the medium-term fiscal and expenditure frameworks. This includes a resident advisor, short-term expert missions, and staff missions from headquarters. Other TA could be provided in this area at the authorities' request.

16. We wonder whether this cash transfer mechanism is sufficiently targeted towards low income households as 80 percent of the population is covered and 50 percent of the population are expected to be fully compensated under the current system. Staff comments are welcome.

17. We welcome the recently introduced cash transfer mechanism under the Citizen's Account Program. However, this program covers half the population, and we invite staff's comments on whether there is scope to tighten the targeting of benefits.

- Ultimately, the decision on how much compensation to provide is a political one. Given that the recent increases in energy prices are beginning to remove major distortions to energy consumption in the country, we believe that ensuring the sustainability of these reforms is the main priority at this time. This may require compensating the middle class as well as the less well-off to ensure buy-in to the reforms. We are therefore comfortable with the current targeting of compensation.

- The data provided by the authorities indicates that only a small share of the monthly citizens' accounts payments goes to households in the top half of the income distribution.

18. Could the staff inform us whether the authorities intend to change the current compensation program once the planned additional (energy) price increases are being implemented?

19. Are compensation packages designed to be incentive compatible with reform goals? Are they permanent, or will they be withdrawn once certain targets are achieved?

- The authorities have said they will constantly review the citizens' account program to ensure compensation remains adequate and will likely raise compensation payments when energy prices are raised further.

- We believe the compensation is compatible with reform goals, and indeed is essential to equitably achieve the reform goals. We do not expect that the compensation through the citizens' accounts will be withdrawn in the future.

20. Are staff able to provide any update on when they expect that information will be made available on the next round of energy price reforms?

- The authorities have not announced exact details of when the next round of energy price reforms will take place, but the 2018 Budget Statement does show the broad plan of price increases between 2019 and 2025. Further increases in gasoline prices, and increases in diesel and natural gas prices are planned for next year.

- As we have noted in the staff report, the authorities have no plans at present to provide additional details of future price increases beyond what is set out in the 2018 Budget because the timing of the increases will depend on economic conditions among other things.

21. Did staff discuss with the authorities the timeline for completing the approval process for and going into force of the privatization and PPP law?

- The draft "Private Sector Participation Law" has just been released for a 3-week public comment period. Comments will then be included in the draft and the legislative approval process will begin. It is not clear how long this will take, but the authorities hope to have the law enacted by year-end. FAD is reviewing the draft legislation and will provide comments to the authorities.

22. Do the authorities have in place a mechanism to communicate the importance of reform efforts and meeting budget targets, even in the context of rising oil prices?

- The main vehicle the authorities use to communicate their fiscal policy objectives is the Fiscal Balance Program (FBP) which is updated annually at the time of the budget. In addition, the Ministry of Finance plans to produce a mid-year budget report and a pre-budget statement starting this year which will help assess fiscal performance and update the fiscal outlook. They are also publishing quarterly budget updates, although these are factual not policy related.

External Sector and the Exchange Rate

23. On the EBA-lite approach, could staff provide additional comments on what explains the different results and how the staff assessed CA gap is computed? On a more general level, we understand that the EBA models do not include Saudi Arabia. How does this square with multilateral consistency of the results presented in the ESR?

- The EBA-lite methodology covers a sample of around 150 economies. The EBA-oil methodology, which has been developed by MCD staff, estimates similar regressions to the EBA-lite on a smaller sample of oil exporters to provide a better fit for oil exporters.

- The difference in the policy gaps between the two approaches is due to the different coefficients for the fiscal policy variable. In the EBA-oil methodology, the coefficient is higher than in the EBA-lite, which is consistent with the fact that fiscal policy plays a more important role for external adjustment in oil-exporting countries.

- Currently, there are 49 countries covered in EBA, representing over 90 percent of world GDP. The EBA sample coverage is guided by balancing two considerations: capturing a large share of the global economy and avoiding too much heterogeneity in the regression samples. Countries where oil exports are a very high share of the economy (e.g. Saudi Arabia, Venezuela) are excluded since assessments of such cases require special considerations that would be too challenging to include in the EBA panel regression.

- Saudi Arabia, however, is in the ESR which looks at the multilateral consistency of the “staff-assessed” gaps of the economies it evaluates, and the ESR also includes other non-EBA economies. Staff strives for overall consistency, but understands there could be a small margin of error, given sample coverage issues. Those concerns are far outweighed by the benefit of including the key non-EBA economies in the ESR discussion/analysis.

24. Can staff provide a more detailed information and appraisal on the Saudi Arabia’s external lending?

- Staff does not have detailed information on Saudi Arabia’s external lending.

- The Saudi Fund for Development (SFD) provides funding to developing countries. In 2016, the SFD signed 33 loan agreements with 16 developing countries, mostly in Africa and Asia for a total value of SAR 4.3 billion ($1.1 billion).

- In addition, Saudi Arabia has provided significant support to countries in the region including Egypt. In March 2018, Saudi Arabia signed an agreement to lend $2 billion to Yemen. Saudi Arabia, Kuwait and UAE have recently pledged $2.5 billion of support to Jordan and talks are ongoing with Bahrain to provide financial support.

25. We welcome staff's suggestion for greater exchange rate flexibility and wonder if this could be recalled in the staff appraisal.

26. We invite staff's comments on the conditions that would trigger a gradual relaxation or removal of the peg.

- Staff is not calling for a move away from the dollar peg as we believe this remains the best exchange rate option for Saudi Arabia given the structure of the economy. We have, however, tried to reflect the pros and cons of both a pegged and flexible exchange rate in the text of the staff report, while supporting the peg.

- We do believe, however, that as the structure of the economy changes with the ongoing reforms, the exchange rate regime should be reviewed to ensure it remains appropriate.

- We would want to see further reforms to support diversification and evidence that diversification was well-underway. We also believe that greater economic certainty in the region would be important because the peg is a strong anchor and reduces uncertainty for households, businesses, and investors. Increasing uncertainty would not be helpful at this time.

Financial Sector

27. Could staff shed light on the reasons behind the recent increase in the LTV ratio for first-time owners to 90 percent?

28. While we note that authorities judge that financial stability risk from the change of the LTV ratio is deemed to be limited, we would ask staff's view on the risk of overheating housing market.

- The authorities raised the LTV ratio for first time homebuyers because they believed that credit conditions in the mortgage market were too tight. They see the risks associated with housing credit growth as limited since mortgage credit is a small share of banks' overall portfolios, default rates are low, and banks have direct claims on borrowers' salaries through the "salary assignment" system.

- Although raising the LTV limit at a time when mortgage lending is growing strongly could lead to risks, mortgage lending is currently small, and residential real estate prices are currently stabilizing, not rising. Staff believes this is a potential risk for authorities to continue to monitor.

29. We would welcome staff views on the effectiveness of the SME support program and what lessons are there for other countries wanting to support SME growth.

- Until recently, SME support programs had met with limited success, although assessments were complicated by the absence of a clear definition of what constitutes an SME and data constraints.

- The authorities have recently strengthened and revamped many of the SME support programs. They are enabling the credit bureaus to collect SME data, providing alternative SME funding options (e.g., private equity and venture capital), developing a program to improve the financial literacy of SMEs, and improving the legal credit infrastructure. The credit guarantee scheme Kafala is being restructured to ensure the financial sustainability of the scheme as well as financial and economic additionality. They have also agreed on a consistent definition of an SME, broadly in line with international standards, which will help analysis of the sector going forward.

- Staff believes these reforms are in the right direction, although it is too early to comment on their effectiveness or if there are lessons for others to draw.

30. What do staff consider to be the reason behind this lack of (deposit) growth? Is this being acted on?

- In May 2018, bank deposits were still below their level at end-2015. However, in recent months, deposits held by individuals and businesses have begun to pick-up (annualized growth of about 6.5 percent over the past six months) while deposits of government entities have declined quite sharply. We believe the former is being driven by improved economic activity and the impact of the Royal Decree Allowances. We are not sure why government entity deposits are declining, but it may be due to continued portfolio reallocation by the PIF and one of the pension funds. With higher projected non-oil growth, staff expects faster deposit growth in 2018 and 2019.

31. Could staff elaborate on the role assigned to domestic banks in the Vision 2030?

- Saudi Arabia is in the process of launching 13 Vision Realization Programs (VRPs) that are designed to meet the objectives of Vision 2030. One of these, the Financial Sector Development Program (FSDP), focuses on the financial sector.

- Banks are integral to the FSDP. Specific targets involving banks include raising the share of SME financing from 2 to 5 percent, the share of mortgage financing from 7 to 16 percent, and total financial assets to above 200 percent of GDP, all by 2020. Maintaining financial stability through compliance with international standards is also a stated target.

- Through the primary dealer system initiated in June, domestic banks have a key role to play in the development of the domestic debt market.

32. We would have expected more elaboration on developments and issues in Islamic banking in Saudi Arabia. Staff comments are welcome.

- SAMA is developing guidelines on mapping the risk profile of Islamic products to the Basel regulatory framework (Appendix V in the staff report). Standardized Islamic contracts are being introduced to facilitate further development of Islamic finance. On the markets side, the government is now issuing both domestic and external sukuk, and has a regular domestic sukuk issuance program.

33. We understand that some financial entities are under supervision of Ministries, and wonder to which extent it would be warranted that they be supervised by the central bank.

- The specialized credit institutions (SCIs) are non-deposit taking institutions and therefore do not have the same financial stability implications as banks. Their fundingis through government capital. The 2017 FSAP did recommend strengthening the governance and transparency of the SCIs through tighter oversight, the adoption of international reporting standards, and regular financial reporting.

34. Can staff brief the Board on the FATF's recent assessment on effectiveness of Saudi Arabia's AML/CTF framework?

35. Could the staff comment on the main conclusions from the recent FATF/MENAFATF Mutual Evaluation Report?

36. Could staff provide an update on the recent FATF evaluation and on the prospect for Saudi Arabia to become permanent member of FATF?

37. We would like to hear from staff on the outcome of discussions on the FATF/MENAFATF Mutual Evaluation Report following the FATF plenary session in June.

- Saudi Arabia's AML/CFT mutual evaluation report was discussed in the joint FATF-MENAFATF plenary in late June. The report is expected to be published in September after a quality and consistency review. While the AML/CFT regime presents strengths, including on assessment of ML/TF risks, AML/CFT supervision and TF mitigating measures, it also presents some shortcomings, particularly on implementation of preventive measures by financial institutions, prosecution of money laundering offenses, and confiscation of proceeds of crime.

- Saudi Arabia has been a FATF observer since 2015 and will be considered for membership in the future, depending on the progress made by the authorities in addressing identified shortcomings.

Structural Reforms

38. Could staff comment on the effects that increased oil production might have on implementing future reforms and how a possible slower implementation pace may influence foreign investment and the business environment.

- Our main concern is whether higher oil revenues beyond those assumed in the medium-term fiscal framework may affect non-oil revenue and energy price reforms and expenditures. As noted in the report, it is important that the budget remains robust to swings in oil prices. Spending should remain at a sustainable level in different oil price environments and avoid a procyclical fiscal policy that would create undue economic volatility. We do not think that higher oil revenues will slow ongoing reforms to improve the business environment for domestic and foreign investors.

- Holding the line on fiscal policy in a higher oil revenue environment will send a strong signal to investors and businesses about the authorities' commitment to the reforms it has started.

39. We would appreciate more details on youth unemployment and the impact of the related measures.

- Youth and female unemployment have hovered around 30 percent over the last five years. The youth and female unemployment issues are overlapping as a large share of youth unemployment is among women.

- Beyond the policies to increase female employment, youth unemployment may also be helped by the government being clear about the limited future employment prospects in the public sector—there still appears to be significant queuing for government jobs. This may encourage young people to seek jobs and careers in the private sector. Improved education and training will also help young people develop the skills in demand in the private sector, while well-designed temporary wage subsidies may help young people initially get jobs by reducing their costs to employers while they learn on the job.

40. ***Is there any transition from the current approach to one closer to staff's recommendations envisaged in the current set of labor market reforms? What are authorities' views on these issues?***

41. ***While we concur with staff on the proposed multi-pronged approach to address the wage gap, could staff comment more on the implications of proposed reform measures in expatriate labor policies to address this?***

- The expatriate levy when fully implemented in 2020 will be equivalent to 20 percent of the current average wage gap between Saudi and expatriate workers in the private sector.

- Staff believe that additional reforms are needed to further reduce the wage differential between nationals and expatriates. This should include reforms to the sponsorship system and residency rights to allow greater mobility of expatriate labor and a more level playing field between Saudis and expats. Additional reforms to the visa system could seek to gradually reduce the number of visas available and target them more to occupations requiring higher skilled workers or occupations Saudis are unlikely to want to join such as construction. A mechanism for auctioning visas to employers could possibly be introduced.

- The authorities are in the process of considering reforms to the visa system for expatriates to allow movement between jobs once initial contracts have been completed. More broadly, they agree with staff on the need for a comprehensive set of measures to create jobs for nationals and have put in place a Labor Market Policy Committee to lead this work. This committee includes representatives of the Ministry of Labor and Social Affairs, Ministry of Education, Ministry of Commerce and Investment, and Ministry of Civil Service.

- These policies should be introduced gradually to ensure there is no large-scale dislocation in the labor market and in the competitiveness of the corporate sector.

42. ***Staff comments on further measures to open-up the labor market for women are welcome.***

43. ***We would appreciate it if staff would give comments on whether these measures are effective enough to facilitate FLFP, and if not, what kind of additional measures the authorities should take further***.

44. ***Could staff detail which policy actions the authorities could usefully take to improve women's participation to the economy, with a focus on financial inclusion as it seems that reforms could be implemented there according to paragraph 39 of the report?***

- The female participation rate has increased in recent years, but remains low. The authorities are pursuing policies to increase female participation through efforts to ease transportation and childcare constraints and encourage teleworking through pilot programs. Women are now also able to drive. We believe all these measures will help boost female participation, as will the demonstration effect as examples of women working become more prevalent.

- Staff believe that help could be given to businesses to build or reconfigure work spaces to accommodate women in line with social norms and dedicated programs could be set up to support female entrepreneurs.

- The development of Fintech, and in particular digital banking, as well as financial literacy programs are key enablers to overcome obstacles related to physical financial access and social norms and could therefore support financial inclusion for women. Higher female employment and increased female financial inclusion are likely to go hand-in-hand.

45. Have staff discussed with the authorities the timing and phasing of these (labor market) reforms?

- Yes, the prioritization and sequencing of reforms was a central part of our discussions with the authorities during the Article IV mission. Staff emphasized that reforms should be introduced gradually to minimize disruptions and that reforms to reduce the cost of doing business should go together with those that are raising business costs, including through the labor market and energy price reforms.

46. Could the staff comment on whether the recent January Royal Decree, which creates additional monthly allowances for public sector workers, does not undermine this (Saudization) strategy and if it should not be recommended to reverse it?

- We believe the Royal Decree Allowances should be allowed to expire as planned at end-2018 both for fiscal and labor market incentive reasons.

47. We invite staff to comment on how the current active labor market interventions (including Nitaqat, wage subsidies for nationals, and "expat levy") could affect delivering these ambitious objectives (of job creation for women).

- Programs such as Nitaqat, wage subsidies for nationals, and the expatriate levy were not designed to specifically support female labor force participation, but rather to increase the employment of nationals in general in the private sector. However, a recent study has shown that following the Nitaqat implementation, there has been a significant reduction in the share of firms with no female employees so there has clearly been some effect.

- Efforts to restrict employment in certain retail sectors to Saudis is also aimed largely at increasing the availability of jobs for women. This sector is a large employer of expatriate labor and is seen as one that provides jobs Saudi women are interested in working in.

- Staff recognize that there is a long way to go to achieve the government's goal of increasing female labor force participation to 30 percent by 2030, but the current increasing trend is encouraging.

48. We wonder about the potential impact of the Saudization strategy beyond the labor market, on the short-term GDP prospects in general and on some sectors in particular, for instance on the housing sector. Staff comments are welcome.

- As the Selected Issues paper indicates, there could be costs to growth of some of the labor market reforms even if they are beneficial for the employment of Saudis. And the effects of the substitution of Saudi for expatriate workers will depend on relative wage and productivity differentials.

- Expatriate employment fell by 670,000 over the year to 2018Q1 according to the Labor Market Survey. This is reported to be putting downward pressure on rents in certain segments of the housing market, and the rent component of the CPI declined by 2.5 percent (y/y) in May 2018.

49. Do staff agree with the policies to give Saudi workers preferential treatment? Do staff consider there to be resulting risks to the overall economy?

- Staff believes that the current policy measures are first steps in mitigating major distortions visible in the labor market that impede the employment of Saudis in the private sector. Many of the policies are moving in the direction of levelling the playing field between Saudi and expatriate workers—at present many private sector employers have a strong preference for hiring expariate workers.

- Our analysis, however, does suggest that the impact of labor market reforms on the economy is not always positive. Therefore, we recommend gradual implementation of labor reforms to minimize the impact on growth, and a comprehensive set of measures to maximize the chances of positive employment outcomes.

50. Can staff provide any non-perception-based estimates for the corruption cost in Saudi Arabia, and quantitative estimates for the near and long-term growth effects of the proposed anti-corruption measures in paragraph 34?

- It is challenging to go beyond the indicators reported in Box 7 and directly measure the cost of corruption, but a senior government official in Saudi Arabia has indicated that corruption in procurement may have cost 5-10 percent of government spending in recent years.

- The literature shows that corruption imposes substantial economic costs. Box 7 notes that if corruption indicators in Saudi Arabia moved to the average level observed in advanced economies, this could raise real GDP growth by 0.5-1 percent. It is challenging to pin down the speed with which this growth impact is likely to be realized, as well as the extent to which it might persist in the long term.

51. Could staff inform us about the high-level anti-corruption committee's activities?

- The anti-corruption committee is at this time mainly involved in working through the cases and settlements with the people arrested at the end of last year. This process is expected to still take some time. There have also been some recent reports of arrests of government officials charged with corruption.

52. Did staff discuss with the authorities any existing governance vulnerabilities that are macro-critical in line with the Framework for Enhanced Fund Engagement (FEFE)?

- The authorities believe that addressing governance weaknesses is critical to the success of their reform program. A senior official has indicated that corruption in procurement may have cost 5-10 percent of government spending in recent years.

- Given the need for the containment of government spending growth against the background of new and emerging spending priorities, improved use of public money is essential. This is a reason why the new procurement law is in the process of legislative approval. This is one area where discussions during the mission focused.

- Although the mission took place after the April 2018 Board discussion and adoption of the new framework to enhance Fund engagement on governance issues, staff did not have sufficient lead time to apply the framework in this round of the Article IV consultation. Staff has established a centralized process to identify and assess the nature and severity of governance weaknesses under the new framework which is being implemented for countries with policy consultation meetings/missions in Q3 of 2018. For Saudi Arabia, the mission and discussion with the authorities took place prior to this, and as such the new Framework has not been applied at this point. The Article IV consultation did, however, draw from the Board paper on the analysis of macroeconomic impact of corruption and tailor it to the context of Saudi Arabia. Saudi Arabia would be assessed under the framework for the next Article IV and the assessment would be used as input in the next staff report.

- In line with the November 2017 Board Paper on the Use of TPIs in Fund Reports, the use of TPIs in the staff report only supplements—rather than replaces—the discussions with the authorities. Staff has followed this guidance and, accordingly, staff views and analysis are only informed by TPIs, not reliant solely on them. Staff's characterization of the source data for ICRG is consistent with the terminology used in the Indicators Digest which was originally issued to the Board in October 2017 and an updated version was issued in May 2018.

53. Could staff clarify the scales in "indicators of corruption" in Box 7 of the report?

- For the "rule of law" and "control of corruption" indices, the scale ranges from -2.5 to +2.5. For the "corruption perception" index, the scale is from 0 to 100, and for the ICRG corruption index the scale ranges from 0 to 6.