جدوى للإستثمار
Jadwa Investment

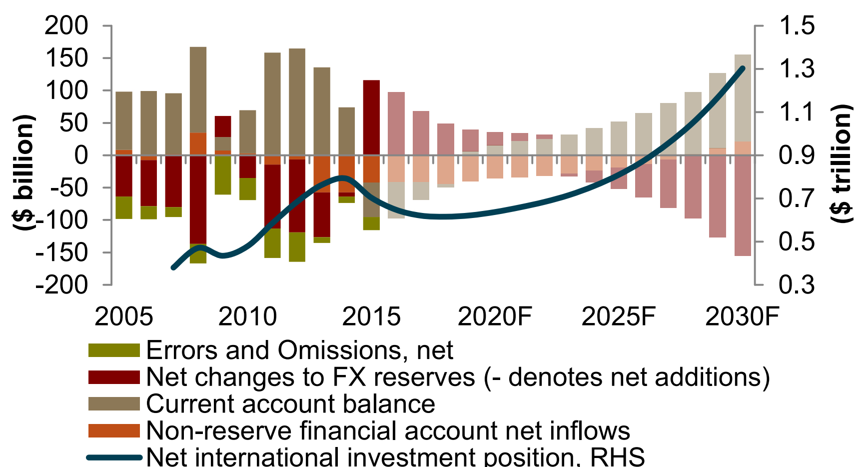
September 2016

International Trade and Investment Outlook

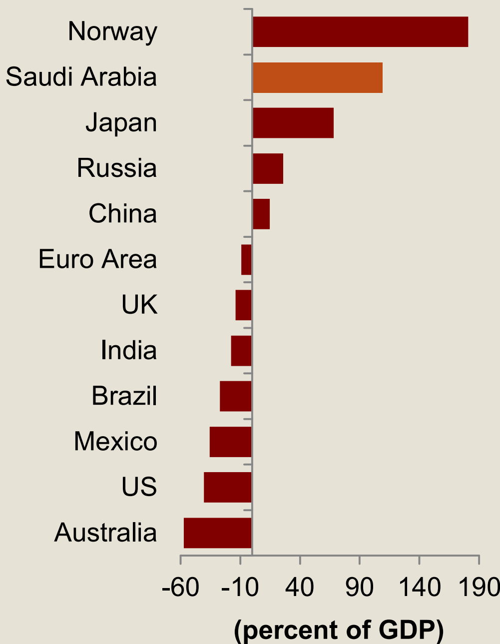
Vision 2030: A New Trade and Investment Model in the Making

- The Kingdom's structural economic transformation, envisaged by Vision 2030, will have significant implications on trade and financial flows over the next fifteen years.
- This report looks at the evolution of the current account for the period 2016-30, which is forecast to reach a surplus of $135 billion (8 percent of GDP) by 2030.
- While oil export receipts are expected to recover over the next fifteen years, their share of total current account inflows is forecast to decline, falling from 65 percent in 2015 to 57 percent by 2030.
- Meanwhile, structural reform will lead to non-oil current account inflows rising from $85 billion in 2015 to $262 billion by 2030.
- We forecast non-reserve financial inflows to rise significantly over the next fifteen years, as they become driven by reforms in key areas of doing business in the Kingdom such as property rights, labor market regulations, contract enforceability, etc…
- As a result, the non-reserve financial account deficit will gradually diminish over the next fifteen years, with the Kingdom attracting more foreign investors and creditors.
- The anticipated improvement in these inflows will have significant implications on the domestic financial system, as linkages to international financial institutions grow.
- The rising role of non-reserve financial flows will mean that the fixed exchange rate will remain intact and will act as an anchor for stability, supporting a period of rising investment and financing activity.
- Implementing the reforms envisaged by Vision 2030, will contribute to supporting the Kingdom's net international investment position (NIIP), which we forecast to reach $1.3 trillion (77.6 percent of GDP) by 2030.

Figure 1: The Kingdom's BOP and NIIP Outlook



Net International Investment Position (2015)



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1. The Balance of Payments

Over the course of the Kingdom's history, the structure of its BOP has remained nearly unchanged.

Episodes of high oil prices enabled the government to elevate its spending...

...which, in turn, supported both economic growth and accumulation of official foreign reserves.

However, a dramatic shift over the next fifteen years is likely…

...as the structural reform announced in Vision and NTP will have major implications on trade and financial flows.

Over the course of the Kingdom's history, the structure of its Balance of Payments (BOP) has remained nearly unchanged (Figure 1). The Kingdom had relied on current account surpluses, which were dependent on oil export revenues, to sustain its economic growth model. This model worked through utilizing surpluses to finance spending on the economy. Episodes of high oil prices enabled the government to elevate its spending, which, in turn, supported both economic growth and accumulation of official foreign reserves (Figure 3). During the most recent episode, between 2004 and 2014, the Kingdom was able to simultaneously undergo a significant expansionary stage whilst improving its wealth. As a result, non-oil GDP growth averaged 7.9 percent per annum between 2004 and 2014, while official foreign reserve assets rose, as a percentage of GDP, from 34.5 percent to 97.2 percent, during the same period. However, this model also showed the Kingdom's vulnerability to the cyclical nature of oil prices. Movements in the price of oil still dictated exports, which, in turn, resulted in rapid swings in the Kingdom's current account balance, and consequently on fiscal policy and economic growth. (See box 1 for a brief description of the Balance of Payments). Stripping out oil from the current account shows a stark difference; the non-oil current account balance has been stable but weak over the years, ranging between -22 percent and -34 percent of GDP over the past decade.

This model (Figure 4.1) will likely undergo a dramatic shift over the next fifteen years as the structural reform announced in Vision 2030 and the National Transformation Program (NTP 2020) will have major implications on the Kingdom's trade and financial flows. Both programs highlight a strong willingness to move the economy away from oil as the engine for growth. We believe that several fundamental factors will drive this new economic model, including human capital development, regulatory reform, and entrepreneurship (Figure 4.2). These reforms will contribute to a competitive and highly productive private sector, particularly Small and Medium Enterprises (SMEs), which will help attract foreign capital and contribute to further knowledge exchange, investment, and employment. This dynamic should result in higher disposable income, robust credit growth, and liquidity. The increasingly competitive tradable private sector would potentially export new goods and services, boosting both economic growth and net external wealth. Eventually, this would

Figure 2. Cyclical Vulnerabilities

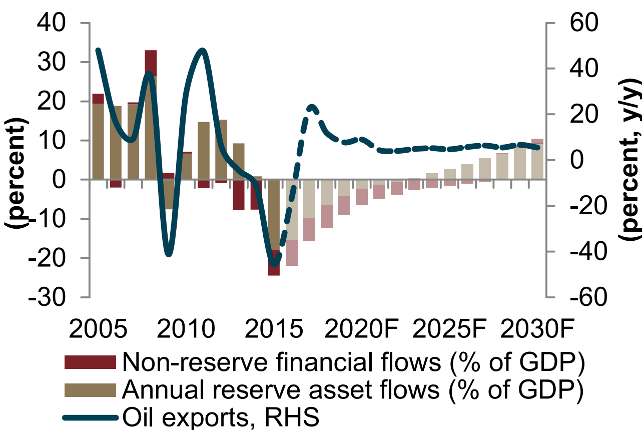
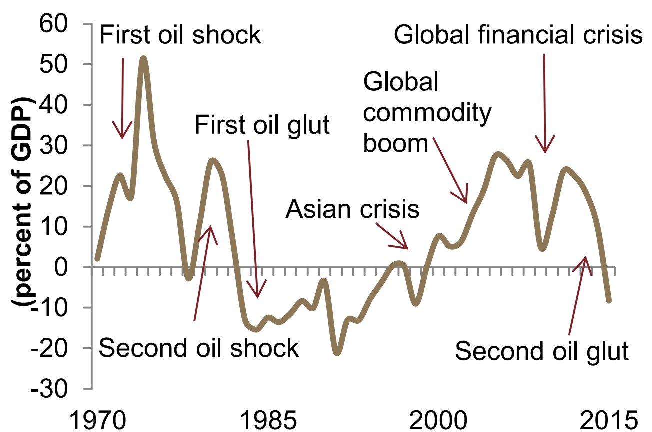


Figure 3. The Kingdom's Current Account Balance



improve investor confidence toward the Kingdom, thereby creating a positive loop, as more capital inflows improve the non-reserve financial account and reduce the pressure off official foreign reserves.

Figure 4.1: The Kingdom's traditional trade & investment model

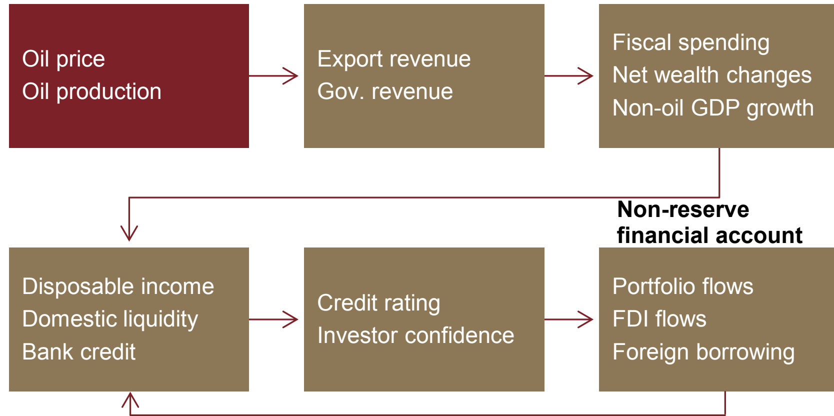
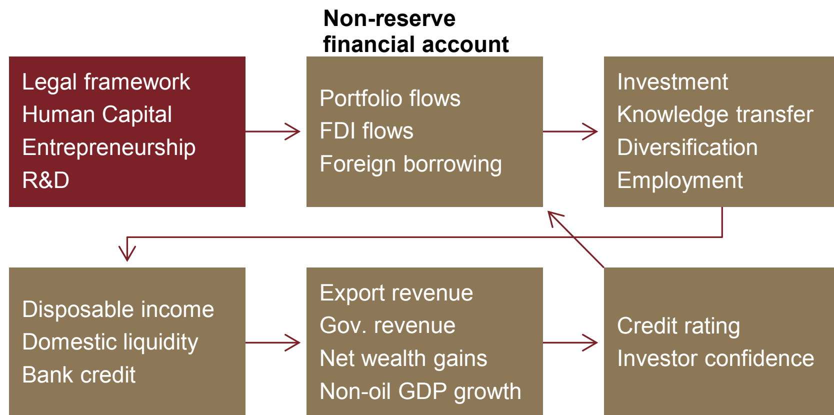


Figure 4.2: The Kingdom's new trade & investment model



The BOP is a double entry system that systematically summarizes a country's transactions with the rest of the world.

Any deficit in the current account would conceptually have to be covered by a surplus in the financial account.

Box 1: Balance of Payments Framework

The BOP, which includes the current and financial accounts, is a double entry system that systematically summarizes a country's transactions with the rest of the world for a specific time period. Current account transactions involve trade in goods and services, as well as income and transfers with the rest of the world (See sub-section 1A). Each of these transactions consists of offsetting credit and debit entries which reflect the economic values provided or received in exchange for other economic values. For instance, the physical export of a barrel of crude oil is countered by an offsetting export receipt that is recorded as a current account inflow. Financial account flows reflect changes to an economy's foreign assets or liabilities.

Any deficit in the current account would conceptually have to be covered by a surplus in the financial account; meaning that, on a net basis, an economy would have to either draw down its foreign reserves, or accumulate debt in a given year in order to plug the current account deficit for that same year. Within the financial account, transactions are mainly recorded as reserve asset flows, which are managed by the Central Bank, or non-reserve financial

flows (see sub-section 1B) in the form of direct investment, portfolio investment, loans, and deposits. This consistent body of positive and negative entries between the current and financial accounts should conceptually result in a zero balance. However, in most cases, the resulting balance will show a net credit or a net debit, which is a result of errors and omissions. The size of these errors and omissions depends on the quality and accuracy of data collection in a given economy. The standard practice is to show a separate item for net errors and omissions as a statistical discrepancy to offset the overstatement or understatement of the recorded components. (See page 16 for the Kingdom's key balance of payments statistics and forecasts).

The BOP framework is closely related to the concept of stocks recorded under the International Investment Position (IIP).

The BOP framework is closely related to the concept of stocks recorded under the International Investment Position (IIP), which is a statistical statement compiled at a specified date to present the value and composition of the stock of an economy's claims on and liabilities to the rest of the world (see section 2 on page 14).

1A. The Current Account

Between 2005 and 2015, current account inflows were dominated by oil export receipts, at 77.6 percent...

...while outflows usually mirrored government spending.

The Kingdom's current account has traditionally been driven by oil exports on one hand, and government spending on the other. Between 2005 and 2015, current account inflows were dominated by oil export receipts, at 77.6 percent, while outflows usually mirrored government spending for every corresponding year, and were mainly in the form of payments for imports of goods and services (83 percent) and worker's remittances (11.6 percent). In this section, we attempt to explain how the Kingdom's traditional trade model played out in the current account in the past. We also focus on the long-term current account evolution in light of what has been announced in the Vision 2030 and NTP 2020, and present a forecast that takes into account the implementation of the new trade model we illustrated in the previous section (See key data table on page 16).

The Kingdom has seen volatile shifts in its current account, mirroring swings in oil prices (Figure 4). In just three years, the Kingdom's current account swung from an all-time high of $165 billion (22.4 percent of GDP) in 2012 to a deficit of –$56 billion (8.8 percent of GDP) in 2015. These swings had a direct implication on the investment behavior within the domestic economy (Figure 5). Volatility of export receipts caused abrupt delays and cancellations

Figure 5. Investment and Oil Prices

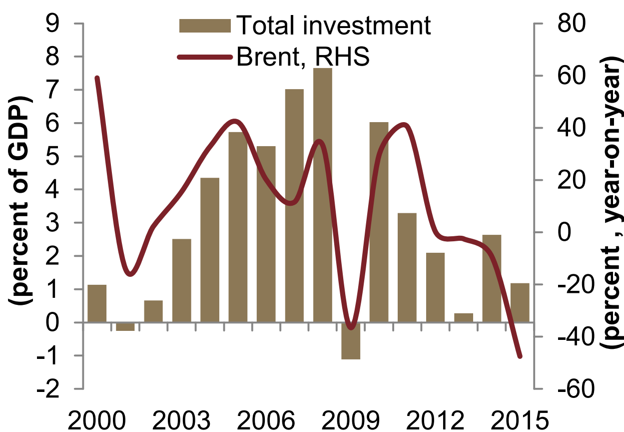
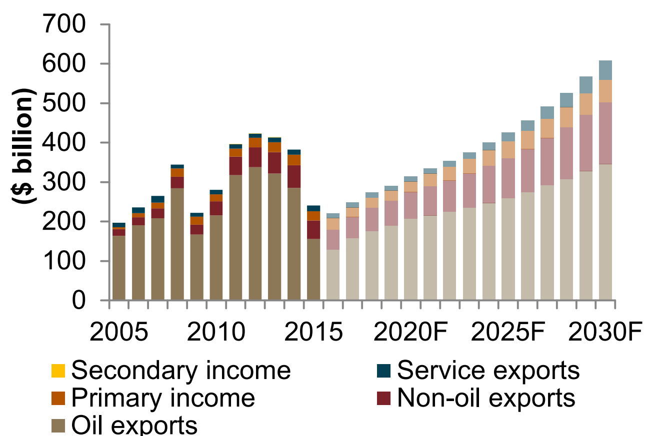


Figure 6. Current Account Inflows



Volatility of export receipts caused abrupt delays and cancellations to projects and initiatives.

The announcement of a highly ambitious vision for the next fifteen years is likely to break the mold.

Total current account inflows fell significantly from $382 billion in 2014 to $240.7 billion in 2015…

...mainly owing to lower oil exports.

to projects and initiatives, which had knock-on effects on investor sentiment, negatively impacting private sector investment, the stock market, and economic growth. Taking the 1998 episode as an example, oil export receipts fell by 39 percent following the Asian financial crisis, resulting in government cutting its spending by 14 percent. Consequently, non-oil GDP growth slowed sharply from 5.1 percent in 1997 to 2.6 percent in 1998. This time however, the announcement of a highly ambitious vision for the next fifteen years is likely to break the mold, placing the Kingdom on a more sustainable and stable path. Embedded in the Vision are multiple commitments to address external vulnerabilities, including non-oil export promotion, foreign direct investment (FDI) attraction, and local content development.

1A.1 Current account inflows:

Total current account inflows fell significantly from $382 billion in 2014 to $240.7 billion in 2015, mainly owing to lower oil exports (Figure 6). While less significant, non-oil exports and primary income (an average of 21 percent of total inflows for the period 2010-15) also fell between 2014 and 2015, owing to subdued global demand as well as volatility in global financial markets. Meanwhile, service exports (small at 3.6 percent of total inflows between 2010 and 2015) were the only source of inflows to record an increase in 2015. These service receipts are mainly collected from non-residents while visiting the Kingdom for religious tourism. Unofficial news reports have estimated that the annual number of Umrah visitors rose from 3.5 million in 2010 to 6 million in 2020. That said, we expect that over the course of the next fifteen years, numerous initiatives and KPIs specified in both Vision 2030 and NTP 2020 will significantly contribute to growing these types of inflows, which should reduce the Kingdom's reliance on oil. We also believe that the new trade and investment model we illustrated is derived directly from those reform plans.

Oil export receipts, (71.6 percent of 2015 total export receipts), fell significantly from $285 billion in 2013 to $155 billion in 2015. This fall was a direct result of the persistent glut in global oil balances, which caused Brent oil prices to decline from an average of $99.4pb in 2014 to 52.1pb in 2015. During the same period, **non-oil export receipts** (21.7 percent of 2015 total export receipts) also fell from $57.3 billion to $47 billion, mainly impacted by lower prices of petrochemicals and plastics (61.8 percent of non-oil exports). That

Figure 7. Oil Exports
(percent of total goods exports)

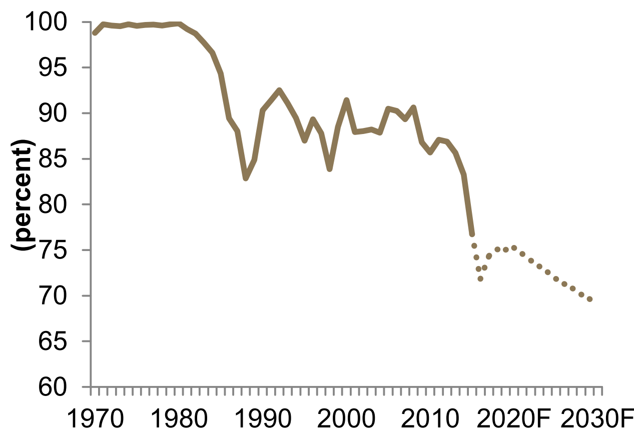
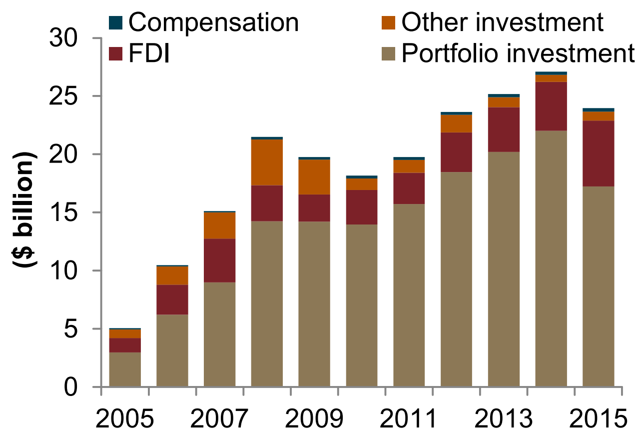


Figure 8. Primary Income



said, the decline in oil exports was more significant, leading to its share of total goods exports to fall from 83 percent in 2014 to 77 percent in 2015, the lowest on record (Figure 7).

Looking ahead, we expect export diversification to slow as a gradual recovery in Brent crude prices takes place.

Looking ahead, we expect export diversification to slow, in value terms, as a gradual recovery in Brent crude prices takes place, which we forecast to reach $105pb by 2030. Also, significant improvements in both refining and crude oil production capacity will boost oil exports over the next fifteen years, leading to a rise in total oil exports from $155.2 billion in 2015 to $501.9 billion in 2030. That said, significant structural reform should boost investment in non-oil industries over the same period. Vision 2030 aims to make the Kingdom a logistical trading hub, catalyzing exports and re-exports of non-oil goods, and supporting national companies in the fields of banking, telecom, food, healthcare, and retail by promoting their products abroad. Vision 2030 also aims to boost exports by SMEs. The recent move by the Public Investment Fund (PIF) to establish a $4 billion venture capital fund highlights the serious intent of creating opportunities for SMEs. This will contribute to fostering an entrepreneurial environment in which innovation can be achieved, leading to larger opportunities for a wider export base. Concurrently, investment in strategic sectors such as downstream petrochemicals, mining, and industrial supplies should continue to rise, leading to a deeper and broader non-oil export base.

Vision 2030 aims to make the Kingdom a logistical trading hub, catalyzing exports and re-exports of non-oil goods.

Table 1. Localization initiatives in the NTP

Government Body*	NTP initiatives targeting the development of local content
MEP	Coordinate efforts to develop the national framework for local content
MCI	Increase the competitiveness of locally produced products and services
MEIP	Increase local contributions in the provision of goods and services in the major sectors
RCJY	Localization of the renewable energy industry in Yanbu Industrial City Localization of the spare parts for basic industries and desalination in Yanbu Industrial City Localization of the Rubber Industry in Yanbu Industrial City
SAGIA	Increase the percentage of local content Develop and execute a plan for localizing construction material and equipment industries Develop and execute a comprehensive plan for localizing the transport sector Develop and execute a plan for localizing healthcare industry and services sector Establish a comprehensive framework to enhance local content
Health	Localization of the pharmaceutical industry
KA-CARE	Develop and localize industrial and service opportunities Localization of small nuclear reactors compact (SMART Technology) Localize needed renewable energy technologies to support water desalination sectors Localization of nuclear fuel cycle in uranium production, achieving investment returns
MCIT	Legislation to ensure that local IT SMEs receive a specific share of government IT contracts
KACST	Enhance equipment and facilities necessary for the development of local content Regulatory framework for local content Technical Leadership Development Program to support local content R&D support for universities and research institutions to develop the local content program Localization and transfer of mining technology and advanced materials Localization and transfer of health, energy, IT, water, oil, and transport technology

*Abbreviations: MEP: Ministry of Economy and Planning. MCI: Ministry of Commerce and Investment. RCJY: Royal Commission for Jubail and Yanbu. SAGIA: Saudi Arabian General Investment Authority. Health: Ministry of Health. KA-CARE: King Abdullah City for Atomic and Renewable Energy. MCIT: Ministry of Communications and Information Technology. KACST: King Abdulaziz City for Science and Technology.

Service exports rose from $12.5 billion in 2014 to $14.5 billion in 2015.

Payments on goods and services by inbound travelers makes up 70 percent of service receipts...

...which is dominated by religious tourism to Mecca and Medina.

Aside from goods, **service exports** (6.7 percent of 2015 total export receipts) continued to grow, rising from $12.5 billion in 2014 to $14.5 billion in 2015. Payments on goods and services by travelers into the Kingdom makes up a majority of service receipts (70 percent), and is dominated by inbound religious tourism to Mecca and Medina, including the Umrah ritual and the annual Hajj pilgrimage. Vision 2030 aims to quintuple the annual number of Umrah pilgrims over the next fifteen years to 30 million pilgrims, from 6 million pilgrims in 2015. This should contribute to major growth in this particular segment, as more pilgrims spend on local services such as food, accommodation, retail, and domestic transport. Therefore, we expect growth in service exports to accelerate, rising from $14.5 billion in 2015 to $48.5 billion in 2030 (8.8 percent of total export receipts).

Table 2. Export receipts of goods and services

	2015		2030F	
	$ Billion	% of total	$ Billion	% of total
Goods exports	**202**	**93.3**	**502**	**91.2**
Oil exports	155	71.6	346	62.8
Non-oil exports	47	21.7	156	28.4
Service exports	**14**	**6.7**	**49**	**8.8**
Total export receipts	**419**	**100.0**	**1,052**	**100.0**

Non-trade primary income fell from $27.1 billion in 2014 to $24 billion in 2015.

We expect the recent restructuring of the PIF, will contribute to significantly increasing portfolio returns in the future.

Non-trade primary income fell from $27.1 billion in 2014 to $24 billion in 2015. Primary income sources are dominated by inflows from portfolio investment abroad (72 percent), followed by returns from direct investments abroad made by Saudi residents (24 percent). Within portfolio investment returns, interest income reached $10.9 billion in 2015, falling from $13.3 billion in 2014. Meanwhile, income from equity and investment fund shares also saw a decline from $8.7 billion in 2014 to $6.3 billion in 2015 (Figure 9). These declines may be attributed to a fall in the largest component of portfolio investment, the stock of foreign reserve assets, but could also be due to heightened volatility in global financial markets during 2015 and the low global interest rate environment (See Jadwa Investment report titled Saudi Stock Exchange in 2016). Having said that, we expect the recent restructuring of the PIF, with its new mandate of investing 50 percent of its non-Aramco assets abroad, will contribute to significantly increasing the equity investment component of portfolio returns in the future, thus helping to diversify current account inflows (Figure 10).

Figure 9. Returns From Portfolio Investment

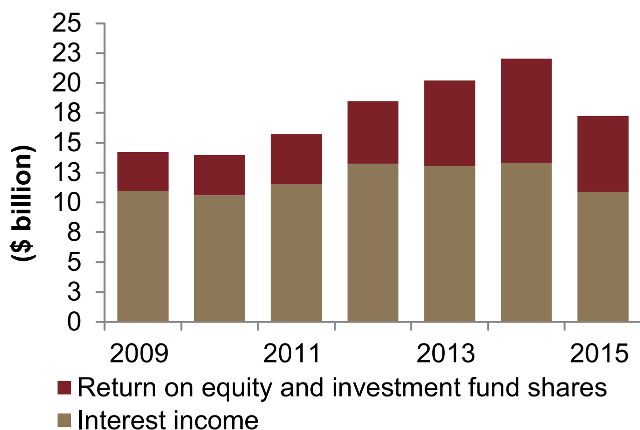
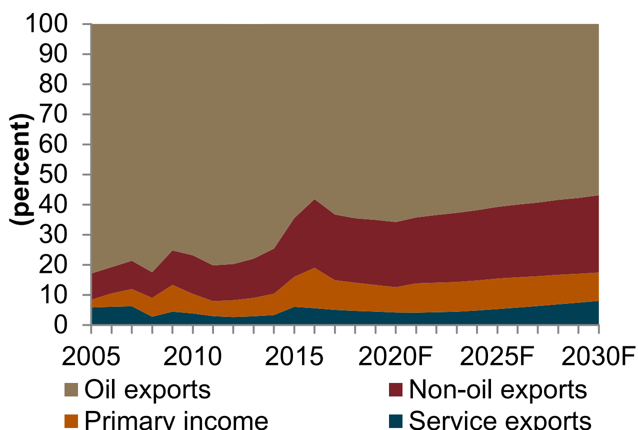


Figure 10. Breakdown of Current Account Inflows
(percent of total inflows)



1A.2 Current account outflows:

Total current account outflows declined from an all-time high of $308 billion in 2014 to $294 billion in 2015.

Current account outflows have usually been highly correlated with government spending.

The new economic model will weaken the relationship between government spending and current account outflows.

This is because of the new focus on developing local content in key industries.

Total current account outflows declined from an all-time high of $308 billion in 2014 to $294 billion in 2015. The main source of outflows during 2015 was payments for **goods imports** (52.7 percent), followed by payments for **service imports** (30.7 percent), and **workers remittances** (12.9 percent). An interesting dynamic reflecting the traditional structure of how the economy functions is that current account outflows have usually been highly correlated with government spending (Figure 11). This dynamic shows the centrality of government spending in the economy, as significant levels of government spending, be it on wages, projects, or operations, eventually leaves the economy in one form or the other. We believe that going forward, the new economic model will mean that the relationship between government spending and current account outflows will be weakened. This is because of the new focus, as highlighted by both Vision 2030 and NTP 2020, on developing local content in key industries. Promoting local content will significantly reduce the pressure on current account outflows, and would result in much more value-addition being generated within the domestic economy. Table 1 lists the initiatives highlighted so far in the NTP 2020 to promote local content. That being said, the effort to move towards industries with a higher value-addition will require a higher demand for imports of intra-industry goods and services (i.e. the exchange of similar products belonging to the same industry). As a matter of fact, trading in intra-industry goods and services is a sign of a maturing economy, since most bilateral trade amongst advanced economies is intra-industry.

Other reforms highlighted in the Vision 2030 and NTP 2020, include...

...more privatization initiatives…

...FDI promotion…

...and capital market liberalization.

Other reforms highlighted in the Vision 2030 and NTP 2020, which will weaken the above mentioned relationship between government spending and capital outflows, include more privatization initiatives, FDI promotion, and capital market liberalization, all of which are parts of the non-reserve financial account (see next page). Meanwhile, growth in remittances will likely be significantly lower over the forecasted period. Permanent residency for expatriates, the prospect of imposing a tax on remittance outflows, and ongoing Saudization initiatives will significantly limit the growth in outward remittances. We forecast total current account outflows to reach $469 billion by 2030, but they will constitute a smaller share of GDP at 28 percent by 2030, compared to 45 percent in 2015 (Figure 12).

Figure 11. Fiscal spending and current account outflows

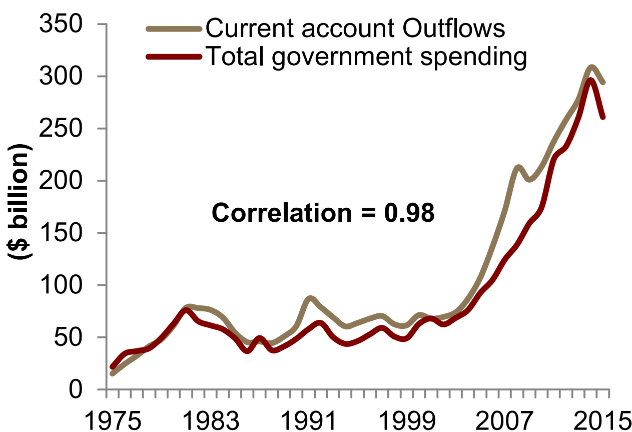
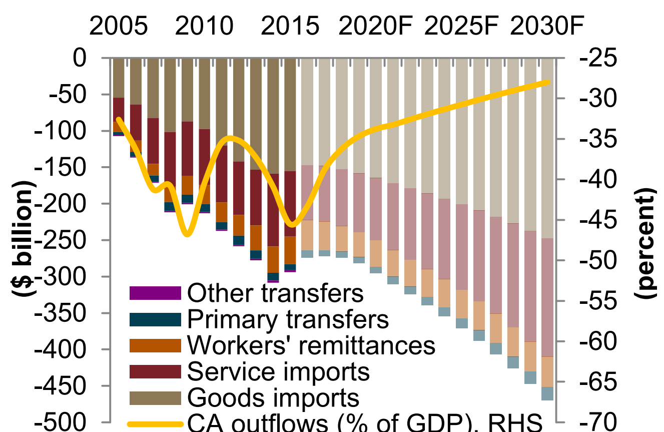


Figure 12. Current account outflows forecast



1B. The Non-Reserve Financial Account

The non-reserve financial account is a vital source of financing current account outflows.

Aside from official foreign reserve assets, the non-reserve financial account is a vital source of financing current account outflows. Traditionally, the non-reserve financial account only played a small role in financing the Kingdom's current account outflows, whether in the form of portfolio investment, FDI, or foreign borrowing. In fact, total non-reserve financing of current account outflows have dropped over the past six years as foreign reserve assets increasingly bore the brunt of financing these current account outflows (Figure 13). Not only that, but the non-reserve financial account balance have consistently been in a deficit since 2011, meaning that withdrawals from foreign reserve assets were used to cover that deficit as well (Figure 14). The rising value of outflows from 2013 to 2015 were mainly concentrated in outward investment in securities and deposits. We believe this dynamic is somewhat a reflection of the traditional economic model, as lower oil prices impacted investor confidence, which apparently resulted in investors pulling their deposits outside the Kingdom. Further, although total financial outflows declined year-on-year in 2015, this was mainly due to a fall in trade credit outflows, which is a financing item for non-residents to import Saudi goods and services, and is a reflection of lower demand for Saudi exports, rather than investor-related asset relocation.

Total non-reserve financing of current account outflows have dropped over the past six years...

...with the non-reserve financial account consistently being in a deficit since 2011.

When considering the Kingdom's new economic growth model (see page 3), non-reserve financial inflows will become a primary source of financing payments made by the private sector to import goods and services. These inflows will become driven by reforms in key areas of doing business in the Kingdom such as property rights, labor market regulations, contract enforceability, etc… The Kingdom's Vision 2030 touches on all these critical aspects of structural reform, which will likely accelerate over the next five years, particularly with the implementation of the NTP (Table 3). These reforms should boost productivity, transparency, and competitiveness of the non-oil private sector, eventually attracting foreign capital.

We believe non-reserve financial inflows will become a primary source of financing future imports of goods and services.

1B.1 Non-reserve financial inflows

Non-reserve financial inflows declined from $44.6 billion in 2008 to $12.4 billion in 2015…

Non-reserve financial flows into the Kingdom declined gradually from $44.6 billion (21.1 percent of current account outflows) in 2008 to $12.4 billion (4.2 percent of current account outflows) in 2015. The

Figure 13. Non-reserve Financial Account Inflows

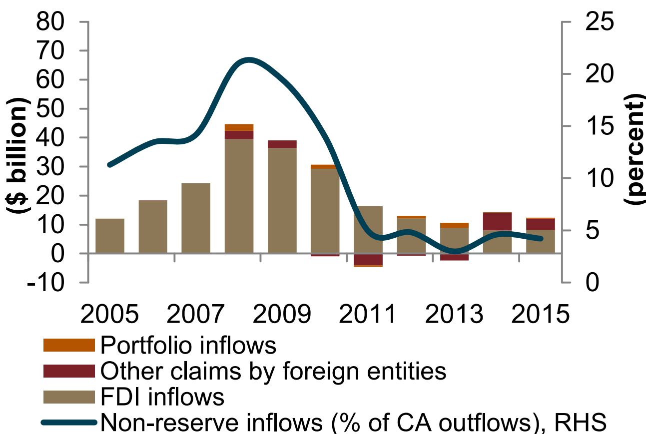
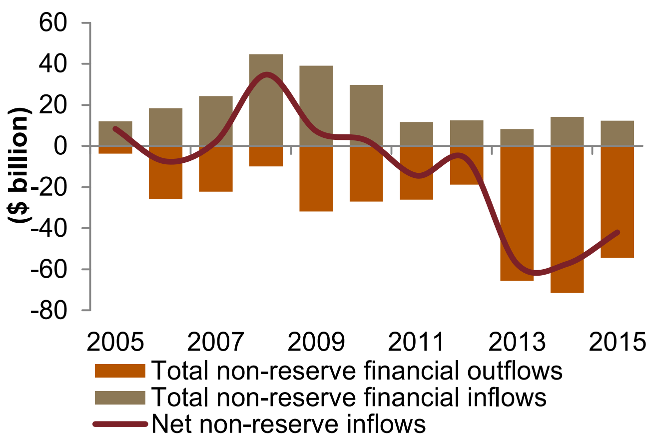


Figure 14. Non-reserve Financial Account Balance



...mainly owing to lower inward FDI.

majority of this fall was due to lower **inward FDI**, which usually made up the largest portion of non-reserve financial inflows. Annual FDI inflows declined significantly over the same period, falling from $39.5 billion in 2008 to $8.1 billion in 2015. We believe that reform towards the end of the last decade helped attract foreign capital into the Kingdom, but developments in ease of doing business in other regions around the world, coupled with slowing progress towards reforms in the Kingdom, global financial market volatility, and regional instability meant that FDI found other more safe haven assets.

According to the Doing Business surveys, the Kingdom's distance to the frontier dropped from 68.2 in 2010 to 62.7 in 2015.

According to the World Bank's Doing Business surveys, the Kingdom's distance to the frontier dropped from 68.2 in 2010 to 62.7 in 2015, ranking 84 out of 189 countries. Meanwhile, the United Arab Emirates saw improvements in its distance to the frontier, rising from 71.6 in 2010 to 74.3 in 2015 (Figure 15). Looking ahead, we believe that the highly anticipated reforms highlighted in both NTP 2020 and Vision 2030 will help attract significant non-reserve flows over the next fifteen years. That said, we forecast non-reserve inflows to rise to $78.6 billion (16.7 percent of current account inflows) by 2030.

We forecast non-reserve inflows to rise to $78.6 billion (16.7 percent of current account inflows) by 2030.

We anticipate a decline in inward FDI in 2016, mainly owing to negative investor sentiment…

...with a pick in inward FDI starting from 2017.

...accelerating to reach $76.6 billion in 2030.

The NTP already specified a target FDI figure of $18.7 billion by 2020, while Vision 2030 included a target of 5.7 percent of GDP in 2030, which we estimate to be the equivalent of $95.6 billion. The NTP also aims to improve the Kingdom's ranking in the Ease of Doing Business survey from 82 in 2016 to 20 by 2020. According to our forecast, we anticipate a decline in inward FDI from $8.1 billion in 2015 to 4.9 billion in 2016, mainly owing to the negative investor sentiment and general slowdown in economic activity during the year. However, a pick in inward FDI should start from 2017, in line with the likely fast paced implementation of reforms. The Council of Ministers recently approved 100 percent foreign ownership in the wholesale and retail sector, which is likely to be one of several anticipated moves to allow more foreign investment into the Kingdom. Also, embedded in the NTP are KPIs for SAGIA to reduce the number of days needed to issue work visas for expatriates from 30 to 10, and reducing the days for issuing new business permits from 19 to 1. This should further help streamline regulations for direct foreign investment, and directly serve one of the Vision's pillars;

Table 3. Foreign capital attraction initiatives in the NTP

Government Body*	NTP initiatives targeting the attraction of foreign capital
SAGIA	Establish and launch investors services centers of a unified model Launching the unified permits for foreign investors Execute the National Investment Plan
MOJ	Engage the private sector in notarization Engage the private sector in providing support services for the execution judiciary Establishment of Comprehensive Service Center Amendment of real estate property registration regulation Activation of reconciliation offices Digitizing real estate properties archive
MCI	Launch 3 branches for Saudi Centre for Commercial Arbitration Launch of the National Programme to combat commercial concealment Establish the Saudi Intellectual Property Authority Support the need of commercial activities through empowering policies and laws
MLSD	Development of labor disputes resolution bodies Develop and apply professional assessments for technicians Vocational Rehabilitation for basic education students Capability building in vocational training colleges

*Abbreviations: SAGIA: Saudi Arabian General Investment Authority. MOJ: Ministry of Justice. MCI: Ministry of Commerce and Investment. MLSD: Ministry of Labor and Social Development

making the Kingdom an investment powerhouse. We forecast FDI to reach $14.8 billion in 2020, before accelerating rapidly as confidence in the new economic model rises, reaching $76.6 billion in 2030 (Figure 16).

Portfolio inflows did not rise significantly in 2015 despite favorable QFI regulations…

...since foreign investors still view the oil market as the main driver for purchasing stocks on TASI.

Portfolio investment inflows (2.8 percent of 2015 non-reserve inflows) did not show a notable improvement despite favorable regulations allowing more access to the stock market through the Qualified Foreign Investors regulation (QFIs) during 2015 (Figure 17). We believe that the traditional economic model is manifested here, since foreign investors still seem to view the oil market as the most fundamental driver for purchasing stocks on TASI (See our June 2015 publication titled Oil prices and the Saudi Stock Exchange). Nevertheless, we expect that this source of financing will still be a fundamental part of non-reserve financial inflows in the future, as further improvements to the governance framework of listed corporations, and TASI's anticipated inclusion in the MSCI Emerging Market Index, attracts more QFIs. Also, the partial privatization and listing of Aramco will surely attract foreign investors, boosting portfolio inflows.

Inflows towards debt instruments will likely increase over the forecast period.

Also, inflows towards debt instruments will likely increase over the forecast period. This is because we expect the government to issue international bonds in order to avoid draining liquidity out of the domestic banking system. Further, the government's international bond issuance will likely act as a precursor to establishing a benchmark yield curve, which may allow for the development of a debt market in the Kingdom. Efforts to tap the international debt market by both private and public sectors should also be thought of as a precursor to enhancing financial linkages with global financial institutions, which will have implications on the Kingdom's domestic liquidity and financial stability *(See box 2).*

Loans from foreign residents recorded the largest increase on record in 2015.

We believe that this category will become an important source of non-reserve financing in coming years.

Other investment inflows (31.4 percent of non-reserve inflows), includes claims to foreign residents in the form of loans (69.1 percent), currency and deposits (22.4 percent), and other accounts receivable (8.5 percent). It is worthy to note that loans from foreign residents recorded the largest increase on record in 2015 (Figure 18). We believe that this category will continue to increasingly become an important source of non-reserve financing for both the public and private sectors, particularly after the progress of implementing the ambitious reform plans gets reflected on the Kingdom's credit profile.

Figure 15. Ease of Doing Business in the GCC
(distance to frontier)

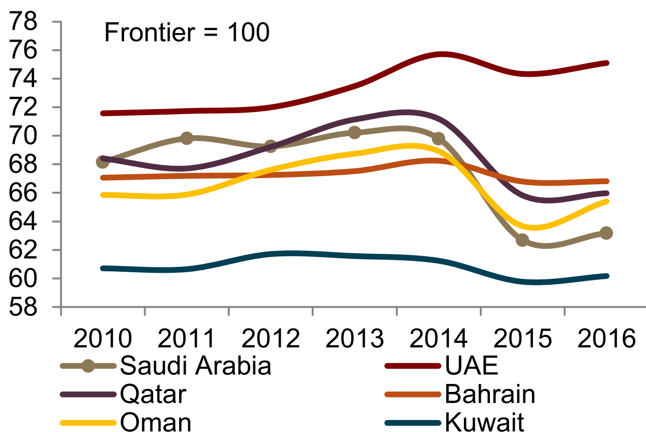
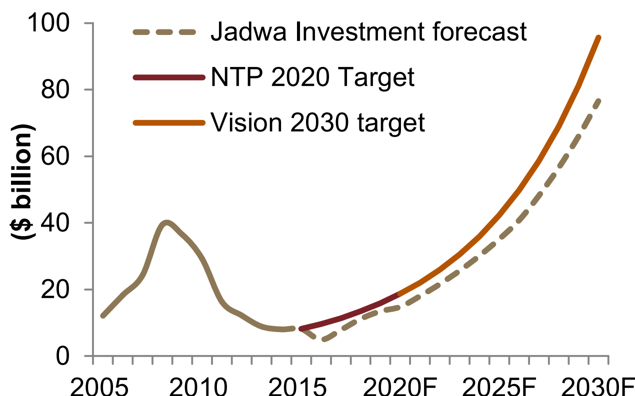


Figure 16. Inward FDI Forecast



Running an orderly public debt management program would ease liquidity pressures off domestic banks.

Since June 2015, domestic banks saw a rapid depletion to their liquidity buffers…

...which coincided with the government's launch of its domestic bond-selling program.

We estimate the total value of outstanding corporate bonds and Sukuk at $134 billion in mid-2016…

...making up 15.1 percent of total corporate financing in the Kingdom.

Non-reserve outflows reached $38.6 billion in 2015, slightly lower than $39.2 billion in 2014.

Box 2: Financial Stability & Liquidity Considerations

The prospect of the government tapping into the international debt market will likely be a first step in a long process of increasing the country's financial linkages with international financial institutions. The 2016 budget statement already included a brief mention regarding the establishment of a debt management unit responsible for developing and overseeing the public debt and financing strategy, and strengthening the Kingdom's ability to borrow both domestically and internationally. Running a transparent and orderly public debt management program would instantly ease liquidity pressures off domestic banks, and would contribute to establishing a benchmark yield curve in the Kingdom over the long-run, allowing the domestic market to easily price new issuances.

Ever since the government launched its domestic bond-selling program in June 2016, banks saw a rapid depletion to their liquidity buffers, while the loan-to-deposit ratio reached seven-year highs (Figure 19). If continued, this may have the potential to negatively impact credit to the private sector, which may eventually harm growth in the non-oil economy. Therefore, launching a foreign bond-selling program would instantly ease the liquidity pressure off domestic banks, allowing them to continue extending credit to the private sector.

Over the long-run, establishing a benchmark yield curve would significantly improve the number and the amount of domestic bond and Sukuk issuances. We estimate the total value of outstanding corporate bonds and Sukuk at $134 billion in mid-2016, which makes up 15.1 percent of total corporate financing in the Kingdom (Figure 20). Expanding this market would help diversify financing sources, which should spread corporate risk beyond banks, making them more resilient to tail risks. Further, establishing deep fixed income markets will also contribute to reducing the pressure off Specialized Credit Institutions (SCIs), thereby curbing the growth in their financing needs from the annual budget in coming years.

1B.2 Non-reserve financial outflows

Non-reserve outflows reached $38.6 billion in 2015, slightly lower than $39.2 billion in 2014. However, the decline in outflows does not accurately reflect the underlying factors, since the majority of this

Figure 17. Claims to Foreign Residents: Portfolio Investment Inflows (equity and debt instruments)

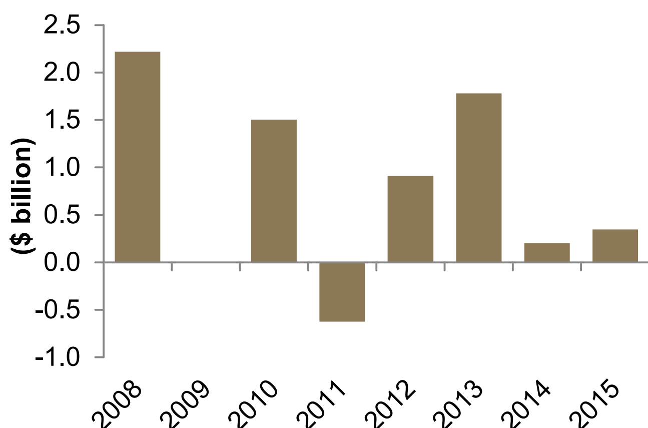
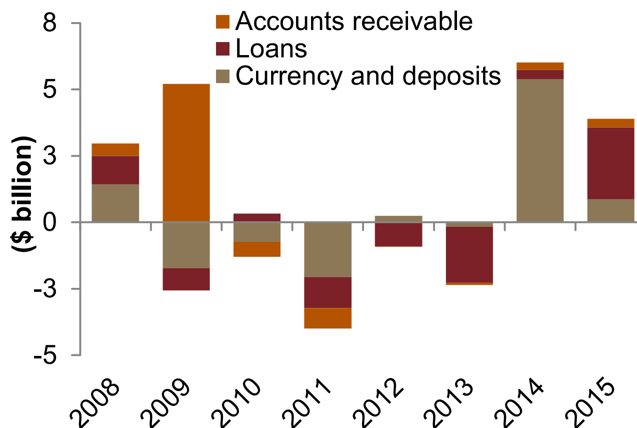


Figure 18. Claims to Foreign Residents: Other Investment Inflows



Outflows of currency and deposits increased from $9.5 billion in 2014 to $20.6 billion in 2015.

Financial outflows' share of current account inflows were the highest on record in 2015…

...indicating that more trade and income receipts have been reinvested abroad.

Reforms should lead to an improving non-reserve financial account balance…

...with surpluses forecasted from 2028.

We believe that the peg will remain intact.

Foreign reserve assets are forecast to fall to a minimum of 14 months of imports by 2022…

...before rebounding to reach 26 months of imports by 2030.

decline was because of a fall in trade credit extended to foreign residents. This fall in trade credit was mainly due to lower Saudi exports during 2015. Meanwhile, outflows of currency and deposits increased from $9.5 billion in 2014 to $20.6 billion in 2015, as uncertainty prior to the announcement of the reform programs was at its height during 2015. This caused financial outflows' share of current account inflows to increase from 18.7 percent in 2014 to 22.6 percent in 2015, the highest on record (Figure 21), and indicating that more trade and income receipts have been reinvested abroad rather than being kept domestically. This was expected given the rising uncertainty throughout 2015.That said, recent quarterly data on currency and deposit outflows showed that net outflows have turned negative during Q1 2016, which suggests that the surge in currency and deposit outflows have stabilized.

We believe that implementing the reform plans, including local content development and investment promotion, will eventually de-incentivize local residents to move their deposits abroad. Altogether, these reforms should lead to an improving non-reserve financial account balance, with surpluses forecasted from 2028. This will comfortably finance any unexpected current account deficits, and will reduce the pressure off foreign reserve assets as well (Figure 22). It is worthy to note that reaching a non-reserve financial account surplus will take considerable time due to an acceleration in outward investment activity, which will likely be led by PIF. As we mentioned earlier in the primary income section of the current account, Vision 2030 includes a designated program for restructuring PIF, with an aim to increase the fund's foreign holdings from 5 percent of total non-Aramco assets to 50 percent by 2030, and doing so would entail significant financial outflows over the forecasted period.

1B.3 Exchange rate policy

Given the anticipated growth in total financial account activity (from 10.3 percent of GDP in 2015 to16.1 percent of GDP by 2030), we believe that the peg will remain intact. The fixed exchange rate will continue to be an anchor for stability, especially amidst an anticipated period of rising investment and financing activity to promote local content development and diversification. Foreign reserve assets are forecast to fall to a minimum of $328 billion (14 months of imports) by 2022, before rebounding to reach $889 billion (26 months of imports) by 2030. To put this into context, the general

Figure 19. Estimate of Bank Excess Liquidity

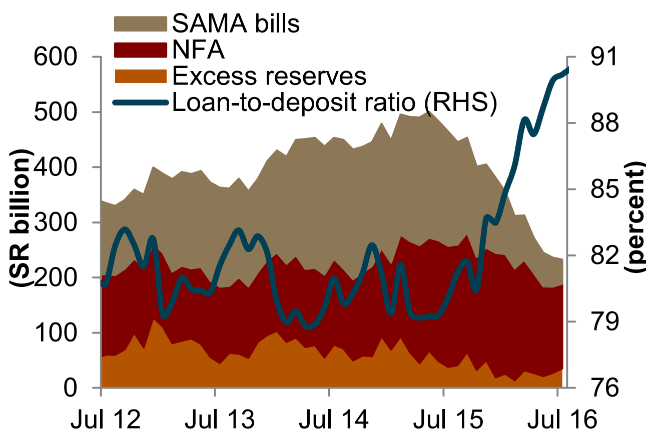
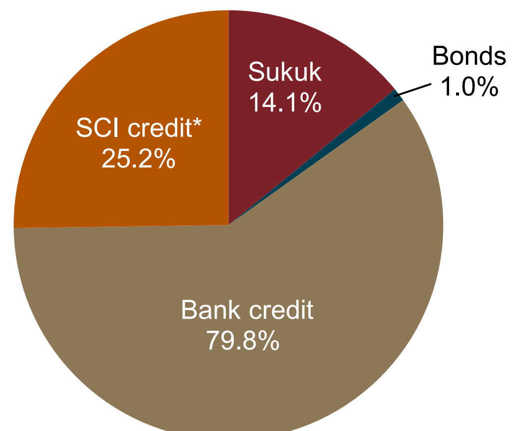


Figure 20. Breakdown of Saudi Corporate Debt
(percent of total corporate debt, as of June 2016)



SCI*: specialized credit institutions' outstanding loans

rule of thumb, which countries tend to follow, is to hold foreign exchange reserve at value close to 6 months of imports, significantly lower than even the minimum level forecasted for the Kingdom. This ample reserve will help protect the peg against any speculative activity over the long-run.

2. The outlook for the Kingdom's NIIP

The Kingdom's total stock of gross foreign assets fell from $732.4 billion in 2014 to $616.4 billion in 2015...

...mainly owing to a drawdown of foreign reserve assets to finance deficits in:

…the current account

...non-reserve financial account…

…and fiscal budget.

According to data from SAMA, the Kingdom's gross foreign assets fell from $732.4 billion in 2014 to $616.4 billion in 2015, mainly owing to a drawdown of foreign reserve assets to finance deficits in the current account, non-reserve financial account, and fiscal budget. Meanwhile, gross foreign liabilities, i.e. (what Saudi residents owe to foreign entities), continued to grow, reaching $289 billion in 2015, up from $278 billion in 2014. The combination of falling assets and rising liabilities led to a decline in the Kingdom's net international investment position (NIIP) from $792 billion in 2014 to $703 billion in 2015. However, in percentage of GDP terms, NIIP has actually continued to grow during 2015, rising to an all-time high of 108.9 percent, up from 105 percent in 2014. We view this as reassuring for the Kingdom's credit profile, and this reflects an important strength when considering future financing options from abroad. The data series for the Kingdom's international investment stock statistics was first published in 2012 (See Jadwa Investment report titled Rapid Growth in The Kingdom's Foreign Assets). Looking ahead, we expect the Kingdom's implementation of its reform programs to lead to a decline in its NIIP to 68.6 percent of GDP by 2022, before rebounding to reach 77.6 percent by 2030 (Figure 23).

We forecast the fastest growth in foreign asset accumulation to be in the form of portfolio and other investments.

Gross foreign assets are currently dominated by foreign reserve assets held by SAMA (62.1 percent), followed by portfolio investments (20.4 percent), other investment (11.1 percent), and direct investment abroad (6.4 percent). Our assumptions and forecasts for the BOP will mean that the fastest growth in foreign asset accumulation will be in the form of portfolio and other investments (Figure 24). We forecast these two categories of investments to rise from a combined total of $313 billion in 2015 to $1,480 billion by 2030. We believe that this significant growth will be enabled by the partial privatization of Aramco. While it is still challenging to put a valuation on Aramco, early estimates from various sources suggest that it is in the $2-$4 trillion range. We

Figure 21. Non-reserve Financial Outflows

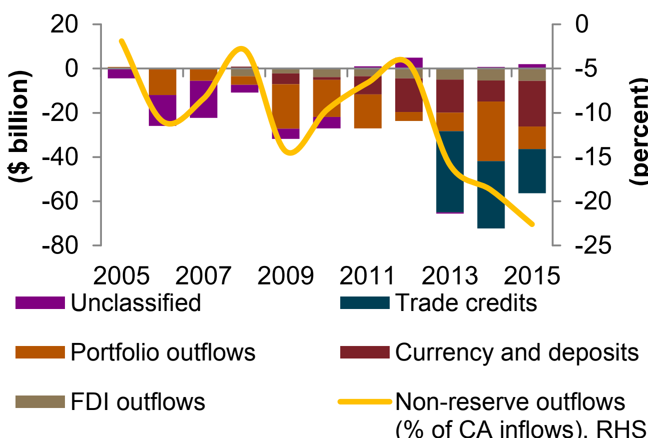
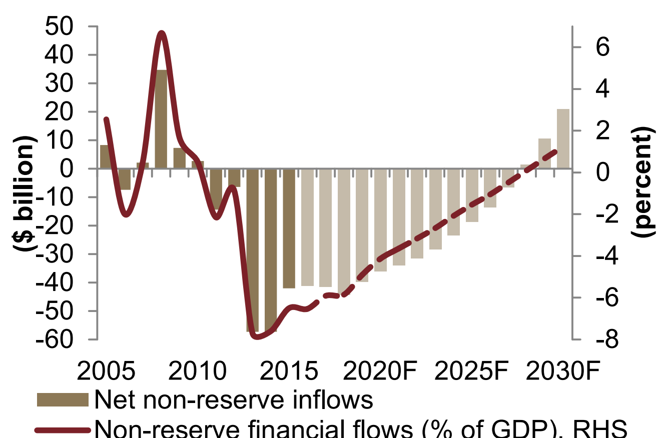


Figure 22. Net Non-reserve Financial Inflows



therefore believe that even a partial privatization will allow PIF to enjoy receipts large enough to justify such growth in investment abroad.

Gross foreign liabilities are dominated by FDI stock in the Kingdom (77.4 percent).

We forecast FDI to rise from $224 billion in 2015 to $695 billion by 2030.

Gross foreign liabilities are dominated by FDI stock in the Kingdom (77.4 percent), followed by other investment in currencies, loans, and deposits (16.8 percent), and portfolio investment (5.8 percent). We forecast FDI to rise from $224 billion in 2015 to $695 billion by 2030, but will see its share of total liabilities decline to 57.6 percent. This is because portfolio inflows will surge significantly over the forecast period from $17 billion in 2015 to $434 billion by 2030. We assume that portfolio inflows will be mainly attracted by the partial listing of Aramco, as well as improvements in capital market accessibility (see page 9). That being said, the share of portfolio stock is forecast to reach 36 percent of total liabilities by 2030 (Figure 25).

The Kingdom still enjoys a very strong NIIP at 108.9 of 2015 GDP…

...which can instantly attract significant inward investment once the reform plans are implemented.

The strength of the Kingdom's **NIIP** (108.9 of 2015 GDP) will mean that implementing the reforms highlighted in the Vision 2030 and NTP can directly attract significant investment into the Kingdom, whether in the form of FDI, portfolio investment, or loans. Enjoying such a large NIIP is very important for the macroeconomic stability of any economy, and we believe that the Kingdom sits comfortably when it comes to this issue (Figure 26). This large buffer should also provide the necessary timeframe to implement the reforms needed, allowing the transformation into the new economic model to be realistically achieved within the next fifteen years.

Figure 23. The Kingdom's NIIP

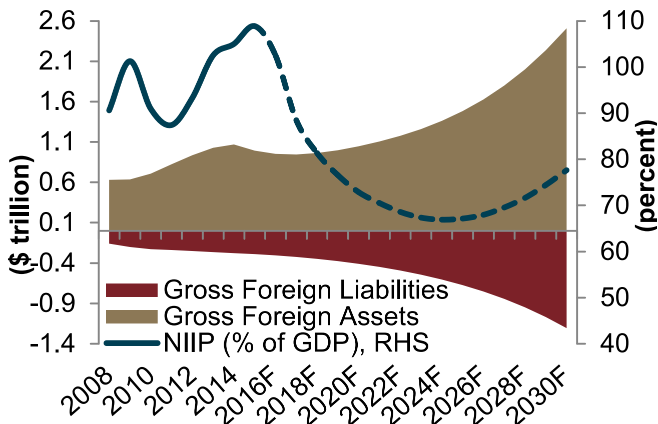


Figure 24. Gross Foreign Assets

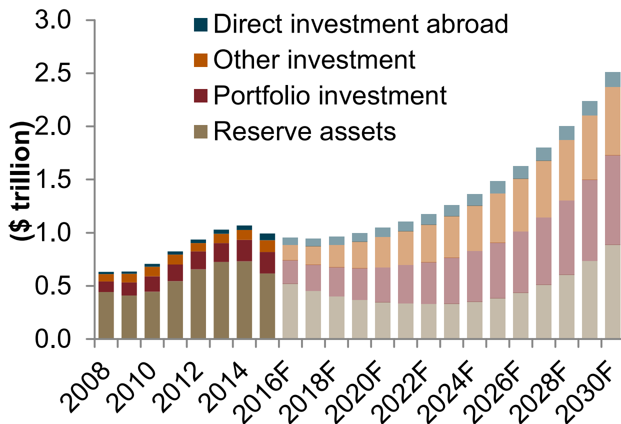


Figure 25. Gross Foreign Liabilities

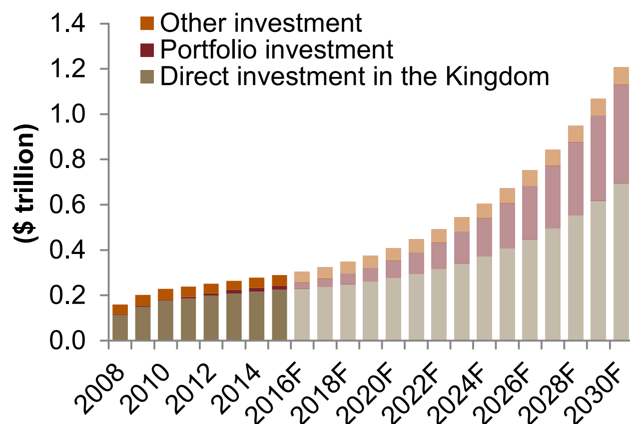
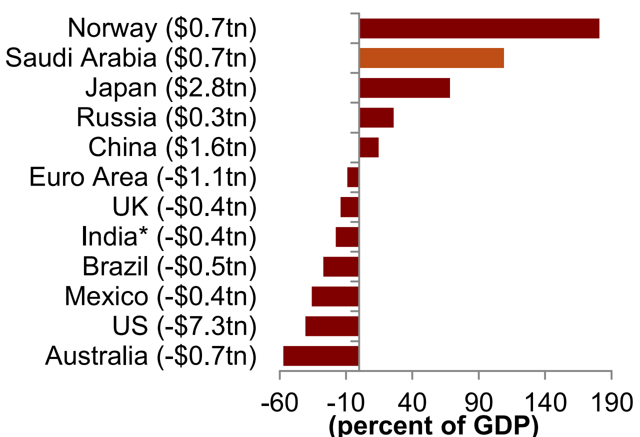


Figure 26. NIIP by country in 2015



Note*: 2014 is the latest available NIIP data for India

Key Data

	2013	2014	2015	2016F	2020F	2025F	2030F
Balance of Payments ($ Billion unless otherwise noted)							
Trade balance	**222**	**183**	**47**	**31**	**109**	**159**	**253**
General Merchandise							
Exports	376	342	202	179	275	361	502
Oil exports	322	285	155	129	207	259	346
Other exports and re-exports	54	57	47	50	68	101	156
Imports (f.o.b.)	153	158	155	147	165	201	248
Services, net	**-65**	**-88**	**-76**	**-63**	**-73**	**-95**	**-114**
Credit	12	13	14	12	13	22	49
Debt	-77	-101	-90	-75	-86	-117	-162
Income, net	**14**	**17**	**16**	**20**	**18**	**30**	**39**
Transfers, net	**-36**	**-39**	**-41**	**-44**	**-39**	**-41**	**-44**
of which: workers remittances	34	36	38	42	36	39	42
Current account balance	**135**	**74**	**-53**	**-56**	**15**	**52**	**135**
(% of GDP)	18.2	9.8	-8.3	-8.8	1.8	4.3	8.0
Non-reserve financial account, net	**-57**	**-57**	**-42**	**-41**	**-36**	**-19**	**21**
Direct investment, net	-4	-3	-3	0	-10	-30	-71
Abroad	5	5	6	5	5	5	5
In Saudi economy	9	8	8	5	15	35	77
Portfolio investment, net	7	27	10	13	13	15	17
Abroad	8	27	10	23	29	47	76
In Saudi economy	2	0	0	10	17	32	59
Other investment	55	33	35	29	33	33	34
Abroad	52	39	39	30	35	36	36
In Saudi economy	-2	6	4	1	2	2	2
Change in reserve assets	**69**	**7**	**-116**	**-97**	**-21**	**33**	**155**
Capital and financial account, net	**-127**	**-64**	**74**	**56**	**-15**	**-52**	**-135**
Errors and omissions	-9	-9	-20	0	0	0	0
International Investment Stock ($ Billion unless otherwise noted)							
Gross foreign assets	1,028	1,069	993	953	1,047	1,483	2,509
Gross foreign liabilities	265	278	289	305	410	674	1,207
Net International investment position	**763**	**792**	**703**	**648**	**637**	**810**	**1,302**
(% of GDP)	102.5	105.0	108.9	102.5	72.9	67.2	77.7

Source: Saudi Arabian Monetary Agency and Jadwa Investment forecast

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