Transforming Saudi Arabia's Capital Markets

Strengthening the Financial Triad

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KEY POINTS

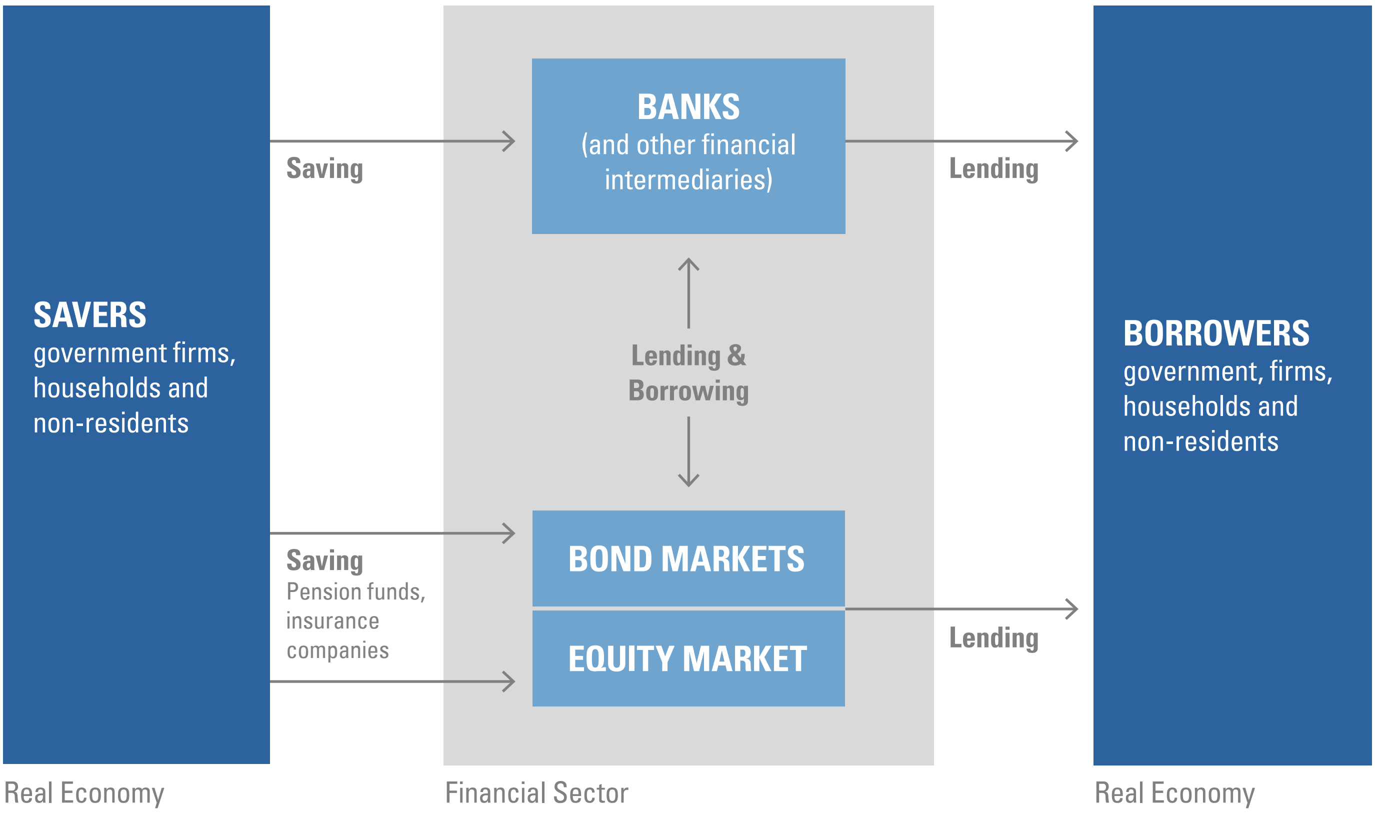
- Vision 2030 and the Aramco privatization mark a decisive point to advance Saudi Arabia's financial sector — a critical ingredient to the country's economic transformation.
- Saudi's "Financial Triad" remains partially incomplete with a sound banking system and a rapidly emerging equity market, but an immature bond market.
- The privatization of Saudi state assets (including Aramco) could deliver a boost to the depth and sophistication of the Saudi equity market and — if cleverly designed— have positive spillover effects into other areas of finance and policy.
- The timing is ideal to launch an accompanying systematic drive to build local currency bond markets, which is a prerequisite for achieving the broader economic goals of Vision 2030.

VISION 2030 & THE FINANCIAL TRIAD: BANKS, EQUITY & BOND MARKETS

Saudi Arabia's Vision 2030 is remarkable in its aspiration to engineer far-reaching economic transformation. As a global asset manager, we note that one of the three pillars of this vision sets out the aim to make the country a "global investment powerhouse."[1] While Saudi Arabia has a strong legacy as a sovereign investor in foreign markets, this ambition also requires its local financial system to deepen across all sectors. Strong capital markets work together with a banking system to channel investment and ensure efficient capital allocation across the economy. In the absence of such channels, many worthwhile business ventures never take place, capital is misallocated and underutilized, and economic growth remains below its potential.

Underdeveloped markets characterize Saudi Arabia today. In the World Bank's most recent *Doing Business* report, access to financing was deemed the fourth most problematic factor for doing business in Saudi Arabia.[2] The current financial architecture represents a mixture of challenges, notably with regard to insolvency resolution, protection of minority shareholders and access to credit. Other international reports draw similar conclusions. The World Economic Forum's *Global Competitiveness Report* highlights that financial market development is one of Saudi Arabia's weaknesses in relative terms, especially in relation to access to financing and the predictability of the legal system.[3] Despite some recent progress over the past two years, such as the draft insolvency law, the creation of arbitration mechanisms and improvements to minority protection, more needs to be done to advance Saudi's financial sector.

Figure 1: Illustration of Financial Sector Relationships With the Real Economy and Each Other



Source: State Street Global Advisors.

Comprehensive capital market reforms are not only advisable, but essential to ensuring higher economic growth in the face of a stagnant oil price environment. The IMF calculates that implementing the full range of structural reforms could boost trend growth by 2.1% per year.

Financial sector reform alone would directly account for 0.5% of that, i.e., about a quarter.[4] Related changes to make the business environment more competitive would add another 0.3%. Many of these depend on parallel changes to financial market regulation and practices.

In short, a healthy financial sector is a critical component of future reform and requires three robust constituent parts: a) a banking system; b) equity markets; and c) bond markets. As Figure 1 shows, these three elements are interconnected in a triad; when reforms strengthen one component, they promote the development of the others too. This paper examines the state of each component and its need for reform.

ISLAMIC FINANCE AND CAPITAL MARKET DEVELOPMENT

"Living by Islamic values" is one of the key principles underpinning Saudi Arabia's Vision 2030.[5] This has implications for the financial industry, the main elements of which must remain sharia compliant. For capital market development, Islamic finance creates both restrictions and opportunities.

Among key Islamic finance principles is the prohibition of *riba* (usury) and *gharar* (excessive uncertainty).[6] The former has a significant impact on fixed income products – deposits have to be either non-interest bearing or exhibit some element of profit-and-loss sharing[7], while bonds usually have to be backed by an asset pool and have quasi-equity features (commonly known as sukuks). The gharar principle leads, for example, to the prohibition of short-selling. The concept of life insurance is also viewed as non-compliant, and is thus organized in a form of a mutual social assistance scheme (*takaful*).[8] Regarding pensions, sharia principles do not affect them per se, but a sharia-complaint funded pension plan has to be invested in compliant assets.

Sharia-compliant equivalents exist for most of the prohibited products, and an IMF study found little difference between the practical functioning of Islamic and non-Islamic financial systems.[9] The main challenges for policymakers are to correctly place the Islamic financial products on relevant risk scales (for example, within Basel) and to find an optimal regulatory approach to those institutions that are engaged in both Islamic and non-Islamic products.[10]

Islamic finance can also create considerable opportunities. It is an industry with US$2 trillion in assets, which has grown fivefold in the last decade. Saudi Arabia can continue to be a key market for Islamic finance and became a regulatory pioneer in many of its aspects, helped, for example, by the Jeddah-based Islamic Development Bank.

BANKING SYSTEM

Banks play several roles in the economy. First, they underpin the economy's payments system which facilitates transactions between economic agents in a cost-efficient and frictionless way. Second, banks safeguard the basic layer of private sector assets in the form of deposits. Third, banks provide debt capital by intermediating customer deposits into loans.

The safeguarding function differentiates banks from other profit-maximizing institutions, given that banks have a large base of very small investors. Hence, banks typically are heavily regulated to ensure their liquidity and solvency. An illiquid or insolvent bank is unable to perform either payments or safeguarding functions. Solvency risks are often addressed via some form of risk-adjusted capital framework; there is usually a set of minimum liquidity requirements as well. To provide an extra layer of safety, governments often make use of a deposit insurance scheme.

On this account, Saudi Arabia finds itself in a strong position. Despite the significant shock of lower oil prices, both the solvency and liquidity metrics are adequate. Twelve key banks have passed regulatory stress tests and a deposit insurance scheme was established in 2016.

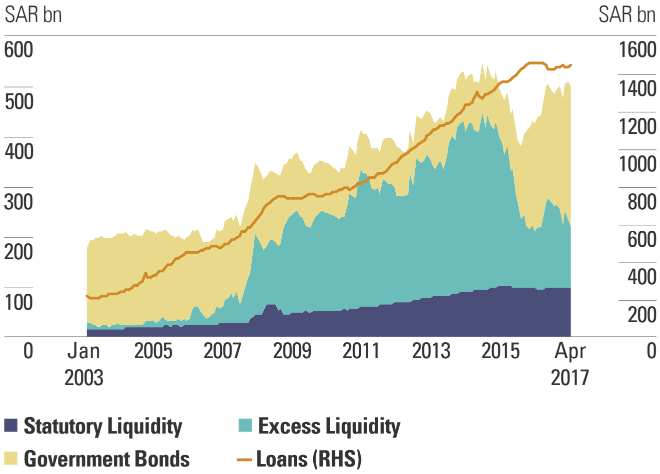
The third function of being a capital provider is not unique to banks, but the way they carry it out is crucial. Banks do not simply allocate savings to different forms of capital as fiduciaries do, but act as principals in their own right. The central bank provides the monetary base while commercial banks leverage it through a controlled multiplier and provide money supply to the real economy. Success in this dimension requires sophisticated asset-liability matching, which is especially hard if other parts of the capital markets are underdeveloped. It is by nature pro-cyclical, especially under a fixed exchange rate like the Saudi Riyal, and there are segments of the capital markets which the banking system does not reach.

The banking system of Saudi Arabia has struggled to perform this function. Evidence is visible in Saudi Arabia's historically high deposit-to-loan ratios (averaging 125% since 2008)[11] compared with the standard for emerging markets (far below 100%). The inflows of oil wealth increased the earnings of all sectors and resulted in a larger demand for deposits. The loan books grew at a slower rate. The largest export industry was cash-rich and the large current account surplus prevented the capital shortfalls experienced by other markets, where fast growth created demand for credit which banks were unable to meet with deposit funding alone. In those markets, the banks resorted to wholesale funding, often with a currency mismatch.

Such prudence in Saudi Arabia has been supportive of the safeguarding function. However, the excess liquidity has had significant opportunity costs. The lack of developed fixed income markets meant that the bulk of liquidity was placed with the central bank, and the banks did not establish a presence or track record in the capital markets because deposit funding sufficed. Thus the Saudi interbank lending market remains somewhat thin.

After the recent oil price shock in 2014-2015, the deposit-to-loan ratio decreased as liquidity conditions worsened. A mild decline in asset quality drove banks to be more cautious, and the active issuance of government debt met the banks' demand for safe assets. Therefore, the funding base of banks shrunk while the pool of available non-loan assets widened, which made banks less likely to extend new loans. Figure 2 shows how excess liquidity dropped and new loan growth flattened after 2014.

Figure 2: Selected Assets on Saudi Bank Balance Sheets 2003–2017 (SAR bn)



Source: Saudi Arabian Monetary Authority.

This pattern demonstrates pro-cyclicality, which is a defining characteristic of most banking systems. To some extent, this can be mitigated by central banks reducing interest rates and providing additional liquidity during downturns. However, a fixed exchange rate significantly limits the scope for countercyclical monetary policy. Some qualitative easing has been done by tweaking repo rules, and the government has boosted banks' liquidity by moving some of the deposits under its control into commercial banks.

Just as government bonds helped diversify the asset side of the banks, a wider range of instruments on the liability side could also bolster the banking system. Such instruments can be issued in the context of a resolution framework, where banks may issue convertible instruments of varying seniority to build additional solvency buffers. Even for a bank-based economy, it is vital to build other elements of the capital markets to complement it.

Even if the cyclicality issues of the banking systems were to be addressed, banks would still not reach key market segments. Banks are well placed to provide mortgage and consumer lending for households. For established small enterprises, banks provide financing, more effective capital allocation and diversification from informal networks. Larger enterprises may use banks to fund working capital or particular projects. However, lending to large firms in a concentrated economy creates concentration risks. In Saudi Arabia, there are a small number of large, dominant firms across each industry that have deep banking relationships to secure financing. In contrast, expansion projects of medium-sized enterprises may go beyond the appetites of the banking system — there is no incentive to take on particular credit risk. Moreover, banks are not able to provide any venture capital for start-ups, especially in new and emerging sectors.

What Next for Saudi Banks?

Saudi Arabia has been successful in maintaining the solvency of its banking system. In tighter liquidity conditions, it is vital to expand the range of instruments available to banks both on the asset and the liability side. Liquidity regulations could be further refined, as recommended by the IMF's latest Financial Sector Stability Assessment,[12] and procedural improvements in regulation can be made. However, a holistic approach to improving the banking system needs to proceed in parallel with developing other parts of the capital market, namely the equity and bond markets.

EQUITY MARKET

Several positive developments have occurred in the Saudi Arabian equity market in recent years, as evidenced by the growth in market capitalization. As a percentage of GDP, Saudi equities have risen in value from just over 50% in 2011 to just below 70% in 2016.[13] In addition to increasing the relative size of the market, the Saudi stock exchange (Tadawul) has also recently taken steps to broaden its appeal, including introducing a parallel equity market, "Nomu", with lighter listing requirements, to serve as an alternative platform for small and medium-size enterprises (SMEs) to go public and, in time, potentially transition to the main market.

Notwithstanding this progress, three major developments in the imminent future could prove transformational. First, Saudi Arabia's equity market is nearing inclusion in key indices. Major institutional investors and leading global equity index providers point to several structural improvements to the Saudi equity market in the year through April 2017. These have led FTSE Russell and MSCI to start independently considering upgrading Saudi Arabia within their index frameworks. For example, both have mentioned the simplification of the Qualified Foreign Investor (QFI) registration process, the movement to an international standard T+2 settlement cycle with Delivery versus Payment (DvP), and the introduction of short selling as well as securities borrowing and lending facilities as key upgrades to the market structure.

FTSE Russell's opinion in their Annual Country Classification Review was that "Saudi Arabia is to be congratulated on the pace of the recent market reforms which are widely acknowledged as being positive."[14] As a result, they retained Saudi Arabia on their watch list for possible reclassification to Secondary Emerging Market status, and brought their next formal assessment of Saudi Arabia's classification status forward to March 2018.

Similarly, MSCI has launched a consultation with institutional investors on a proposal to reclassify the MSCI Saudi Arabia Index from Standalone Market to Emerging Market status, which could in turn result in its inclusion in the widely followed MSCI Emerging Markets (MSCI EM) Index. MSCI will announce its decision in June 2018, with any proposal to implement the reclassification potentially occurring in two steps, coinciding with the May 2019 semi-annual and August 2019 quarterly index reviews.

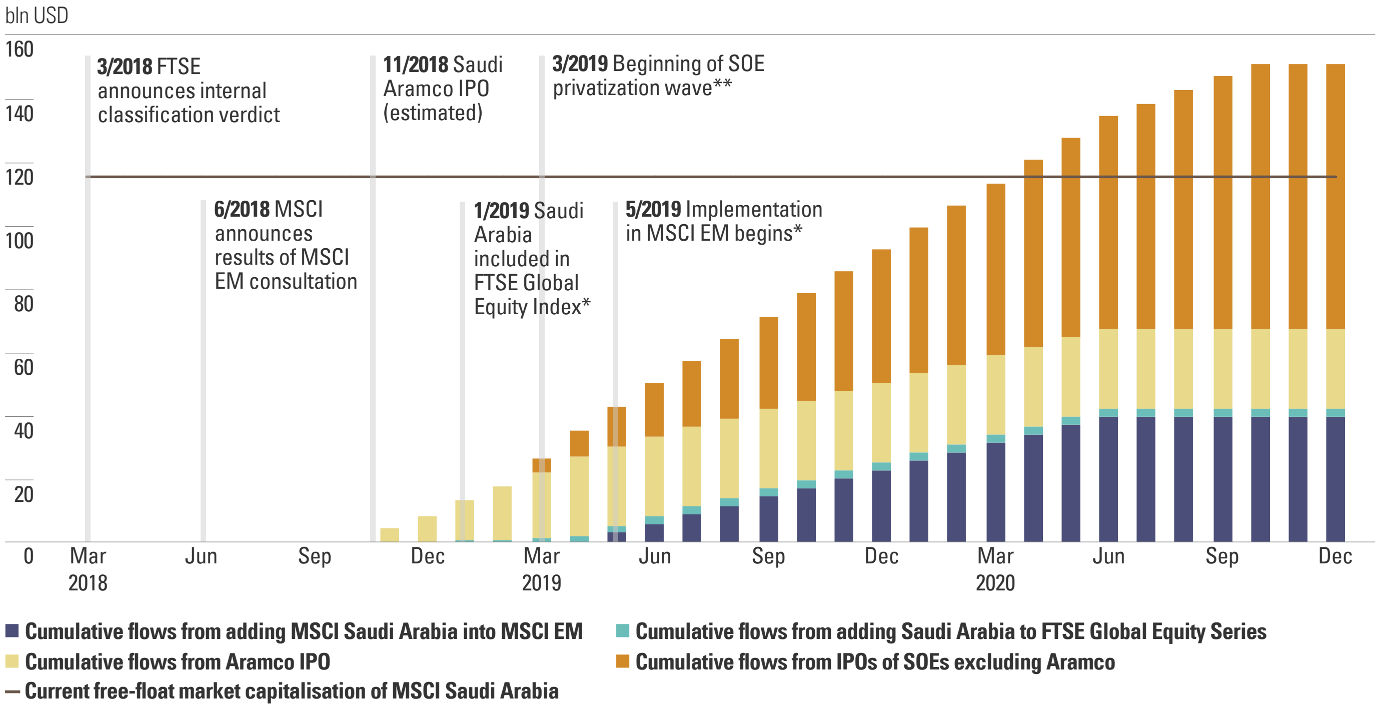
According to MSCI's estimates, US$1.6 trillion is currently passively tracking the EM Index. Based on their initial calculations, one could assume that Saudi Arabia would form 2.4% of the new EM Index upon full inclusion, implying an inflow from passive trackers over the inclusion period of around US$38 billion. Adding an estimated US$3.5 billion of initial inflows from inclusion in the FTSE Russell,[15] one could assume capital inflows easily worth more than a third of MSCI Saudi Arabia's current free-float market capitalization, before even taking into consideration any other passive or non-benchmarked flows, as visibility improves.

Second, potential exists for an additional US$200 billion in privatizations across a range of sectors, not including the potential sale/IPO of Saudi Aramco.[16] These span a wide range of sectors: environment, water and agriculture; transport; energy, industry and mineral resources; labor and social development; housing; education; health; municipalities; telecommunications and information technology; and Hajj and Umrah [Islamic pilgrimage] services.[17] Clearly, these additional flotations should in turn bring with them increased flows of funds into the domestic equity market.

And third, the above numbers do not take into account any potential additional inflows from the proposed partial (5%) IPO of Saudi Aramco, currently still planned for H2 2018. Valuations have ranged from as low as US$400 billion to as high as US$2 trillion, meaning this flotation could result in another US$8

Figure 3: Saudi Arabia Equity Market Inflows

Equity Market inflows to reach $144.5 billion by December 2020



Estimated implementation if results of consultation and classification are positive. Flows will materialize as and when respective IPOs occur.

The following additional assumptions are used in the chart: (i) we estimate the total capital inflows due to MSCI inclusion to total US$38 billion over 14 months, based on our current estimates of the volume of investors which track the index; (ii) we estimate the total capital inflows due to FTSE inclusion to total US$2.5 billion over 6 months, based on our current estimates of the volume of investors which track the index; (iii) we forecast Saudi Aramco IPO to generate between US$8 and US$40 billion in inflows; we use the center point of the interval of US$24 billion for this chart; we assume that the flows will occur over the period of 6 months and (iv) we forecast the IPOs other than Saudi Aramco to generate US$80 billion of inflows, which we expect to occur evenly over 20 months.

Note: Projected numbers are based upon estimates and reflect subjective judgments and assumptions. There can be no assurance that developments will transpire as forecasted and that the estimates are accurate.

Source: State Street Global Advisers.[8]

to US$40 billion of pure passive MSCI-related inflows. Figure 3 illustrates the cumulative inflow of capital based on the full realization of the above plans.

Given the potential size of the Aramco flotation, the Kingdom needs to look outside the Tadawul for the liquidity needed to trade the stock in an orderly fashion. Much has been noted of the eagerness of overseas exchanges to provide a home for Aramco, with London and New York most commonly mentioned as the leading contenders. This first additional overseas listing of any Saudi company could not only serve as the nexus of international liquidity for Aramco as the company's flotation advances, but also act as a very visible symbol abroad for the progression of the Kingdom's privatization plans.

The financial press has tended to focus sensationally on the size of Saudi Aramco's partial IPO, the uncertainties around proven reserves, expenses, tax rates, and hence valuation, and the timing and possible venues of an initial and any secondary listings. However, we believe that most of this coverage has missed the key point: the listing of Saudi Aramco is integral to plans for the transformation of the rest of the Saudi economy. Beyond purely providing a source of discrete cash flows to be invested elsewhere by various government agencies, the Saudi Aramco transaction should be leveraged in a much more significant way to change the relationship between the Saudi Kingdom, the stewards of its economy, its citizens and the international investment community.

How to Maximize Equity Market Reform

As markets mature, policymakers have fewer opportunities to intervene and constructively shape a market's evolution. With respect to Saudi's equity market, the coming years represent the opposite. Developments associated with reforming the stock market offer a unique chance to engineer wider economic transformation. In this regard, we highlight two major recommendations:

1 Efficiently manage the sizable inflows of foreign capital.

The above analysis suggests that benchmark-associated (in the wider sense) portfolio flows could amount to US$50–US$100 billion, much of which will remain rather sticky. In other words, these flows are likely to be less volatile than regular portfolio flows. Under a fixed exchange rate, portfolio flows typically accrue to a central bank's foreign reserves and are treated as if matched one-to-one to foreign liabilities (i.e., they are sterilized and make no contribution to the domestic money supply). They therefore sit on a central bank's balance sheet as foreign exchange in the event that the foreign investor suddenly wishes to repatriate the portfolio investment and needs to convert the currency. However, in Saudi Arabia's case, the resulting rise in foreign reserves would be structural, and only a portion of them may need to be sterilized. Alternatively, the proceeds of sterilization could be invested on a longer-term horizon, enabling the Saudi Arabian Monetary Authority (SAMA) to generate extra investment income and create more buffer space for the country to manage the introduction of future reforms.

2 Use the privatization wave and Aramco IPO to revolutionize Saudi finance and society.

The financial tool used to achieve this would be a "National Privatization Fund." This would be an equity fund (either mutual fund or ETF vehicle) that is offered pro-rata to Saudi citizens at a slight discount to the net asset value of the fund.[19] This would minimize any political controversies over the sale of public assets.[20] Moreover, it would have three other positive effects on the Saudi citizenry. First, it would give Saudi citizens a real sense of ownership of the future by mobilizing their capital to be staked on the country's success. Second, it would help build a new investor class and lay the seeds of a wider retail investor culture. And third, it would symbolize the gradual transition away from a government-dominated economy to one based much more on individual household responsibility, fostering a retirement and savings culture.

The last point is fairly novel by the standards of Saudi Arabia, and therefore it is crucial that citizens are offered the chance to actively participate in the upside of any economic reform. Apart from engaging households in financial markets directly, this can be done via non-bank financial intermediaries who serve households. Two important types of such intermediaries are private pension funds and insurers. Private pension funds in Saudi Arabia are embryonic, but the main public pension fund — GOSI — is the major investor into the domestic stock market; equities are important risky assets which savers need at the early part of their life cycle to maximize the value of their savings.[21] The insurance industry also has considerable room for growth, as the total gross insurance premiums in 2016 stood at 1.5% of GDP compared to 4.7% in Chile and 13.3% in Korea.[22]

BOND MARKET

If Saudi Arabia enjoys a strong banking system and develops a vibrant equity market, why is a local currency bond market still necessary? The answer is that local bond markets can provide three additional functions.[23] First, local bond markets significantly improve the policymaking toolbox. We highlighted in the section on banks the restrictions on monetary policy under a fixed exchange rate. Under such circumstances, the central bank can resort to using the banking system only as an indirect transmission channel to implement monetary policy. As Figure 4 shows, the presence of deep capital markets (both equity and debt) expands policy flexibility by being able to transmit monetary policy also through asset prices and interest rates, as the central bank would be able to buy and sell local bonds in open market operations.

Second, local currency bond markets are critical to enhancing financial stability. As the IMF has written, "a more diverse financial system that includes capital markets alongside banking markets tends to be more stable and better able to absorb shocks. For example, bond markets can act as a 'spare tire' to bank finance in case of banking crises, thus helping to absorb the shock of bank distress."[24]

Diversifying the financial system not only speaks to the creation of bond markets in parallel to a sophisticated banking system, but also to simultaneous developments in equity markets. The logic is that price discovery is mutually supported by providing comparative price references. By spreading sources of funding and the range of investment options, the financial system distributes credit risk across a larger number of economic actors. In addition to diluting the concentration risk from the banking system, a deep local currency bond market minimizes individual balance sheet asymmetries such as reliance on short-term funding for longer-term finance.

And third, local bond markets would be a major boost for economic development. The availability of local currency debt instruments allows local financial firms to expand their services and accelerates financial development. Instead of recycling national savings abroad, local bonds (especially long-term) would help promote the wider domestic asset management industry. Bonds are critical to the portfolio construction process of insurance companies and pension funds; in the context of the demographic changes Saudi Arabia is experiencing, the development of both those industries would be beneficial to its long-term development.

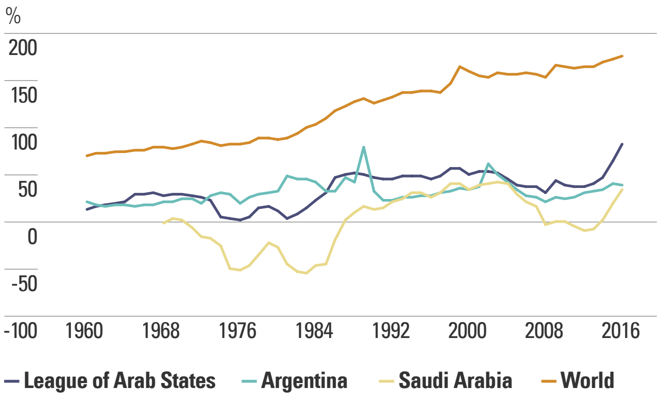
Figure 4: Comparative Effectiveness of Monetary Policy Transmission Channels

		Exchange Rate Regime			
		Flexible		**Fixed**	
Depth of local capital markets and financial intermediation		*Deep*	*Shallow*	*Deep*	*Shallow*
Transmission Channel	Bank Credit	High	Limited	High	Medium-High
	Asset Price	High	Limited	Medium-High	Limited
	Interest Rate	High	High	Medium	Limited
	Expectations	High	Medium	Limited	None
	Exchange Rate	High	High	None	None

Source: State Street Global Advisors.[25]

There are further positive spillover effects such as helping the development of the banking system.[26] Figure 5 shows how deeper capital markets enhance the lending power of the financial sector in several countries, even illustrating that credit growth in Saudi Arabia moves up during times of higher government bond issuance. This is because sovereign local currency bonds serve as benchmarks for companies to issue debt to finance longer-term loans. And further afield, the maturing of a local bond market helps to raise corporate governance standards and support legal reform. In other words, it not only helps build a local financial industry but is a foundation of broader economic growth.

Figure 5: Domestic Credit Provided by Financial Sector (% of GDP) for Argentina, Saudi Arabia, League of Arab States and World



Source: World Bank, SSGA as of 9th Oct 2017.

How to Build a Saudi Riyal Bond Market

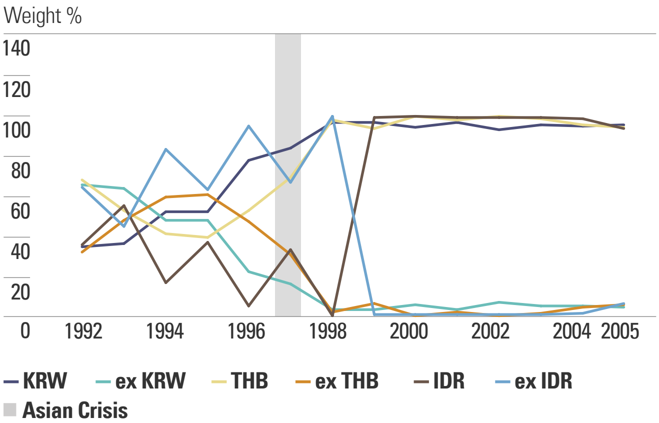
As with other aspects of the financial system described above, debt markets cannot easily develop without the appropriate engagement of Saudi policymakers. The future path of bond markets will reflect choices made today.

The term "debt market" refers to both sovereign and corporate bond markets. In this context, the government is simultaneously the arbiter of the debt markets and a participant through bond issuance. This gives it a unique first-mover advantage in setting the terms of the market. The way it approaches its debt issuance today will have at least a medium-term effect on the development of bond markets as a whole. Corporate debt markets typically rely on the sovereign bond markets as a reference point, and often have a somewhat narrower investor base. We see five important issues for Saudi policymakers:

1 The first decision for Saudi Arabia is to issue in Saudi Riyal, given the expectation of budget deficits through 2022.[27]

Currently, the country enjoys a strong fiscal balance sheet and good access to international USD debt markets, but the experience of Asian countries in 1997 suggests that the overreliance on external debt can be perilous. As Figure 6 shows, South Korea, Indonesia and Thailand were all heavily affected and subsequently shifted their borrowing patterns towards local currency — a mistake that Saudi Arabia is well placed to avoid if it builds out its domestic debt market now.

Figure 6: Gross Issuance of Debt in Domestic and Foreign Currency From Thailand, Indonesia and South Korea



Source: SSGA, Bloomberg as of 6th Oct 2017.

In fact, Saudi Arabia should be less tempted to use foreign currency debt as the yield differentials are not as significant as they were for the Asian economies in the 1990s. Issuance cost of USD bonds was lower than that of domestic currency bonds by 8.2% in Thailand and by 4.8% in Korea. In contrast, the funding rates of domestic currency SAR and USD denominated government bonds in 5, 7 and 10 year tenors are similar.[28]

2 The second important decision is targeting the right investor base.

The local currency debt market naturally attracts domestic investors, which dominate it at the moment. However, attracting international investors would considerably widen the scope of the market and positively shape the corporate local currency debt market in the future. That said, while local investors are satisfied with the yield levels given the currency's peg to the USD, international investors may demand higher returns than a similar maturity USD bond, so the government may need to pay a premium to bring in foreign investors.

3 Policymakers should take a strategic approach to debt management as it serves both capital markets and the government's fiscal strategy.

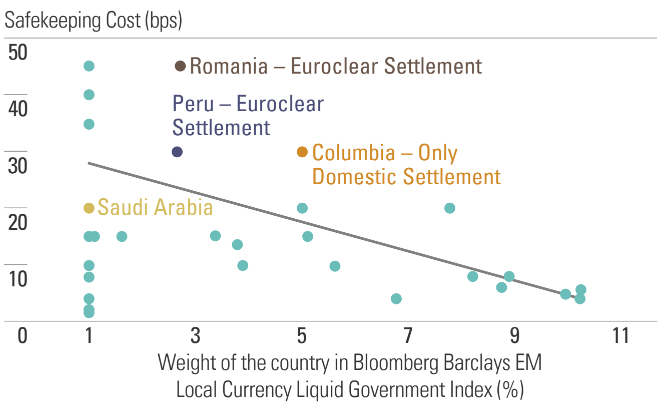
Market-building requires issuances at different maturities and in different markets to build appropriate yield curves, which could then serve as a vital reference point for corporate debt markets. This would sometimes mean maintaining a degree of market presence even in the absence of imminent cash needs. In order to navigate this highly complex task, governments typically roll out dedicated Debt Management Offices (DMOs), which Saudi Arabia has already done. A well-functioning DMO would trickle down into other necessary markets structures, such as primary dealers and market makers. It would also encourage the development of other financial instruments like exchange traded futures and currency derivatives, among others.

4 Institutional bottlenecks must be removed.

For government debt, a certain level of primary market demand would always be present in the form of the treasuries of domestic financial institutions. However, a wider investor pool requires several basic building blocks in order to be considered a viable market.

One such issue is the ease of settlement. The safekeeping cost of bonds held in smaller domestic bond markets can be quite high, but they should get lower as competition builds up in bigger markets. Countries with bigger bond markets (and therefore higher weights in EM bond indexes) tend to have lower safekeeping custody charges, as can be seen from Figure 7. Low safekeeping charges encourage foreign investors, because the hurdles of bond ownership are reduced. Of course, the development of domestic custody banks is also a major step, so the government could allow bonds to settle internationally in Euroclear as costs are much lower there, while tolerating higher fees domestically. Such an approach has yielded positive results for economies like Peru, Romania and Russia.

Figure 7: Safekeeping Charges in Emerging Markets



Source: State Street, Barclays as of 9th Oct 2017.

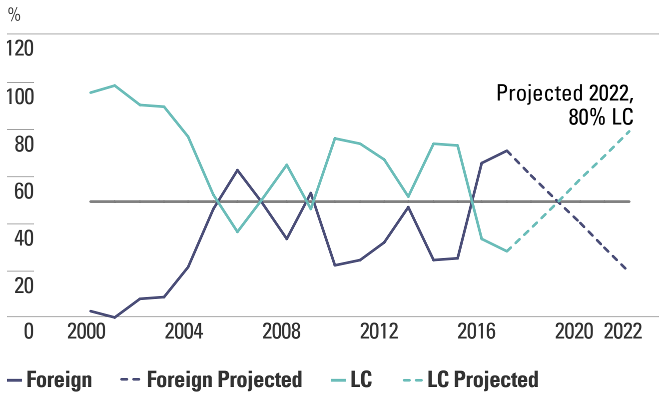
It is also important to align market conventions with international practice. For example, short settlement cycles are often a barrier for US investors, which was why both China and Saudi Arabia moved their equity markets to T+2 settlements. Listing government bonds on an exchange, as is already expected in Saudi Arabia, would be beneficial for the secondary market and increase the appetite of international investors. Many international funds (like UCITS funds) can only invest in securities if they are listed on registered stock exchanges. Improved transparency and information flows would also be a positive result. Finally, the current 4% withholding tax is too small to materially benefit government finances but is big enough to cause discomfort for international investors. Taxes like that increase reporting complexity while effectively lowering yields, and many governments are considering (e.g., Colombia) or have already implemented (e.g., China) their removal. Of course, some well-established borrowers still impose them, but there is some evidence to suggest that it may delay or discourage index inclusion (e.g., the Philippines).

5 Deepen local markets with strategic partnerships.

In response to the Asian financial crisis, a Pan Asia bond fund was set up to encourage the development of domestic local currency bond markets, which was a useful instrument to overcome these markets' dependence on foreign currency funding. At the moment, the Gulf countries are infrequent issuers with an increasing (albeit volatile) share of debt issuance in foreign currency (see Figure 8 below).

The share is beginning to approach the Asian levels of 1990s, and the establishment of a Pan Arab Debt fund could attract additional investors who want to have broad exposure to the region and reduce the dependence on foreign currency bonds. Figure 8 shows our expectation of the relative share of local currency issuance among five Arab states, a development that could be self-reinforcing.

Figure 8: Historical and Projected Issuance UAE, Saudi Arabia, Bahrain, Kuwait and Oman



Source: Bloomberg, SSGA as of 9th Oct 2017.

As with the equity market, the government and regulators could work together with international index providers to ensure compatibility with rapid index inclusion, following the successful pattern established in Asia. Saudi Arabia's potential bond market size would naturally make it a very appealing component of benchmark local government bond indices.

CONCLUSION

The ambitious goals laid out in Vision 2030 forge a path towards the economic transformation of the Kingdom of Saudi Arabia. Such broad economic development necessitates the concurrent evolution of the financial sector, particularly local capital markets. It enables better risk sharing throughout the economy and increases the efficiency of savings and investment.

This is most necessary when boosting private sector development. Most economies rely heavily on small- and medium-size enterprises (SMEs) to generate growth and employment. In Saudi Arabia, too, these constitute about 90% of private businesses and 25% of employment — but represent only 2% of bank lending.[29] Banks will not raise that share without advancing capital markets. As private firms are able to raise money through equity markets or through issuing bonds, banks are likely to increase their lending to worthy economic participants that have previously lacked access to capital.[30]

This is why we stress the need for the holistic development of all three components of the financial triad that are interdependent. Vibrant bond markets help nurture equity markets and the banking system, and vice versa. We have also highlighted the significant amount of foreign capital that could flow into Saudi Arabia in the form of portfolio investment. This not only supports the stabilization of the country's foreign reserves, but should encourage foreign direct investment, as it provides a larger toolbox for foreign investors managing their direct investments.

Finally, a close examination of Saudi's current and potential financial sector should reaffirm the aspiration of making Riyadh a world financial center. Saudi Arabia could offer sufficient scale in its domestic markets and enough regional weight to create a hub — provided it starts building out its capital markets now.

[1] Foreword to Vision 2030, http://vision2030.gov.sa/en/foreword.

[2] World Bank, *Doing Business* report 2017.

[3] World Economic Forum, *Global Competitiveness Report* 2016–2017.

[4] IMF Article IV Consultation Saudi Arabia, IMF Country Report No. 17/316, 5 October 2017, p.19.

[5] http://vision2030.gov.sa/en/node/11.

[6] M Hussain, A Shahmoradi, and R Turk (2015): An Overview of Islamic Finance, IMF Working Paper 15/120.

[7] IMF Saudi Arabia : Financial System Stability Assessment, IMF Country Report No. 17/318, 5 October 2017, p.9.

[8] Masud, H. Takaful: an innovative approach to insurance and Islamic Finance. U. Pa. J. Int'l L. 32 (2010): 1133.

[9] M Hussain, A Shahmoradi, and R Turk (2015): An Overview of Islamic Finance, IMF Working Paper 15/120.

[10] IMF (2017): Ensuring Financial Stability in Countries With Islamic Banking.

[11] Saudi Arabian Monetary Authority.

[12] IMF Saudi Arabia: Financial System Stability Assessment, IMF Country Report No. 17/318, 5 October 2017, p.4.

[13] IMF Article IV Consultation Saudi Arabia, IMF Country Report No. 17/316, 5 October 2017, p.46.

[14] FTSE Russell Annual Country Classification Review 2017.

[15] FTSE Russell Denies Saudi Arabia Entry to Emerging Markets List, Bloomberg, 29 September 2017, found at https://www.bloomberg.com/news/articles/2017-09-29/ftse-russell-denies-saudi-arabia-entry-to-emerging-markets-list.

[16] According to Vice Minister for Economy and Planning Mohammed al-Tuwaijri, as reported by Reuters in www.reuters.com/article/us-saudi-economy/saudis-eye-200-billion-in-revenue-as-privatization-drive-starts-up-idUSKBN17T2TB.

[17] National Centre of Privatization, Saudi Arabia, http://www.ncp.gov.sa/.

[18] Estimated implementation if results of consultation and classification are positive. Flows will realize as and when respective IPOs occur.
The following additional assumptions are used in the chart: (i) we estimate the total capital inflows due to MSCI inclusion to total 38 billion USD over 14 months, based on our current estimates of the volume of investors which track the index; (ii) we estimate the total capital inflows due to FTSE inclusion to total 2.5 billion USD over 6 months, based on our current estimates of the volume of investors which track the index; (iii) we forecast Saudi Aramco IPO to generate between 8 and 40 billion USD in inflows; we use the center point of the interval of 24 billion for this chart; we assume that the flows will occur over the period of 6 months and (iv) we forecast the IPOs other than Saudi Aramco to generate 80 billion USD of inflows, which we expect to occur evenly over 20 months.

[19] Hentov, Elliot. "Selling Saudi-Aramco: Necessity or Opportunity?", March 2016, p.6.

[20] As Saudis prepare to sell shares in oil giant, some have misgivings, Reuters, 24 February 2017.

[21] Hentov, E, Petrov, A, Roy, A: EM Pension Systems: A Cross-Country Analysis, State Street Global Advisors, October 2017.

[22] OECD data.

[23] See Hentov, Elliot and De Montpellier, Louis. "To Borrow or Not To Borrow?", State Street Global Advisors, August 2015.

[24] Laeven, Luc, "The Development of Local Currency Capital Markets: Rationale and Challenges", IMF Working Paper, December 2014, p.5.

[25] Hentov & De Montpellier, p.4.

[26] Burger, John D. and Francis Warnock, "Local currency bond markets", Staff Papers, IMF, Vol. 53, September 2006.

[27] IMF Article IV Consultation Saudi Arabia, IMF Country Report No. 17/316, 5 October 2017, p.41.

[28] As per Bloomberg, the differentials on the 5-, 7- and 10-year never breached 16 basis points during the most recent quarter (July – September 2017).

[29] IMF Financial System Stability Assessment 2017, Country Report 17/318, 5 October 2017, p. 25.

[30] Projections are based upon estimates and reflect subjective judgments and assumptions. There can be no assurance that developments will transpire as forecasted and that the estimates are accurate.

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