Transforming Saudi financial markets

Aramco listing offers chance to catalyse change

by Elliot Hentov in London

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At the Future Investment Initiative conference in Riyadh between October 24-26, investors fixated on the potential earnings of the planned privatisation of Saudi Arabia's national oil company, Saudi Aramco. But they were missing the broader point.

Widely expected to be the largest initial public offering in history, the partial listing of Aramco represents a unique opportunity for Saudi Arabia to quicken the development of its equity and bond markets. This will optimise capital allocation to propel growth and help diversify the economy, as well as complement social change in line with Vision 2030, the country's ambitious reform plan.

There are several reasons why transforming its financial markets matters to Saudi Arabia's development. The first is to ensure sufficient access to capital for businesses. A simple way to think about financial systems is to consider banks, equity and bond markets as a 'triad' of finance. Strong economies tend to connect savers with borrowers through a mixture of these three channels.

Relying too much on one channel can lead to a capital supply shortage if it becomes impaired. European businesses, for instance, have historically been overly reliant on bank finance. This precipitated marked difficulties during the euro area crisis. Even companies with strong balance sheets struggled to access credit.

Saudi Arabia has a strong banking system, but bank liquidity moves procyclically in line with oil prices. Liquidity falls during oil downturns, just as other sectors retrench, exacerbating economic slumps. It is therefore critical for Saudi Arabia's equity and debt markets to expand and offer meaningful financing alternatives.

Second, the Tadawul, Saudi Arabia's stock exchange, is moving into a phase of internationalisation and is on the cusp of multiple index inclusions. This has prompted it to modernise rapidly in anticipation of increasing numbers of participants. Moreover, a concurrent surge of privatisations could dramatically deepen the equity market. The Aramco IPO is only the beginning of possible capital inflows, which could reach $140bn by the end of 2020 if Saudi Arabia fully embraces market reform. Much of these inflows would remain committed to the Saudi market and thereby buttress the country's foreign reserves in the medium term.

Third is the opportunity to include the Saudi people in the privatisation process. This could be achieved through a 'national privatisation fund'. This would offer ownership of the privatised assets to Saudi nationals at a discount, encouraging them to take a stake in the country's future. It would help set the foundations of a retail investor class and symbolise a shift in responsibility away from government policies to individual households. Fostering such a retirement and savings culture would facilitate other reforms and complement social change.

Fourth is the potential to build a domestic bond market. Saudi Arabia runs a fiscal deficit, but this presents an opportunity to develop the local debt market as a third financial pillar. For the sake of liquidity and ease of access, the kingdom has issued dollar bonds to finance the large deficits of 2016 and 2017. However, future debt would be better issued in riyal as part of a cohesive debt management strategy. This would anchor the construction of a sovereign yield curve, which in turn would set a reference price for the local corporate debt market and aid the introduction of other financial instruments.

The key point is that the three components of the financial triad – banks, equity and bond markets – are interdependent. Improvement in the price discovery mechanism in one segment refines pricing elsewhere until capital is optimally priced. Around 90% of Saudi businesses are small and medium-sized enterprises, but these represent only 2% of bank lending. If more firms could raise money through stock listings or debt issuance, banks would be more likely to increase their lending to worthy economic participants. This in turn would promote higher and broader economic growth.

The Future Investment Initiative re-affirmed Riyadh's aspiration to become a more important financial centre. Given the momentum behind its reforms and the potential scale of its domestic markets, this is a conceivable goal. However, it cannot be achieved without transforming the Saudi financial system to offer better access to capital, in line with Islamic values and social requirements. The Aramco sale is an ideal opportunity to catalyse these developments.

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