There have been four important changes to the kingdom's economic policies that may pave the way for increased foreign investment, though not likely immediate job growth.

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While an Aramco initial public offering (IPO) has moved to the backburner of Saudi Arabia's, and more importantly, Crown Prince Mohammed bin Salman's, priorities, there have been four recent and important changes to the kingdom's economic policies that may pave the way for increased foreign investment, though not likely immediate job growth.

Two recent advances in law, the approval of a bankruptcy law in February (set for promulgation on August 18) and a draft law for public-private partnerships (PPPs), are major efforts to create an environment friendly to foreign investment. The other two institutional changes are more about guiding the liberalization process. In April, the Council of Economic and Development Affairs, which oversees the Vision 2030 implementation, released two delivery plans: one for privatization efforts and one for the development of the financial sector.

Vision 2030 was retooled with 12 Vision Realization Programs announced in 2017; the Privatization Program and the Financial Sector Development Program are just two of those programs meant to serve as bureaucratic field maps with very specific objectives achievable in short time frames, many by 2020. Yet, these two programs are probably the most important in terms of restructuring the economic institutions of the state.

Vision 2030 Vision Realization Programs

Vision 2030

These two delivery plans will be supported by the new laws covering bankruptcy and privatization, and more specifically PPPs. New legislation in Saudi Arabia encounters a time consuming labyrinth: The bankruptcy law set to formally go into effect in August was first released as a draft in 2016. Likewise, the newly released draft privatization law will likely move slowly to promulgation.

Attention Seeking over Reform Delivery

The good news is that Saudi institutional reforms are slowly catching up to the crown prince's headlines. An IPO of Aramco generated headlines intended to signal to capital markets that Saudi Arabia would be serious about economic liberalization. As a public relations strategy, perhaps even with the failure to deliver on the listing, Saudi Arabia has been successful in getting the financial world's attention. Subsequent high-profile arrests of business executives, members of the royal family, religious leaders, and women's rights activists have also generated less welcome media scrutiny while displaying the very severe limits of individual and corporate rights in the kingdom. Saudi Arabia's young leadership has established a cinematic and performative strategy, inviting the world to watch it painfully experiment in major social and economic restructuring.

They have our attention. But what is happening behind the scenes, in the work of bureaucrats, lawyers, and the many national and foreign consultants and advisors tasked with turning a vision into a functioning reality, may have more lasting impacts on the structure of the Saudi economy. The real test of the liberalization agenda will be for these new laws to be used and, more importantly, to build a rules-based system that can exist in parallel authority to royal decree. Creating law and enforcing it in Saudi Arabia is complex, and commercial law is still a relatively new field. What would be helpful for institutional change to take hold would be a little bit of failure.

Instead of seizing assets of failing and indebted companies, let them file for bankruptcy protection. Instead of making private agreements and signing countless memoranda of understanding with foreign investors with implicit future contracts, host a public tender for the privatization or partnership to build a major infrastructure project. And then let everyone watch if something goes wrong. If an investor, or the state, fails to meet its obligations in an agreement, use the new PPP law to settle the dispute. Contracts will need to be enforced and not easily discarded, as has occurred with a recent effort to create PPPs and concessions in the operations of airports in Saudi Arabia. Only by testing its new and fragile institutional framework will Saudi Arabia demonstrate its commitment to economic liberalization.

For Sale

In the very near term, by 2020, the Saudi government has targeted 23 privatization initiatives. According to Jadwa Investment, five of these targeted sector privatizations are planned as asset sales to be completed by then, including: part of the Saline Water Conversion Corporation, four flour mills, a number of Saudi sports clubs, the postal service, and a series of transport projects. In the case of the postal service and transport projects, these are also under consideration as PPP schemes in which the asset would not be wholly sold, but may be leased in a long-term operation contract with an investor, or perhaps a new project to be built and operated by an investor for the government to purchase back at a later date. In the privatization plan, the government also plans to spin off or “corporatize” a number of state-owned assets like ports and hospitals so that they operate independently of government funding.

For the delivery of social services like health care and education, this is a means of cost saving, but it is also a dramatic shift in state responsibility to citizens. Privatization efforts under Vision 2030 so far have not gone smoothly. The flour mills, for example, were first consolidated from nine entities into four new firms in 2015, then prepared for sale in 2016 under the new company the Saudi Arabia Grain Organization. Currently, the government subsidizes the price of wheat and is a monopoly supplier as the Saudi Arabia Grain Organization. When the ownership of these mills goes to private, and likely foreign, investors, bread is going to be a lot more expensive. Privatizations are not only about asset sales for immediate cash in hand. They are also intended to create more efficient and less-costly operations. This usually means operating with less staff, so layoffs rather than job creation should be expected.

These are not the first privatizations in Saudi Arabia, as the government has experience selling state assets like the Saudi Arabia Basic Industrial Corporation, which sold shares of nearly a third of the company to investors in 1984, and the Saudi Telecom Company, which did the same in 2003. What is different now is the scope of privatization in tandem with a series of other reforms (Vision 2030), which will shift the regulatory landscape, imposing new rules and ideas about what business the state should be in.

Moreover, the pace of sales and new efforts to attract foreign investment in partnership with the government in PPP schemes is accelerating before the new laws are fully in place. Foreign investors have not exactly jumped at the opportunity. Foreign direct investment has been in a sharp decline in Saudi Arabia since 2016. The infrastructure investment fund created jointly by the Public Investment Fund (Saudi Arabia's sovereign wealth fund) and Blackstone has failed to meet its capital-raising targets for projects to fund in Saudi Arabia. According to the July MEED Business Review, where there is stronger investor interest (often reliant on local and international bank finance) is in the sale or contracts to operate utilities, especially renewable energy projects, but these new privately run electricity plants will depend on the government moving forward aggressively with subsidy cuts in order for their business models to operate successfully.

Perhaps most alarming is the rate and amount of capital outflows from Saudi Arabia since 2017. Capital outflows into foreign equities were the highest in the first quarter of 2018 since 2008, according to research by Standard Chartered, as much as $14.4 billion. The growth of the private sector in Saudi Arabia is a necessity for job creation, fiscal balance, and ultimately diversification, but it cannot succeed on foreign money alone. Domestic investors must have confidence in the local economy as well.

Structural Reform Pace and Urgency

The sluggish dynamic between institutional reform and attracting investment creates some market uncertainty, but from the government's perspective, time is not on its side. As is the nature of structural economic reforms, the imperative to generate private sector growth continues to be mounting fiscal pressure. The government continues to drive economic growth through its project spending, and consumption patterns are under pressure as structural reforms have gone into effect. This means that the value-added tax, new visa fees on expatriate workers, fees to businesses employing foreigners, and reduced subsidies of electricity and water are making it harder for people to spend extra cash each month to boost growth. The "expat exodus" in which nearly 800,000 foreign workers have lost jobs and exited the country only exacerbates the decline in consumer spending and confidence.

The recent increase in global oil prices is boosting Saudi Arabia's government revenue: Jadwa Investment estimates oil exports will total $223 billion in 2018 with a projected government revenue of over $153 billion, which is much higher than the fiscal budget for 2018 anticipated at about $131 billion. The government is likely to devote these unplanned earnings toward its deficit, rather than further increasing spending. And the government is spending. Saudi Arabia released an expansionary budget for 2018, with major cash outlays in the Citizen's Account program, a direct cash transfer program intended for low income families (though nearly half the citizen population may now receive it). The government also continues to borrow heavily in both international debt markets and local bond issuance. Total government debt is projected to hit $149 billion by the end of 2018, according to Jadwa. Compared to debt levels at the middle of June 2015, when the government's outstanding debt was less than $13.3 billion, the borrowing pace, and ultimately the repayment schedule, is staggering.

Financial Sector Expansion

One immediate path to private sector growth is to expand the financial sector and have more citizens and foreigners actively engaged in financial intermediation – borrowing, lending, and investing at their own risk. The state would like to see its citizens as investors. A new parallel equity market, Nomu, is meant to build a path from small- and medium-sized enterprise (SME) to first listing, to listing on the major Saudi exchange the Tadawul. Expanding access for foreign investors and foreign financial institutions is now in place, as the Capital Market Authority has allowed qualified foreign investors to trade on the Tadawul since 2015, and now has opened "qualified financial institutions," firms with at least $500 million of assets under management, to buy publicly-traded companies on the exchange.

Someone has to buy the shares of newly listed state assets and there will need to be consumers of financial products who can grow a more sophisticated marketplace. Vision 2030 will depend on citizens literally buying into the investment ideas of the state and the services it provides under new private corporations and purchasing the kinds of financial products that offer protection in ways the state once did, like insurance.

The Financial Sector Development Program identifies some surprising weaknesses in the Saudi economy, the largest of the Middle East. Selling insurance to citizens and foreigners will be a big business and the government plans to enforce its mandatory insurance coverage for drivers. Currently, Jadwa reports, from a national insurer's estimates, only 55 percent of vehicles in the kingdom are insured against accidents. Health insurance is also mandatory, though government hospitals provide basic coverage to all citizens. The expansion of the financial sector will provide benefits to Saudi Arabia's private sector growth, but it also provides opportunities for regional investors and neighboring states. The United Arab Emirates and Saudi Arabia in their newly announced strategic partnership have prioritized shared access to insurance markets and coverage for their populations.

Saudi Arabia continues to be a strong cash-based economy. Currently, noncash transactions account for 18 percent of sales. Increasing the use of financial institutions, basic banking, and also newer financial technologies will reduce costs related to cash circulation but also enable collection of taxes. The bank sector can also be a site of business development through improving financial literacy of the population and funding SMEs, which Saudi Arabia hopes will form at least 5 percent of bank loan portfolios by 2020. Currently, SME loans account for just 2 percent of loans.

Housing loans are also a priority, in line with government objectives to provide affordable housing to a young, educated population anxious to achieve the milestones of career and home ownership that were more readily accessible to their parents' generation. Mortgage financing in Saudi Arabia is dwarfed by other countries of comparable size as a percentage of gross domestic product. It is a market ripe for investors that should be improved dramatically with the introduction of the bankruptcy law. But increasing personal loans and mortgages will depend on some improvement in income growth, which needs to be based on new jobs. The goal is to increase outstanding real estate mortgages from about $81 billion in 2018 to nearly $134 billion in 2020. Interestingly, the Privatization Program does not include major public-private partnership initiatives in housing, which are managed under the Housing Program (another of the 12 Vision Realization Programs).

Short- and Long-Term Goals

Saudi Arabia has some serious short-term economic problems, like job creation, and some long-term challenges, including a radical realignment of its workforce to meet productivity demands of a global high-tech economy, and the understanding of how wealth is generated and shared between the state and its citizens. Add to that a history of resource dependency and cyclical fiscal policy tied to oil pricing and it is very clear that Saudi Arabia's economic transformation will not be immediate. The economy, and by extension the functioning of the state, is dependent on oil revenue and will be for some time to come. The Aramco IPO idea is important for its recognition that monetizing the single most valuable asset of the state needs to happen sooner rather than later. There is a limited period of time the global market will need so much of this product and it is better to get it out of the ground quickly and sell it at the highest price possible.

A partial Aramco privatization or offering of a small stake of the company on local or international equity markets has dazzled media attention, but the real challenge for Saudi Arabia has been to prepare its financial regulatory environment to welcome foreign capital, as owners of businesses in the kingdom, as shareholders in new and existing firms listed on the local Tadawul exchange, and as partners with the government in building new infrastructure and services. The four institutional changes discussed here highlight the necessity of two specific legal frameworks to deal with insolvency of any firm, local or foreign, and structuring investments between private and public sector entities. The other two institutional changes are attempts at planning liberalization: The new Privatization Program and the Financial Sector Development Program are much like trying to repair an airplane engine mid-flight.

The optimistic note is that regulatory reform is finally underway. The short-term work ahead will test these legal structures and stretch their purview to include new entities and partnerships that do not yet exist. Higher global oil prices will cushion government spending and create some disincentives to move forward on difficult structural reforms. Political pressure for job creation will grow, particularly as the delicate rebalance from reliance on low wage expatriate workers and Saudization plans unfold. Pressure to devote government resources to foreign policy objectives in Syria, Yemen, and Iraq, as well as support within the Gulf neighborhood will compete with domestic spending priorities. The long-term trajectory is much less clear to those observing from outside the kingdom, and for local actors on the ground.

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