The Kingdom of Saudi Arabia

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This month, I am deviating from prior columns that addressed broad issues of sustainability and duty of care. The recent promotion of Saudi Arabia to emerging market status warrants a discussion.

The promotion of the Kingdom is a tale of two stories. With a population of about 33 million people and a GDP of around US$762 billion, the country is sufficiently large to be considered among the emerging markets. However, until recently, Saudi Arabia was considered to be part of a limited number of countries known as 'special situations'. The country received that distinction based on the challenges international investors faced when trying to participate in the Saudi stock market.

In recent years, Saudi Arabia took steps to open its equity market, and the world noticed. Now, we should consider how it compares to the other countries in the developed and emerging markets. To do the comparison, I will use the Magni Country Score, which measures the quality of governance from an economic perspective. Countries with high scores tend to have faster, more inclusive growth and wealth creation.

Saudi Arabia's score currently ranks it 42nd out of the 49 countries in the developed and emerging markets. That places them just behind the Philippines and Russia and ahead of Pakistan and Peru. Among the Muslim-majority countries, Indonesia has the highest score, followed by Malaysia and then Turkey. In addition to Pakistan, Saudi Arabia is ahead of the UAE, Egypt and Qatar.

The Magni Country Score for Saudi Arabia is another tale of two stories. The country has notable strengths in accounting. It also has somewhat better market integrity and banking regulation than Malaysia.

A strong accounting system helps provide confidence that the financial statements accurately represent the actual performance of businesses. Market integrity means routine financial activities can occur with a low likelihood of corruption. Banking regulation means people can have higher trust in the soundness of the banking system.

Conversely, the opaqueness of the government and the lack of protections for shareholder rights are significant weaknesses. The lack of transparency in government operations, government finances and even the performance of the economy (from the shortage of government-supplied data) creates risks and uncertainties for foreign direct investment.

Simply put, the higher risk means that a project must provide more attractive investment returns to compensate for the increased risk. Projects in countries with lower perceived risk will be funded with relatively lower expected investment returns.

As the country pursues Vision 2030 to diversify the economy, the Saudi government can expect less help from foreign investment due to these risks.

The lack of protections for shareholder rights also creates risk. In most countries, when a company gets into financial trouble there are laws and a court system to determine what happens to the company. In Saudi Arabia, the process is different as it is based on Shariah and a decision from the royal family. Muslims, and non-Muslims who understand Islam, recognize that Shariah provides just rules for handling these situations. For investors without such knowledge, a Shariah-based system appears risky. Furthermore, the opaqueness of the government and of the royal family means that royal decisions carry a degree of uncertainty.

In theory, Saudi Arabia should have an easier time improving its score when compared to other countries as the required changes do not involve its basic infrastructure. At the same time, the transparency required for a better score sits in direct contrast to the traditions and practices dating back to the founding of the Kingdom in 1932.