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THE LONG MARCH FORWARD

Opening Saudi Arabia's Tadawul should just be the beginning.

THE SAUDI CAPITAL MARKET Authority, under new leadership, has announced that qualified foreign institutions will have access to the Tadawul stock exchange from June 15 2015 with the final rules to be revealed on May 4. This comes as no surprise, given the announcement in July 2014 of plans to allow direct foreign purchases of shares in the first half of 2015.

But why does opening up the Saudi equity market matter? What could be some of the macroeconomic effects? With Saudi and other oil exporters facing an oil price tsunami, economic policy should be directed at mitigating the negative consequences.

The IMF estimates that there will be a massive loss of $380 billion in exports, equivalent to a 21 per cent hit to GDP. The expectation is that opening up the market will attract foreign capital that previously did not have access to Saudi investment opportunities.

This capital inflow, in theory, could lead to increased investment in promising sectors, bring in new technology, boost IPOs, galvanise mergers and acquisition and improve corporate governance all of which would translate into greater economic diversification and job creation, the overarching economic policy concern.

The underlying risk is that asset prices get bid up, a bubble forms, Saudi investors sell and real investment does not happen.

YES TO LIBERALISATION

The opening of the market comes as part of a continuing policy of opening up, economic liberalisation and gradual international integration that has been pursued over the past ten years.

Saudi Arabia has been successful in upgrading infrastructure, strengthening education and skills, boosting access to finance for SMEs, and significantly improving the business environment.

Substantial progress has been made on lowering the cost of doing business over the years. Saudi Arabia is today the only Middle East country and only OPEC member among the constituents of the G20. It joined the WTO in 2005 (which included clauses like allowing 60 per cent foreign ownership in banking and insurance, and 75 per cent foreign ownership of distribution within three years).

The Kingdom built economic cities and industrial zones to move away from its over-dependence on oil. But oil still accounts for about 92 per cent of government revenues and though the share of non-oil real GDP has increased over the past two decades, non-oil sector exports remain limited. Foreign investment can support economic diversification.

LIBERALISATION NEEDS ACCELERATION

The conservative Saudi capital market regulator had initiated several steps to liberalise the market over the last few years, including aligning working days with other GCC and international markets and improving corporate governance standards to make the Saudi market attractive to foreign investors.

The underlying risk is that asset prices get bid up, a bubble forms, Saudi investors sell and real investment does not happen.

Draft market access rules, shared in August 2014, included a 10 per cent cap on foreign ownership of the market's value and that a single foreign investor could own no more than five percent of any listed firm, while all foreign institutions combined could own no more than 20 per cent.

If this limit is confirmed then the promised Saudi ouverture might prove to be too timid, a damp squib.

Retail investors massively dominate Saudi and other GCC stock markets. They currently account for more than 90 per cent of the share trading volume of the Tadawul, while foreign investors have been restricted to buying Saudi shares indirectly through swaps or exchange-traded funds.

But retail investors may be prone to fickleness and bouts of irrational exuberance leading to volatility. Institutional investors such as pension funds, insurance companies, and investment funds are less likely to be prone to animal spirits, or so it is hoped. Increasing the share of institutional investors should help stabilise markets.

Opening of Saudi capital markets has been proceeding in phases, initially opening up to GCC investors, then opening to investment funds and now opening to qualified foreign investors. This opening up provides foreign investors access to the largest economy and capital market in the Middle East.

Saudi Arabia is the largest economy