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Examining GCC USD currency pegs sustainability

- GCC US Dollar (USD) currency pegs back in focus. The precipitous decline in oil prices has renewed apprehensions surrounding the sustainability of FX pegs in the GCC region. In the forward currency market, all GCC exchange rates have weakened against the USD, particularly the Omani Riyal (OMR), which recently jumped to an all-time high, albeit has since eased.
- Willingness and capability of sustaining the GCC USD currency pegs. The pegs have served the test of time and remain a credible anchor:
  1. **Structure of the GCC economies**. Oil and gas remains the dominant export for the GCC region. Consequently, a devaluation would have limited impact on GCC export competitiveness which would quickly be eroded by the higher cost of imports and with it higher inflation.
  2. **Wealth buffers**. There are ample financial resources to defend the peg. We project end 2020 GCC wealth buffers (central bank reserves, sovereign wealth fund holdings and public sector banking deposits) at USD3.3tn (184% of GDP) – equivalent to 68 months of goods and services and income payments abroad (note the IMF recommends only 3 months of import cover for pegged exchange regimes). However, the GCC region is not homogeneous and there is a core and a periphery. The latter consists of Oman and Bahrain, which have less firepower to defend their pegs (their wealth buffers are only able to cover current account shortfalls for 2-3 years at most, although external support for both countries is almost inevitable).
  3. **Monetary and external stability**. Nominal and real exchange rates have remained stable under the pegs, as compared with other commodity based currencies (Canadian Dollar, Russian Rouble and South African Rand). Also, exchange rate stability has supported external stability, both on the export and import sides of the current account.
  4. **Political will**. The GCC pegs have been in place for decades during well times of high/low oil prices, as well as during times of political uncertainty.
- Benefits of de-pegging. Notwithstanding the advantages that the pegs have brought to GCC economies over the decades – which far outweigh the costs – this is not to say that the pegs will remain optimal under all circumstances. Should there be a structural shift in long-term oil price expectations, wherein existing reserve buffers become inadequate to cover narrow money (M1) (note we believe that one USD for every local currency in circulation and demand deposits (M1) will keep the pegs bullet-proof), a floating exchange rate may become appropriate in boosting export competitiveness and driving growth. This is however not a valid argument for GCC economies that primarily export oil and gas – the price of which is in USD denominated receipts – so de-pegging is unlikely to stimulate exports, although it would lower imports. Devaluation would raise oil receipts in local currency, but inflation would also rise. Until the GCC tradable sector grows to the point that there can be significant import substitution – which would help increase import demand elasticity and reduce FX pass-through effects – we view that the rationale as to why the peg has been the suitable FX regime choice in the GCC region will continue to hold.

Examining GCC USD currency pegs sustainability

GCC USD PEGGED EXCHANGE RATES BACK IN FOCUS

GCC pegs back in focus

The oil price crash has put US Dollar (USD) pegged currencies in the GCC region under renewed pressure. The evisceration in global demand, due to the COVID-19 pandemic, which has led to airlines grounded, commuters working from home and factories shutting down, which in-turn has led to a crash in oil prices. As a result, spreads on GCC interbank interest rates over US Treasuries have widened sharply and remain close to those in early 2016, when oil prices last declined to current ~USD30/b levels. A similar trend has followed in GCC sovereign bond spreads. In the forward currency market, all GCC exchange rates have weakened against the USD, particularly the Omani Riyal (OMR), which recently jumped to an all-time high, albeit has eased in recent trading days.

GCC pegs have adequately served the region over decades

On net, the GCC currency pegs have served the test of time. The pegs serve as a credible anchor as an appropriate policy framework as they provide a stabilisation mechanism for inflation and output growth given the existing structure of the GCC economy's as hydrocarbon exporters – the price of which is in USD denominated receipts – so a devaluation would have limited impact on GCC export competitiveness which would quickly be eroded by the higher cost of imports and with it higher inflation. Moreover, the pegs have assisted regional sovereigns in managing a high level of monetary stability compared with what would have been the case in a floating rate regime. It has also encouraged a far great accumulation of FX and fiscal reserves that would have been the case under a floating rate regime.

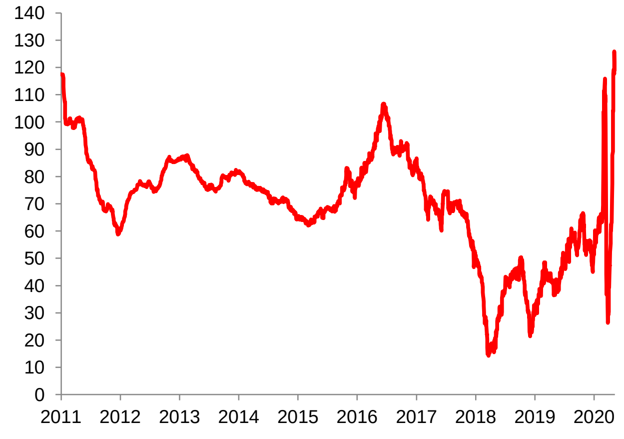
WILLINGNESS IN MAINTAINING GCC CURRENCY PEGS

The desire to maintain USD pegs are sound

GCC countries have experienced large oil price shocks in the past, but have maintained the peg to the USD for over three decades. In this regard, there are two considerations, the desire to maintain the peg and the ability to do so. GCC countries have kept the peg because it has served them well, providing macroeconomic stability. A number of fundamental factors which have made the USD peg appropriate:

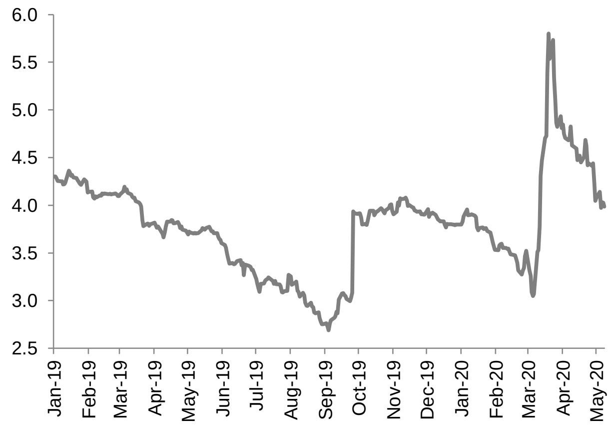
1. Structure of the GCC economies. The currency peg makes intuitive sense given the structure of the GCC

GCC 3 MONTH INTERBANK RATES OVER US 3 MONTH INTERBANK RATES (BASIS POINTS)



Source: Bloomberg, MUFG MENA Research

GCC 10 YEAR SOVEREIGN YIELDS OVER US 10 YEAR TREASURIES (BASIS POINTS)



Source: Bloomberg, MUFG MENA Research

economies. Oil and gas remains the dominant export for the GCC region. Consequently, a devaluation would have limited impact on GCC export competitiveness which would quickly be eroded by the higher cost of imports and with it higher inflation.

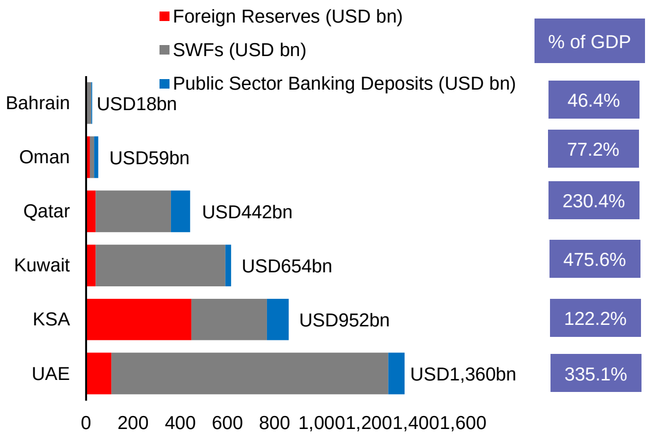
2. Monetary stability. The peg has meant that nominal and real exchange rates have remained stable, particularly compared with other commodity-based currencies. In addition, while there have been periods when monetary policy needs have diverged, there unsurprisingly, has also been convergence for extended periods – the US accounts for a fifth of global economic activity and any US slowdown, lowers oil prices, and thus slows growth in the GCC region.
3. External stability. Exchange rate stability has supported external stability both the export and import sides of the current account. On the export side, the vast majority of GCC exports are USD denominated (oil and related derivatives) and thus for any given oil price level, exchange rate stability provides revenue predictability and stability. On the import side, stability of import prices in principle will reduce volatility in import demand, although the extent to which this is true depends on the elasticity of import demand to the exchange rate.
4. Political will. There is political will to defend the peg. The GCC pegs have been in place for decades and the fixed exchange rate regime has served each GCC country well in times of high and low oil prices, as well as during times of political uncertainty. Indeed, it has provided a credible anchor of price and economic stability, reduced transactions costs and simplified the conduct of monetary policy for policymakers. Also, the USD remains the preeminent reserve currency of the world and has deep and liquid financial markets, an important political consideration for GCC sovereigns.

CAPABILITY IN MAINTAINING GCC CURRENCY PEGS

The capabilities of defending the pegs remain sufficient for the foreseeable future, albeit pressure is mounting in vulnerable Oman and Bahrain

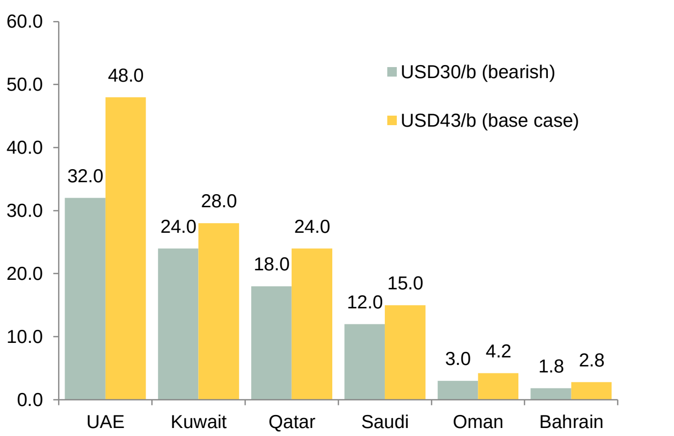
There are ample financial resources to defend the peg in the GCC region. We project end 2020 GCC wealth buffers (Central Bank reserves, sovereign wealth fund holdings and public sector banking deposits) at USD3.3tn (184% of GDP), and equivalent to 68 months of goods and services and income payments abroad (note the IMF recommends only 3 months of import cover for pegged exchange regimes). Whilst some of these reserves have been used in recent months to finance the fiscal deficit and investment programme, they remain sizable and sufficient to defend the

GCC WEALTH BUFFERS : FX RESERVES, SWF ASSETS AND PUBLIC SECTOR DEPOSITS (USD BN ; % OF GDP)



Source: Bloomberg, CEIC, IMF, SWFI, MUFG MENA Research

NUMBER OF YEARS CURRENT ACCOUNT DEFICITS CAN BE FINANCED FROM WEALTH BUFFERS*



*Source: Bloomberg, IMF, MUFG MENA Research; * assuming no government borrowing* peg even if political uncertainty remains high and or indeed oil prices stay low for a number of years. However, the GCC region is not homogeneous and there is a core and periphery, the latter of which consists of Oman and Bahrain, which are more vulnerable given they have less firepower to defend their pegs.

Reserves should be suffice to cover narrow money (M1), which includes currency in circulation and short-term local currency deposits

In determining the precise mechanism for setting aside resources to defend the peg, there is no agreed level. However, as a criterion, we consider that reserves should be suffice to cover narrow money (M1), which includes currency in circulation and short-term local currency deposits. In other words, one USD cover for every local currency in circulation and demand deposits (M1), would keep the peg bullet-proof. In the four largest GCC economies – Saudi Arabia, UAE, Qatar and Kuwait – have enough foreign assets to sustain themselves for several decades. The story is different for peripheral GCC countries, Oman and Bahrain, where net foreign assets adjusted for narrow money (M1) would leave them with less than 2-3 years in financial resources given the fiscal deficit trajectory, before these dry up.

IMPLICATIONS OF A GCC DEVALUATION

Benefits of a devaluation make intuitive sense if GCC economies are well-diversified

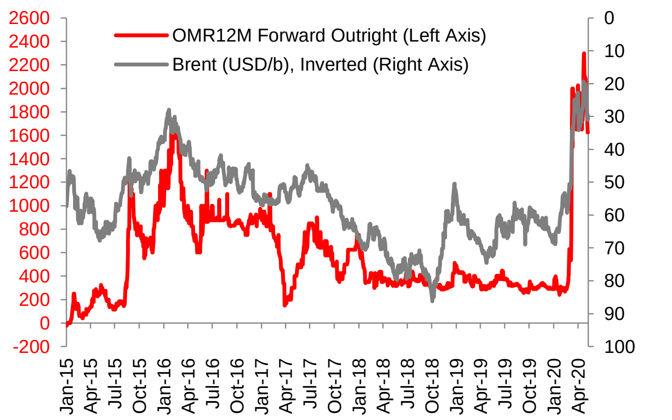
Notwithstanding the advantages the pegs have brought to GCC economies over the decades – which far outweigh the costs – this is not to say that the pegs will remain optimal under all circumstances. Should there be a structural shift in long-term oil price expectations, wherein current reserve buffers appear to be inadequate to cover narrow money (M1), a floating exchange rate may become appropriate in boosting export competitiveness and driving growth. This is however not a valid argument for GCC economies that primarily export oil and gas – the price of which is in USD denominated receipts – so de-pegging is unlikely to stimulate exports, although it would lower imports. Devaluation would raise oil receipts in local currency, but inflation would also rise. Until the GCC tradable sector grows to the point that there can be meaningful import substitution – which would help increase import demand elasticity and reduce FX pass-through effects – we view that the reasons why the peg has been the suitable FX regime choice in the past will continue to hold.

OVERALL ASSESSMENT

Pegs remain an appropriate policy framework as it provides a stabilisation of inflation and output growth

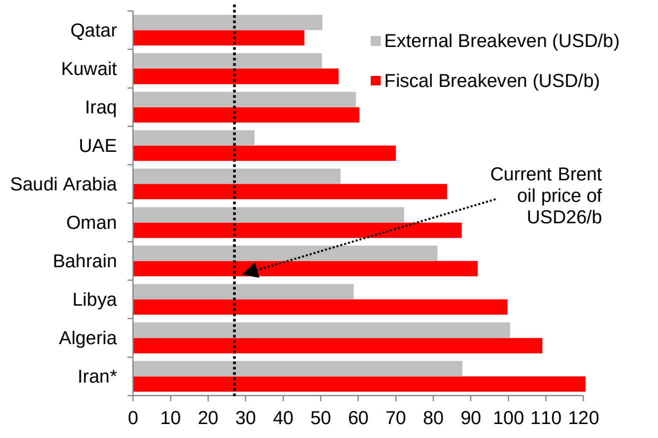
On the whole, the exchange rate peg to the USD is an appropriate policy framework for the GCC region as it provides a stabilisation of inflation and output growth. As the GCC moves further down the diversification path, especially with regards to exports,

OMAN 12 MONTH FORWARD CURRENCT CONTRACT (POINTS) AND BRENT CRUDE (USD/B)



Source: Bloomberg, CEIC, MUFG MENA Research

FISCAL AND EXTERNAL BREAKEVEN OIL PRICE (USD/B)



*Source: Bloomberg, IMF, MUFG MENA Research; * Iran's fiscal breakeven oil price in 2020 is USD194.6/b* it could benefit from a more flexible exchange rate regime in the future. However, until then, there is policy commitment and sufficient resources in GCC countries to maintain the exchange rate peg, albeit pressure is mounting in Oman and Bahrain. However, there are ample financial resources at hand to maintain the peg. The accumulation of large foreign currency savings during the last oil boom can be used to defend the peg. While some of these reserves have been used recently, they remain sizable and sufficient to defend the peg even if oil prices stay low. Finally, there is political will to maintain GCC peg currencies.

Devaluing rather than de-pegging also does not make intuitive sense at the current juncture

The currency peg in place in the GCC has indeed proven to be a successful nominal anchor, and even if the currency is devalued (adjusted) rather than abandoned, this would in our view only add uncertainty about future devaluations, and ultimately make the peg more vulnerable to further speculative attacks. Thus, from an economic policy perspective, it does not make intuitive sense in our view for the GCC authorities to choose to abandon the peg to the USD, or devalue (adjust) it.

- **Key data and events in the past week**:
- **Bahrain** sold a USD2bn dual-tranche bond issuance, after receiving more than USD11bn in combined orders. The investor presentation revealed that the nation expects a fiscal deficit of 4.0% of GDP this year, down from 4.7% last year.
- **Egypt's** PMI plunged to a historic low of 29.7 in April (March: 44.2), with new orders down to 14.1 (March: 40.2) while purchasing slipped to 21 (March: 39.5). As business expectations remain strong, the employment sub-index inched down to just 46.1 from 47.0 the month before.
- **Egypt's** real GDP growth is forecast at 3.5% in the fiscal year 2020-21 (July-June), according to Egypt's Planning Minister. However, should the COVID-19 pandemic continue to December, growth is likely to slow to 2%. Separately, the country's requests to the IMF for a Rapid Financing Instrument (RFI) and its Stand-By Arrangement (SBA) will be considered on 11 May.
- **Kuwait** has imposed a "total curfew" from 10 May to 30 May.
- **Lebanon's** Finance Minister disclosed that the move to a flexible exchange rate will be in a "coming phase", in a "gradual and studied way", and that the currency peg will continue to operate for now.
- **Lebanon's** PMI fell to 30.9 in April from 35.0 in March, given substantial declines in output and exports.
- **Qatar Airways** expects to reopen routes this month, as air travel restrictions are eased across the globe: it hopes to fly to 52 destinations by end May and up to 80 in June (compared to 165 total destinations previously).
- **Saudi Arabia's** PMI edged up to 44.4 in April, from 42.4 in March, owing to higher deliver times. It is important to note that the disruption to global supply chains have resulted in PMI readings around the world being artificially boosted by lengthening supplier delivery times. PMIs are calculated using five components of the survey: output, new work, employment, inventory and suppliers' delivery times. Ordinarily, lengthening supplier delivery times are indicative of increasing demand for inputs and thus push the headline PMI higher. However, the longer delivery times in the last three months have not been due to increased demand but to factory and border closures that have disrupted supply chains around the world.
- **Saudi Arabia** announced a slew of austerity measures to cope with the fiscal impact of COVID-19 and the oil price decline. The steps taken to shore up revenue and rationalise spending are valued at USD26.6bn in total which include: (i) VAT to increase from 5% to 15% from 1 July; (ii) starting 1 June, the government will end a monthly cost of living allowance paid to public sector workers; (iii) some operational and capital spending will be cancelled or delayed; (iv) spending will be reduced on some programmes under Vision 2030; and (v) a committee will study the salaries and benefits given by government entities outside the civil service umbrella (which will give its recommendations within 30 days).
- **The UAE's** PMI fell further to 44.1 in April from 45.2 in March, with both output and new export orders falling to record lows of 39.9 (March 47.2) and 35.2 (March 44.3), respectively. Business expectations for the year ahead weakened to a 32 month low.

- **Key focus in the week ahead**:
  1. **Dubai**'s PMI and nflation data for April 2020.
  2. **Egypt's** interest rate decision.
  3. In **oil markets**, monthly reports from the EIA, IEA and OPEC.

Economic Calendar and Forecasts

Upcoming Events and Data Releases								
Date		**Country**	**Event**	**Period**	**Consensus**	**MUFG* Forecasts**	**Actual**	**Previous**
11/05/2020		Turkey	Unemployment Rate, %	Feb 2020	---	---		13.8%
13/05/2020		Turkey	Current Account, USD bn	Mar 2020	-USD4.3bn	---		-USD1.2bn
12/05/2020		Qatar	CPI, % y/y	Apr 2020	---	---		-1.4%
15/05/2020		UAE	Dubai CPI % y/y	Apr 2020	---	---		-1.8%
14/05/2020		Egypt	Lending Rate, %	14 May	10.25%	10.25%		10.25%
14/05/2020		Egypt	Deposit Rate, %	14 May	9.25%	9.25%		9.25%

** MUFG MENA Research*
Source: Bloomberg, Refinitiv, MUFG MENA Research

MENA Market Indicators – Tables

Benchmark Bond Yields (%, Local Currencies)

	Maturity	01-May	08-May	Change in Yield (bps) Week	MTD*	YTD*
Advanced Countries						
US	10 yrs	0.61	0.68	7.1	4.4	-123.4
Germany	10 yrs	-0.59	-0.54	4.9	4.9	-35.2
Italy	10 yrs	1.76	1.85	8.2	8.2	43.3
Japan	10 yrs	-0.02	-0.00	1.8	2.9	1.0
MENA Countries						
Bahrain***	3 yrs	5.99	5.77	-21.3	-3.4	278.6
Egypt	5 yrs	13.59	13.52	-6.5	21.0	0.1
Qatar***	10 yrs	2.96	2.77	-19.1	-19.0	12.0
Saudi Arabia**	10 yrs	2.44	2.38	-6.0	-4.3	-65.5
Abu Dhabi***	7 yrs	2.15	2.10	-5.0	-5.0	-31.4
Dubai***	9 yrs	3.90	3.82	-8.4	-8.4	65.5

Heat Map Legend: Rising Yields / Falling Yields

Note: * Month to Date and Year to Date; ** 10-year swap rate; *** USD denominated

Exchange Rates vs USD

	01-May	08-May	Change (%) Week	MTD	YTD
Advanced Countries					
US Dollar Index	99.079	99.734	0.7	0.7	3.5
Euro Area*	1.098	1.084	-1.3	-1.1	-3.3
Japan	106.910	106.650	0.2	0.5	1.8
MENA Countries					
Egypt	15.800	15.752	0.3	-0.1	2.0
Kuwait	0.309	0.309	-0.1	-0.1	-1.9
UAE 12M Forward	3.683	3.683	0.0	0.0	-0.1
Bahrain 12M Forward	0.379	0.379	0.0	0.0	-0.2
Oman 12M Forward	0.405	0.401	0.8	0.8	-3.3
Qatar 12M Forward	3.658	3.658	0.0	0.0	-0.4
Saudi Arabia 12M Forward	3.770	3.773	-0.1	-0.1	-0.6
UAE Spot	3.673	3.673	PEGGED		
Bahrain Spot	0.378	0.378	PEGGED		
Oman Spot	0.385	0.385	PEGGED		
Qatar Spot	3.642	3.642	PEGGED		
Saudi Arabia Spot	3.757	3.757	PEGGED		

Heat Map Legend: Stronger Currency vs USD / Weaker Currency vs USD

Note: * Exchange rate quoted as amount of USD per currency in line with market convention, other exchange rates are amount per USD

Equity Indices

	01-May	08-May	Change (%) Week	MTD	YTD
Advanced Countries					
US (S&P 500)	2,831	2,930	3.5	0.6	-9.3
Europe (STOXX 50)	2,928	2,908	-0.7	-0.7	-22.3
Japan (Nikkei 225)	19,619	20,179	2.9	-0.1	-14.7
MENA Countries					
Bahrain (BB)	1,308	1,268	-3.0	-3.2	-21.2
Egypt (EGX 30)	10,415	10,258	-1.5	-2.8	-26.5
KSA (Tadawul)	6,985	6,683	-4.3	-6.0	-20.3
Kuwait (KSE)	4,889	4,812	-1.6	-3.3	-23.4
Oman (Muscat 30)	3,539	3,469	-2.0	-2.0	-12.9
Qatar (Doha 20)	8,701	8,907	2.4	1.6	-14.6
UAE (Abu Dhabi)	4,222	4,119	-2.4	-2.6	-18.9
UAE (Dubai)	2,004	1,902	-5.1	-6.2	-31.2

Heat Map Legend: Higher Equity Index / Lower Equity Index

5 Year USD CDS Spreads

	01-May	08-May	Change in Yield (bps) Week	MTD*	YTD*
MENA Countries					
Bahrain	482.55	469.63	-12.9	-18.2	293.6
Kuwait	104.05	103.04	-1.0	-2.0	66.3
Qatar	124.99	115.09	-9.9	-9.7	78.4
Saudi Arabia	175.21	162.95	-12.3	-6.4	106.0
UAE (Abu Dhabi)	129.64	115.22	-14.4	-9.6	79.1
UAE (Dubai)	290.84	275.66	-15.2	-18.9	184.7

Heat Map Legend: Rising Yields / Falling Yields

Commodity Prices*

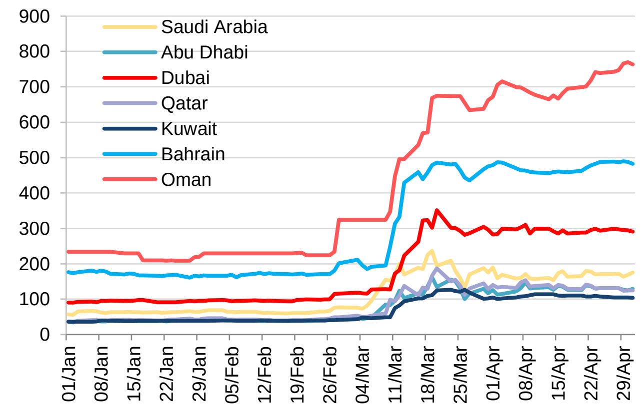
	01-May	08-May	Change (%) Week	MTD	YTD
Energy					
Brent	26.4	31.0	17.1	22.6	-53.1
WTI	19.8	24.7	25.1	31.3	-59.5
LNG	#N/A N/A	1,402.3	#VALUE!	-0.4	41.6
Precious Metals					
Gold	1,700	1,703	0.1	1.0	12.2
Silver	15.0	15.5	3.4	3.4	-13.3
Industrial					
Copper	5,110	5,274	3.2	1.6	-14.6
Steel	480	479	-0.2	2.4	-18.5
Aluminum	1,487	1,485	-0.1	-0.6	-18.0
Wheat	522	530	1.5	0.0	-5.2

Heat Map Legend: Higher Commodity Prices / Lower Commodity Prices

Note: * Spot prices or nearest expiring future

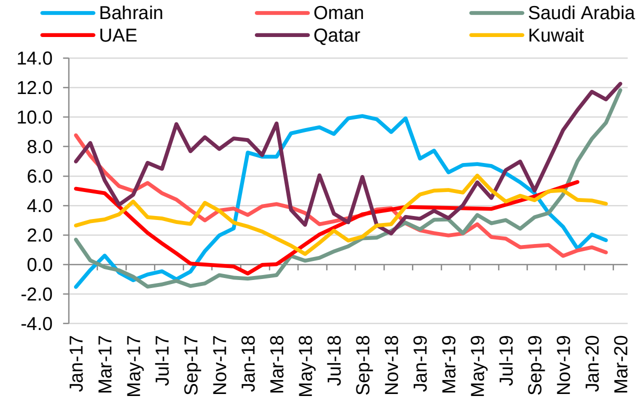
MENA Market Indicators – Charts

CHART 1. GCC 5 YEAR CDS SPREADS (BASIS POINTS)



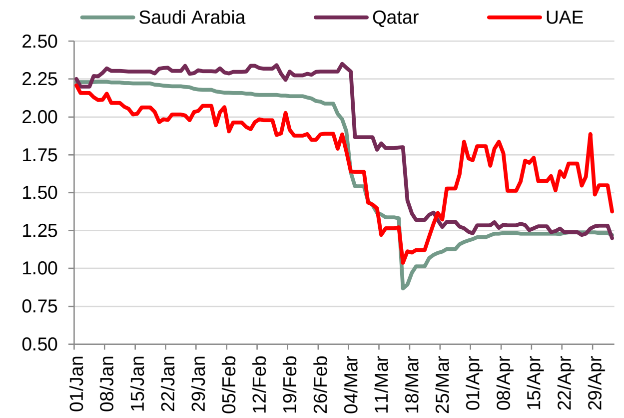
Source: Bloomberg, CEIC Database, MUFG MENA Research

CHART 2. GCC PRIVATE SECTOR CREDIT GROWTH (% Y/Y)



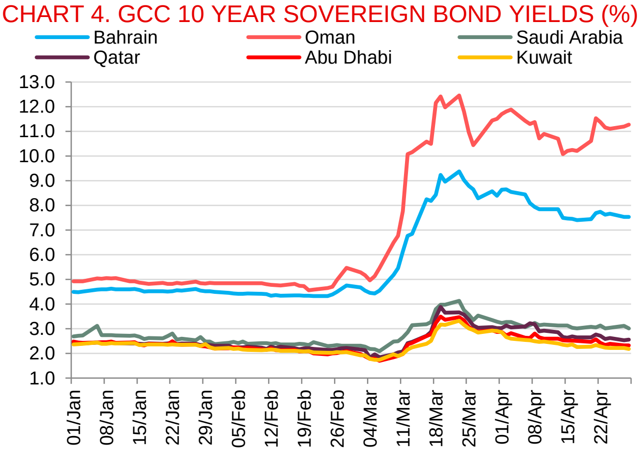
Source: Bloomberg, CEIC Database, MUFG MENA Research

CHART 3. CORE GCC 3 MONTH INTERBANK RATES (%)



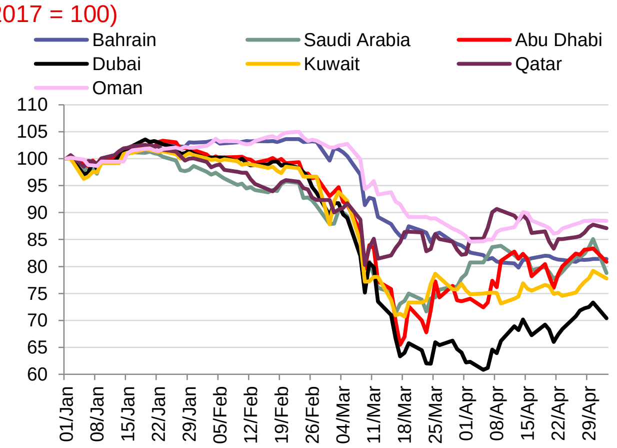
Source: Bloomberg, CEIC Database, MUFG MENA Research

CHART 4. GCC 10 YEAR SOVEREIGN BOND YIELDS (%)



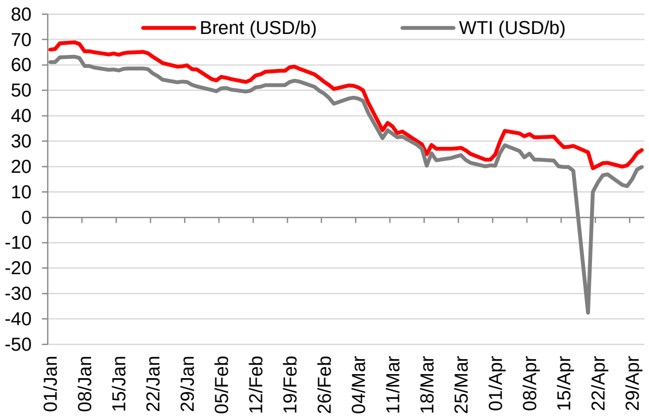
Source: Bloomberg, CEIC Database, MUFG MENA Research

CHART 5. GCC EQUITY MARKETS (REBASED JANUARY 2017 = 100)



Source: Bloomberg, CEIC Database, MUFG MENA Research

CHART 6. BRENT AND WTI CRUDE PRICES (USD/B)



Source: Bloomberg, CEIC Database, MUFG MENA Research

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