Knocking on the wrong door: Gulf currencies, the peg and QE2

Summary

- QE2-linked USD weakness could raise questions about those Gulf currencies that are pegged (Saudi Arabia, UAE, Oman, Qatar, Bahrain) or heavily linked (Kuwait) to the USD.
- Our view: revaluation pressure is likely to remain limited, and governments are highly unlikely to alter the currency regime, for two reasons.
- Firstly, the forces at play today – both domestic and external – are quite different from 2007-08, as Gulf economies are on a recovery path, as is the US economy; hence no harm in following the US policy (rates and FX). Gulf central banks are preoccupied with credit recovery and non-oil private sector growth.
- Secondly, inflation is not a source of concern even if price pressures have been building in some countries, notably Saudi Arabia. Double-digit inflation in all Gulf economies is not forecast through to 2011.

The likelihood of the USD weakening further in light of the new wave of quantitative easing (QE2) by the US Fed once again risks exposing the vulnerabilities of Gulf Arab countries whose currencies are pegged to the USD. The extent of the USD’s depreciation in the months ahead, as well as the extent of complementarities between US and Gulf economic cycles, is likely to renew focus on concerns surrounding imported inflation, the cost of trade and the sustainability of regional currency policies.

However, in our view, a shift in currency regime would be highly unlikely.

Gulf inflation still not ringing alarm bells

Gulf economies are on a recovery footing and inflation rates are not a concern in most of the region like they were in 2007-08. At that time, vigorous currency reform speculation stemmed from the underlying disparity between the US’s struggling economy (forcing Fed rates to fall) and the then-booming economies in the Gulf. Economic cycles are no longer completely out of sync, with loose monetary policy serving the interests of both, and hence upholding the viability of Gulf dollar pegs.

Inflation rates in most Gulf states are rising after a period of rapid deceleration, and deflation in the case of Qatar and the UAE, during 2009. It was inflation reaching double-digit levels in 2007 and 2008 that steered currency speculation as the weak USD drove up imported inflation for import-dependent Gulf economies. In 2008, inflation averaged 15.2% in Qatar, 12.5% in Oman, 12.3% in the United Arab Emirates and 10.6% in Kuwait. Saudi Arabia’s inflation rate accelerated at an alarming average pace that year to a decades-high 9.9% while Bahraini inflation was more subdued at 4.7%. Any USD appreciation in 2011 would dissuade anyone from expecting a quick change in policy. The region is known for not changing its mind based on temporary, short-term fluctuations and views.

John Sfakianakis, Chief Economist BSF-Crédit Agricole Group
+966 1 276 4611, johns@alfransi.com.sa
Even with the current phase of USD weakness, a return to such levels of inflation is unlikely through to the end of 2011. Inflation in Saudi Arabia is now the region's steepest – climbing about 6% in August – but it is resulting more from domestic supply pressures rather than any acute import inflation pressures and a commensurate depreciation in the real effective exchange rate. In the UAE, for the first nine months of 2010 inflation was 0.6% while Qatar experienced deflation of -3.2% in the first three quarters.

Saudi inflation is neither comforting nor alarming at the moment, reaching a historically high 5.2% in the first nine months of 2010 due to a mix of high food prices, continued steep rents and a general rise in the cost of goods and services. Even in Saudi Arabia, though, inflation is nearly half its 2008 peak – and price rises are not fixable with monetary policy at the moment.

Gulf economic cycle today more in sync with US

Economic circumstances in the Gulf region are starkly different to what they were during the cycle of USD weakness that spurred streams of ‘hot money’ into Gulf currencies and assets in 2007 and 2008. Gulf economies are recovering following a challenging 2009, during which aggregate private demand has declined across the region. Money supply growth is subdued throughout the region and private sector investment is taking a very gradual path towards recovery. Banks are holding on to their liquidity due to their reluctance to jump-start lending, while the private sector's appetite for expansion remains anaemic compared with pre-2009 realities. Capital inflows into emerging markets are expected to remain strong; however, Gulf economies are likely to receive a small fraction. Regional equity markets could receive a bit more foreign capital, on a selective basis, but real estate would not as investors still foresee further price corrections due to oversupply. Moreover, as the revaluation debate is not making a comeback, an inflow of capital in the form of bank deposits is not expected to recur.

Across the Gulf, aggregate demand remains a far cry from pre-crisis levels, the real estate frenzy has subsided, wage inflation is subdued and an abundant labour supply is available. We expect inflation in Saudi Arabia and the UAE – the largest Gulf economies – to be contained. Saudi inflation is likely to average 5.3% this year and 4.7% in 2011, while UAE inflation should not exceed 1% in 2010 and 3.1% next year.

Still, further USD weakening does not bode well for Gulf economies. Gulf states are heavily dependent on imports of food, machinery, cars, luxury goods and other items from Asia and Europe. Sharp fluctuations in the USD could lead to additional variations in the cost of importing various commodities. We do not expect imported inflation to pass through immediately, however, since Gulf economies denominate more than 60% of their letters of credit in the US currency. Inflationary pressures among key trading partners – more than 50% of Gulf imports are sourced from China, Japan, the Eurozone and the US – have also not reached alarming levels.
While Gulf import bills may swell in the coming months should USD weakness be sustained, the cost will be largely offset by greater state revenues stemming from stronger exports to Asia and higher oil prices. Still, higher oil revenues cannot cushion local populations from short-term price shocks, and the previous policy of subsidising food and increasing wages and salaries has price pressure perils, negative market consequences, harbours inefficiencies and furthers entitlement expectations.

Currency speculation likely to remain at bay

The USD is still far from – nor do we forecast it to cross – the key 1.50 mark vis-à-vis the EUR, last crossed in late 2009 when oil prices were about USD10 lower than they are now. As a result, we do not anticipate the return of ‘hot money’ speculating on a change in currency policy away from dollar pegs or revaluations. The decision by the Central Bank of Qatar to lower by 50bp the overnight rate in mid-August was prudently intended to curtail additional capital inflows without encouraging a capital exodus at the same time. The overall rhetoric of Gulf policymakers points to unity vis-à-vis currency policy, equity markets have not rallied substantially, real estate prices are still facing downward pressure in most of the Gulf and interest rates remain low.

Gulf benchmark lending rates steady in 2010

Source: Official data

<table>
<thead>
<tr>
<th>Country</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Saudi Arabia</td>
<td>2%</td>
</tr>
<tr>
<td>Bahrain</td>
<td>2.25%</td>
</tr>
<tr>
<td>Kuwait</td>
<td>2.50%</td>
</tr>
<tr>
<td>Bahrain overnight repo rate</td>
<td>5.50%</td>
</tr>
</tbody>
</table>
Yet, bets on an appreciation of the Saudi riyal have widened in the past two months. As at early November, bids on contracts to buy SAR in two years showed investors are pricing in a 0.6% appreciation in the SAR in two years to 3.7255 per USD. One-year forward rates at the beginning of November showed expectations for a 0.4% rise in a year. At the height of speculation in the spring of 2008, the expectation was for a 2.2% appreciation in the SAR in a year and a 2.7% appreciation in the SAR versus the USD in two years – so speculative pressures are comparatively mild. The current forward levels reflect funding swap positions due to a shortage of USD liquidity.

While momentum is building behind the recovery in Gulf economies, economic growth in the Gulf of a projected 3.8% in Saudi Arabia, 2% in the UAE, and above 3% in Kuwait, Oman and Bahrain is being steered by state stimulatory spending. Gulf governments are drawing on foreign assets to finance expansion plans, such as Qatar’s push to build natural gas capacity, the key factor supporting our real GDP growth of 14.8% this year. Saudi Arabia overspent budget targets by 25% in 2009 and is likely to continue spending with similar force in 2010, likely contributing to its second straight budget deficit.

These investment programmes are not in our view propelling inflationary pressures as they were in the pre-crisis years. In the case of Saudi, food price hikes have a pass-through effect of around 75%; housing supply shortages are a structural impediment. Oman and Kuwait are also facing some housing supply shortages that should persist over the medium term.

Gulf economies are, hence, in sync with the recovery focus and low-interest-rate environment in the US. Maintaining dollar pegs is therefore not at odds with the region’s economic ambitions and outlook. With regional governments still struggling to re-engage the private sector in the development process and attract foreign investment, weaker Gulf currencies would better enable the countries to promote their non-tradable (tourism) and tradable sectors (manufacturing) and pick up capital injections from European and Asian companies.
The choice of the currency regime must also be understood in the context of the structural importance of the oil sector for GDP, exports and state revenues. Oil and gas production contributes to about half of GDP and three-quarters of exports for Gulf states. The primary challenge for the Gulf is to diversify its economies away from a reliance on oil as much as possible; only the non-oil private sector will be able to create jobs for rapidly growing national workforces. We maintain our view, therefore, that the region is highly unlikely to move away from the dollar peg regime in the medium term.