



Theme #13: Can SARdines – Stay away from SAR peg trade

- Saudi Arabia still has time to defend the dollar peg but they must act more decisively on fiscal matters. Wait for better levels before buying 12m USDSAR.
- Reserves are nearly equal to GDP and twice the M1 money supply. Debt was far higher and reserves far lower during successful defenses in 1998-2003.
- Both falling oil prices and a rising dollar suppress Saudi inflation but outright deflation is unlikely
- Monetary policy credibility far outweighs any minimal economic gains from releasing the peg
- Other Gulf currencies (Oman), are more vulnerable

Still time to spare in Saudi Arabia

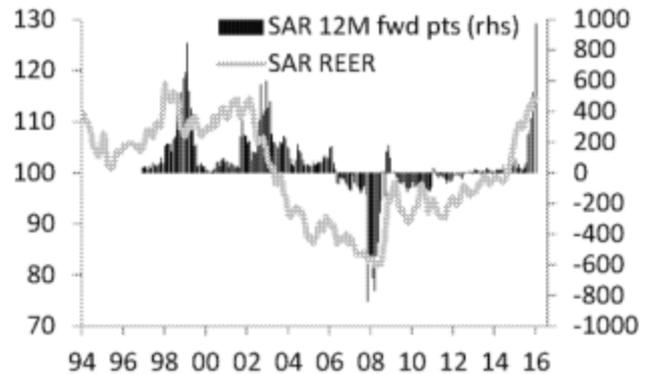
In recent days those sleepy Gulf dollar pegs have suddenly awoken. The dollar's relentless rise has made the Saudi Arabian riyal expensive too and SAR 12m forward points have jumped to record levels (Figure 1).

It turns out those large FX reserve buffers were handy after all. EM exchange rate policy is being challenged in Asia and the Middle East, with the likes of China and Saudi Arabia seeing reserves depleted at rates above 1% per month. Fortunately for the USDSAR peg, Saudi reserves still total \$635 billion, or approximately 95% of GDP. Record outflows may continue for several years, fueled not just by the trade deficit but also by capital outflows, and we project them to be \$510bn by end-17. Even still they will be far larger as a share of the economy than China (30%) and equal to Switzerland. The IMF estimates a 5-year fiscal buffer even at the 2015 \$100 oil budget breakeven price (Figure 2). The reverse repo rate is only 50bp and the economy is not very sensitive to rate increases given low diversification.

Moreover the Saudis have several as-yet untapped sources of dollar financing. One is to simply issue USD debt as in the 1990s – private external debt totals \$68bn, a mere 10% of GDP (by contrast, South African and Turkish total external debt equals 46% and 58% of GDP, respectively). An IPO of Saudi Aramco refining assets, as suggested by Deputy Crown Prince Mohammad bin Salman, can also raise dollar financing.

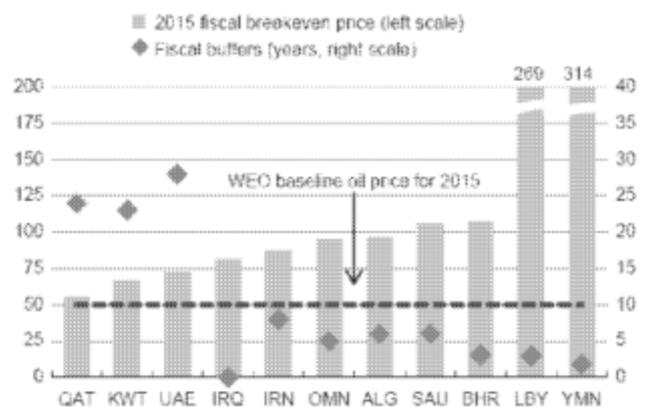
Of course the Saudis must also want to keep the peg if it is to hold – lest we forget lessons learned from the SNB. The Swiss could have increased sight deposits ad infinitum but they lost the will to do so and felt the CHF TWI had depreciated enough (dragged down by the euro peg). DXY strength has a noticeable dampening effect on Saudi inflation independent of Brent prices – 10% DXY lower SA CPI by 1% on average (Figure 3). While it is conceivable the government will tire of SAR TWI strength as well, the authorities have recently issued strongly worded statements in defense of the peg.

Figure 1: Saudi forward points near multi-decade high as dollar peg comes under intense pressure



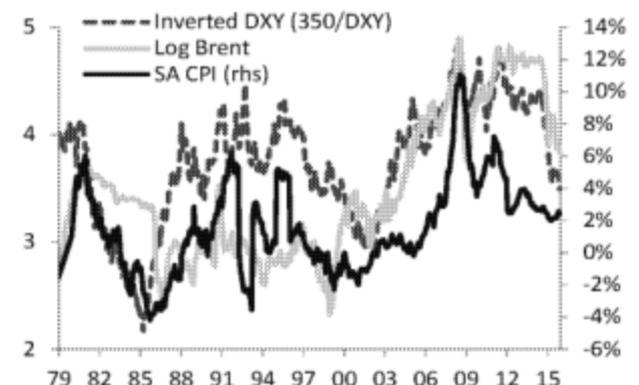
Source: Deutsche Bank, Bloomberg Finance LP.

Figure 2: Fiscal buffers and breakeven oil prices, 2015



Source: IMF, "Regional Economic Outlook: Middle East and Central Asia", 2015, Figure 1.6, p25

Figure 3: Both DXY and Brent matter for Saudi CPI



Source: Deutsche Bank, IMF. Note: USDSAR revalued in stages from 3.295 to 3.595 during 1979-85 and has been fixed at 3.75 since 1-Jun-96