Gulf pegs made economic sense if you can keep them

There are lessons from sturdier pegs as well, notably Hong Kong and Denmark. In cases where the economic rationale for keeping a peg outweighs the loss of independent monetary policy the central bank will go to great lengths to defend it. Saudi Arabia endured several periods of deflation in the 80s and 90s because they have little to gain from devaluation. Chief Saudi economist Melhem Melhem notes that devaluation will not restore competitiveness as oil dominates exports and imports of labor and materials would suffer immediate pass-through inflation.

Further fiscal consolidation is the key for longer-term peg stability. The Saudi government is intensely focused on this issue, having just announced a 50-66% increase in fuel prices. More radical reforms could include introducing income taxes, reducing subsides on education, health care and housing, or further reducing subsidies on electricity and water (The Economist, "The Saudi Blueprint", 9-Jan 2016). But FX forwards markets were underwhelmed by last month's budget proposals. DB strategist Aleksandar Stojanovski notes that while the announced budget of $224bn would result in a $87bn shortfall (13% of GDP) off projected revenues of $137bn, actual spending typically exceeds budgeted spending by 25%; the latter would produce a 21% of GDP budget deficit (see MENA Strategy, 29-Dec-15). The authorities appear more committed to meeting the budget this year with military overruns the key risk as regional conflicts (ISIS, Yemen) intensify.

Oman, Bahrain far more vulnerable, UAE peg safe

Our recommendation is to watch the 12m USDSAR forward for better entry levels to buy. The spring 2015 Brent rally was one such opportunity; 12m SAR forward points fell from 200 to a low of 15 in May. Meantime other Gulf dollar pegs are under more pressure (Kuwait pegs against a basket):

1. Oman: The IMF projects a staggering 15%+ Omani C/A deficit through 2020 even as the Saudi and Qatari C/A return to balance in 2018; unsurprisingly OMR forward points have spiked (Figures 4-5).
2. Bahrain: DB strategist Oliver Massetti notes the Bahrain oil budget breakeven price exceeds $120 and reserves are quite low (Figure 6). Surprisingly, 12m BHD forward points are indicatively trading below SAR.

While the May 2015 USDSAR entry point may appear obvious in hindsight, and unlikely to repeat, markets have time and again proven to have short memories. If we see sub-400 levels in 12m USDSAR forward points again it will be time to buy but for now the trade is too expensive to enter.

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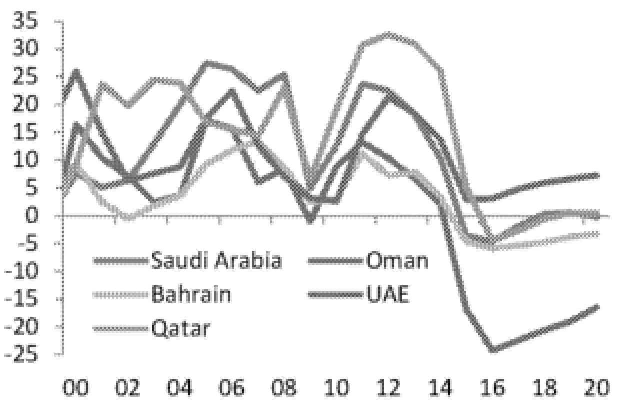
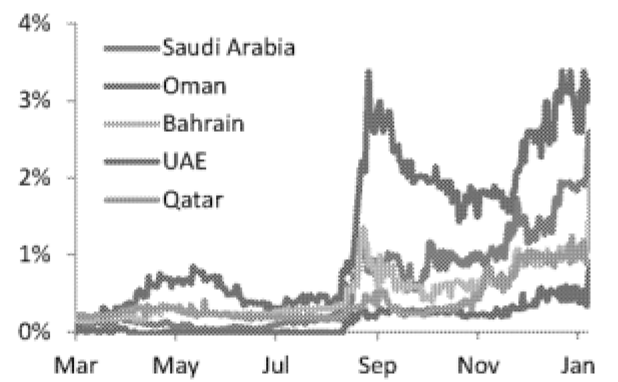
Figure 4: SA reserves offer protection but the Omani dinar looks vulnerable as C/A deficit widens out…



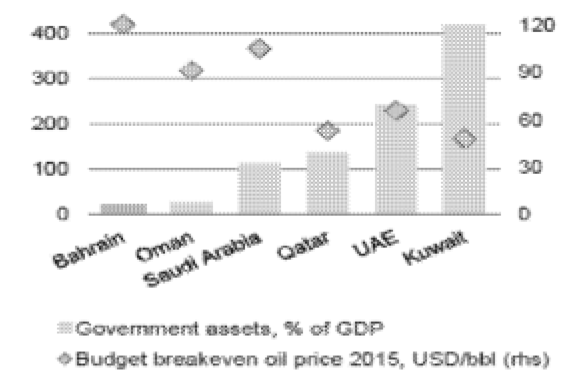
Source: Deutsche Bank, Bloomberg Finance LP.

Figure 5: …as reflected in the 12m forwards (carry)



Source: IMF, Deutsche Bank Frontier Report (Bahrain).

Figure 6: Lower reserves and high oil budget breakevens go hand in hand



Source: IMF, Deutsche Bank Frontier Report (Bahrain).