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Analyst Contacts

Mathias Angonin 971-4-237-9548
Analyst
mathias.angonin@moodys.com

Zahabia S Gupta 971-4-237-9549
Associate Analyst
zahabia.gupta@moodys.com

Steffen Dyck 49-69-70730-942
Senior Credit Officer
steffen.dyck@moodys.com

Malgorzata Glowacka 49-69-70730-938
Associate Analyst
malgorzata.glowacka@moodys.com

Matt Robinson 44-20-7772-5635
Vice President - Senior Credit Officer/ Manager
matt.robinson@moodys.com

Yves Lemay 44-20-7772-5512
MD-EMEA Sovereign
yves.lemay@moodys.com

Alastair Wilson 44-20-7772-1372
MD-Sovereign Risk
alastair.wilson@moodys.com

Sovereigns – Gulf Cooperation Council

Currency Risks Still Low on Average, But Rising in Oman and Bahrain

Pressures on the external payments positions of Gulf Cooperation Council (GCC) countries have prompted renewed questions about the sustainability of currency pegs to the US dollar. GCC countries are on aggregate in a favorable position to withstand these pressures given their large net asset positions and the recent, gradual recovery in oil prices. However, pressures are building in Bahrain (Ba2 negative) because of low FX reserves and Oman (Baa1 stable) because of a large current account deficit. This nurtures speculation about the need for support from other GCC countries.

» **External payments positions have deteriorated across the GCC, albeit unevenly**. The fall in the oil price led to an aggregate current account deficit of -1.8% of GDP in 2016, compared to an average surplus of close to 18% during the 2005-2014 period. Those with high external breakeven oil prices like Oman, Bahrain and Saudi Arabia (A2 stable) have been most affected, whilst Kuwait (Aa2 negative) and the United Arab Emirates (UAE; Aa2 negative) have managed to return to small surpluses.

» **Improvements will only be gradual and driven by oil prices and fiscal consolidation**. The region's aggregate current account deficit should turn into a surplus by 2018, supported by a gradual recovery in oil prices. Falling external breakeven prices from increased non-oil exports and structural reforms should provide additional support.

» **Aggregate buffer to protect pegs is substantial, but reserves are very low in some cases**. Qatar (Aa2 negative), Kuwait and the UAE have very large offshore assets. In Saudi Arabia and Oman, reserves have declined but remain high. Bahrain, however, has seen a more substantial fall in its foreign-exchange reserves to historically low levels.

» **Balance of payments pressures have in the past resulted in intra-regional support to member states under pressure.** While there is little transparency on prospective transfers, Saudi Arabia, UAE, Kuwait and Qatar provided support to Oman and Bahrain via a $20 billion fund set up in 2011.

» **Regulatory regime changes mitigate peg's monetary policy restrictions**. Authorities have developed regulatory tools to maintain price stability following double-digit inflation in 2007. Nevertheless, countries remain exposed to a strengthening US dollar and an increase in interest rates.

» **The authorities are unlikely to abandon US dollar pegs willingly.** The pegs support macroeconomic stability, private sector confidence and lower transaction costs, and import/export elasticities to the exchange rate are low.

Currency Peg Arrangements in the GCC

All GCC countries maintain currency pegs to the US dollar, except Kuwait. Officially, the Omani riyal has been pegged to the US dollar since 1986, the UAE dirham since 1997, the Qatari riyal and Bahraini dinar since 2001 and the Saudi riyal since 2003. In most cases, the pegs existed unofficially before that. However, the Kuwaiti dinar has been pegged to a basket of currencies from 1975 to 2003 and again since 2007, which is believed to be heavily weighted in US dollar.

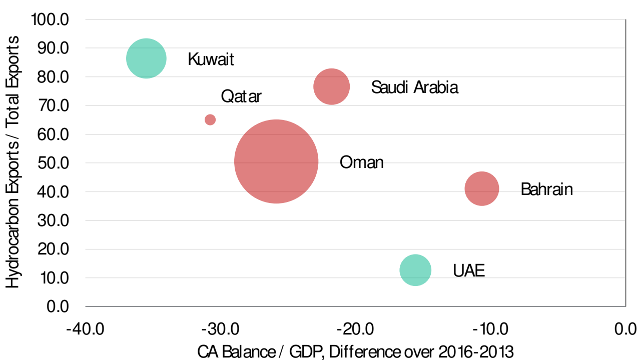
External payments positions have deteriorated across the GCC, albeit unevenly

Since 2014, GCC countries have witnessed a substantial weakening in their current account balances as a result of the fall in oil prices[1] and the dominance of hydrocarbon exports (56% of total exports in the region; see Exhibit 1). A current account surplus of close to 18% of GDP on average over 2005-2014 has shifted to a deficit of -1.8% in 2016, from -1.1% in 2015. This, coupled with higher external debt issuances and drawdown on foreign exchange and sovereign wealth fund reserves, have led to a substantial weakening in external positions. That said, the story is not universal, and this is reflected by the variation in external breakeven oil prices – the oil price at which the current account balance is zero.

In 2016, Oman had the highest current account deficit among GCC countries, which we estimate at 19.3% of GDP, and the highest external breakeven oil price at $78.4 per barrel, according to the IMF. Bahrain and Saudi Arabia registered moderate deficits of around 3.2-3.6% of GDP as per our estimates, while we estimate Qatar's deficit was much smaller at -0.3%. Unlike other GCC countries, Saudi Arabia saw a decline in its deficit from 8.7% of GDP in 2015 partly due to higher oil production and exports offsetting lower oil prices. Kuwait and the UAE maintained surpluses of 4.4% and 2.8% of GDP in 2016, respectively. Yet, Kuwait's surplus was around 35 percentage points (pps) of GDP lower than in 2013.

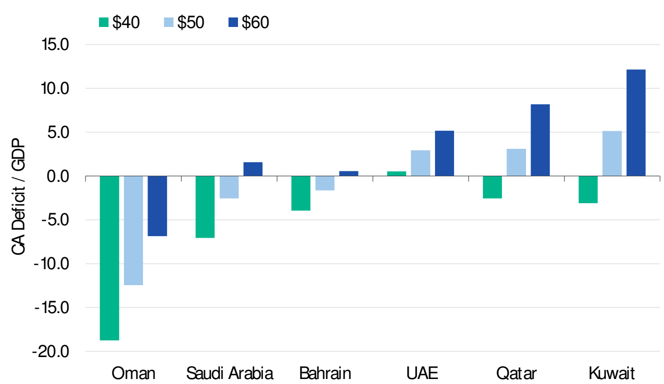
However, countries with a higher exposure to hydrocarbon exports like Kuwait, Saudi Arabia, Qatar and Oman remain more vulnerable to volatility in oil prices (see Exhibit 2). For example, our scenario analysis shows that higher average oil prices at $60 per barrel in 2017 would result in an improvement in the current account position of 7.0 pps of GDP for Kuwait and 5.6 pps for Oman. On the flip-side, lower oil prices at $40 per barrel would likely result in deficits across the GCC except for the UAE.

Exhibit 1
Current account balances have weakened...
Size of bubble reflects current account balance/GDP in 2016



Red reflects a current account deficit, while green reflects a surplus.
Source: National Authorities, Moody's Investors Service

Exhibit 2
...and remain sensitive to oil prices
Brent crude oil prices (US$ per barrel), 2017F



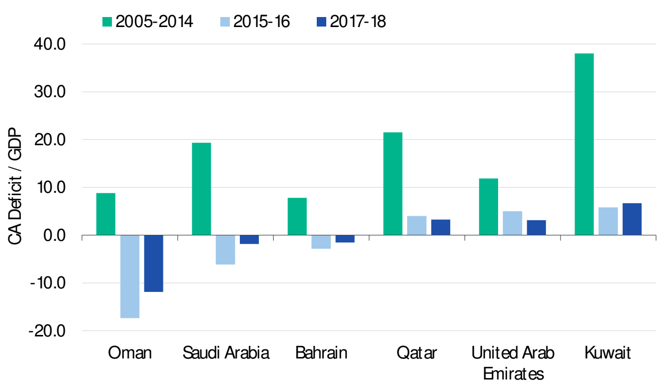
Source: Moody's Investors Service

Any improvements in external positions will be slow and gradual

We expect the GCC's aggregate current account deficit to return to a surplus of $13 billion (0.8% of regional GDP) by 2018 from a deficit of $20 billion (1.8% of GDP) in 2016. This remains in stark contrast to the large surpluses recorded between 2005 and 2014, however (see Exhibit 3). We expect Kuwait, Qatar and the UAE to post average surpluses of 6.7%, 3.2% and 3.1% of GDP in 2017-18. For Saudi Arabia and Bahrain, we expect moderate current account deficits of 1.5-1.8% of GDP on average in 2017-18. Oman has a much larger external gap, and we expect the current account deficit to average 11.9% of GDP over the same period.

Exhibit 3

The GCC is unlikely to return the same level of surpluses seen over 2005-2014

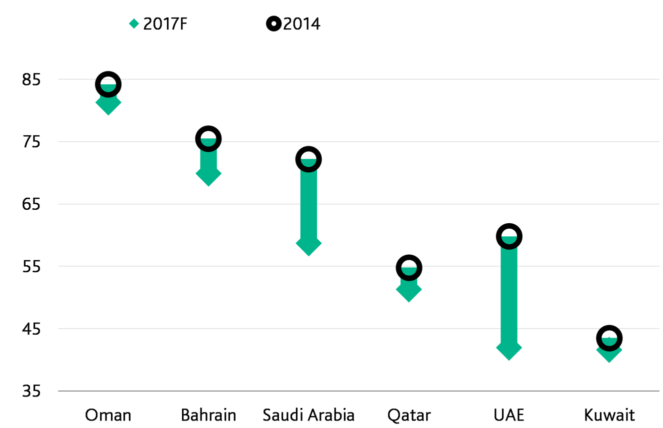


Source: National Authorities, Moody's Investors Service

Exhibit 4

But improvements in external breakeven oil prices will support external positions

US$ per barrel



Source: International Monetary Fund

Falls in external breakeven oil price across the GCC will also continue, reflecting improvements in external positions (see Exhibit 4). These reductions are related to cuts in capital spending as well as structural reforms to increase non-oil exports and services receipts. Energy subsidy reforms and the deregulation of fuel prices in countries such as the UAE and Qatar will also increase efficiency in the energy sectors and support larger export volumes and lower energy imports.

» We expect that the UAE and Saudi Arabia will see their external breakeven oil prices fall the most – by $17.8 and $13.0 per barrel between 2014 and 2017, respectively. These improvements are supported by a planned ramp-up in production volumes of non-oil exports such as petrochemicals. For Saudi Arabia, we also forecast cuts in project spending of around $20 billion and lower imports from subdued consumption due to ongoing fiscal austerity (including lower wages and rising energy costs). The deficit on the services, income and transfers accounts will likely be lower because of reduced remittances outflows resulting from the government's Saudiisation program. The UAE will continue to maintain healthy growth in non-oil exports receipts supported by investment in trade infrastructure.

» Bahrain has made positive strides in economic diversification by increasing the role of financial services and food processing. The proportion of oil exports fell from close to 80% in 2011 to 62% in 2014 and is projected at 44% in 2017, though lower oil imports also contributed to the $5.6 per barrel drop in the external breakeven oil price since 2014. Nonetheless, Bahrain still has the highest external breakeven oil price after Oman, at $69.9 per barrel, due to large import bills and lower overall export competitiveness.

» Oman, Qatar and Kuwait will see very small decreases in their external breakeven oil prices given their continued heavy reliance on hydrocarbon exports. That said, Kuwait already has one of the lowest external breakeven oil price at around $40 per barrel.

Reductions in external break-even oil prices will be slower than any falls in fiscal break-even oil prices in most countries due to the stickiness of imports. In Qatar and Bahrain, ongoing infrastructure investment will continue to increase capital imports and will likely increase their external break-even prices going forward. At the same time, continued reliance on expatriate workers leading to remittance outflows and gradually rising external debt service payments will keep the non-merchandise deficit on an upward trajectory.

Aggregate buffer to protect peg is substantial, but reserves are very low in Bahrain

Large fiscal and current account surpluses in the past enabled most governments to build substantial foreign exchange reserves and sovereign wealth fund assets. We estimate that the region's combined financial assets stood at $2.0 trillion or about 150% of regional GDP at end-2016. This figure will fall slightly to around 144% of GDP in 2017 due to a drawdown in assets to finance current account deficits in Bahrain, Oman and Saudi Arabia.

» Kuwait, Qatar and the UAE not only face the lowest current account pressures, but also have the largest external buffers. Amongst the three, Qatar is more vulnerable to external pressures due to its larger external debt. While Kuwait has the largest external buffers of around 423% of GDP, resulting in an extremely low external vulnerability indicator (EVI)[2] score of 5.3%, its current account remains the most sensitive to changes in oil prices. The UAE has a moderate level of external debt, but the large share of non-hydrocarbon exports to total exports along with large fiscal reserves leaves it less vulnerable to lower oil prices.

» Although Saudi Arabia faces moderate external pressures, it benefits from large foreign- exchange reserves of around 82% of GDP and very low total external debt levels. Nonetheless, reserves had dropped to around $526 billion at end-2016, from $720 billion at end-2014 due to the large twin – fiscal and current account – deficits over 2015-16.

» Bahrain and Oman face the most significant challenges to sustaining the currency peg to the US dollar. Based on current levels of reserves and assuming stable and low oil prices at $50 per barrel, stable oil production, no further economic and fiscal reforms, Bahrain would only be able to sustain the projected 2017 current account deficit for around 4 years. Oman would be able to do so for around twice that period.

» Bahrain's external debt levels are also very high at around 147% of GDP. At the same time, its financial buffers are insufficient to cover its short-term external debt and amortization payments, resulting in a projected EVI exceeding 1,500% in 2017 (see Exhibit 5). A figure of less than 100% for the EVI denotes sufficient resources to cover upcoming external repayments. Unlike Oman, Bahrain is not known to have reserves outside of the central bank.

» Oman is in a more favourable position. Although its gross external financing requirements are larger than Bahrain's (we project the 2017 current account deficit to reach $8.8 billion), these are largely covered by foreign assets, which totaled $38.6 billion as of September 2016 – about equally shared between the central bank reserves and the State General Reserve Fund (SGRF; though they have dropped from $41.5 billion at the end of 2015). At this rate of depletion (assuming continued external debt issuance, similar to 2016), Oman has around nine years of reserves left, providing it with a comfortable cushion. Oman's external payments position is also supported by the relatively low level of external indebtedness. Nonetheless, Oman would be particularly vulnerable to a renewed weakness in oil prices.

Exhibit 5

Heatmap denoting vulnerability to pressures on the currency peg to the US dollar

2017F	Hydrocarbon Exports, % of Total Exports	FX Reserves + SWF Assets, Yrs of CA Deficits	External Debt, % of GDP	EVI, Incl. SWF Assets
Bahrain	43.6	4.2	146.6	1519.4
Oman	54.2	8.1	57.9	31.3
Saudi Arabia	74.5	30.5	24.8	10.5
Qatar	65.3	--	93.1	28.2
UAE	13.7	--	68.6	28.7
Kuwait	86.2	--	29.5	5.3

EVI refers to the External Vulnerability Indicator: (Short-Term External Debt + Currently Maturing Long-Term External Debt)/Official Foreign Exchange Reserves.
For 'FX Reserves + SWF Assets, Yrs of CA deficits', figures for Qatar, the UAE and Kuwait are blank because we forecast CA surpluses in 2017.
Source: Moody's Investors Service

Balance of payments pressures raise the question of regional support

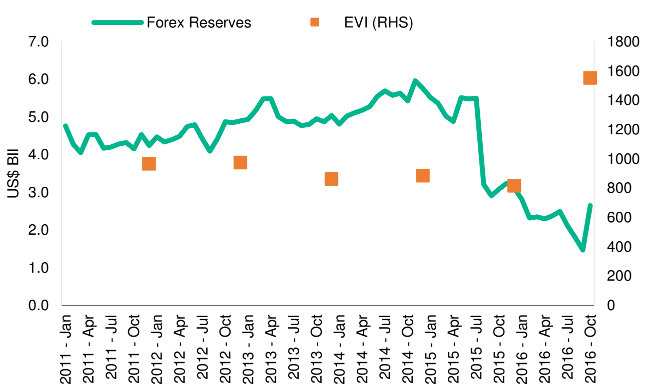
If external pressures were to increase or external funding were to dry up, past experience suggests that support might be forthcoming from stronger GCC countries in the form of deposits, loans or grants. While there is no transparency regarding the likelihood and timeliness of such support, in 2011 Saudi Arabia, the UAE, Qatar and Kuwait pledged $20 billion to Bahrain and Oman in 2011 through a new GCC Fund. Although transfers do not pass through the Bahraini and Omani government budgets, they support their external payments positions. But further support may be needed to protect their pegs.

Pressures are currently most acute in Bahrain. The country's foreign-exchange reserves halved to $1.5 billion (a little over one month's worth of imports) between December 2015 and September 2016, before bouncing back to $2.7 billion in October. This is despite support funding made available to the Kingdom. The total value of projects initiated under the GCC Fund more than doubled in 2016 to $3.1 billion, while the value of projects that went to tender rose 20.5% to $4.3 billion. Consequently, the aggregate value of active projects should continue to expand significantly in the course of 2017 as work on these ventures begins. Disbursement has been slower in Oman. In November 2014, Oman signed an agreement with the Kuwait Fund for Arab Economic Development to fund part of the Al Batinah Expressway project, while in March 2015 Saudi Arabia committed to financing two projects at Duqm.

In the past, Saudi Arabia has taken action to contain economic and social instability in Bahrain, not least to minimize the impact of any unrest within Bahrain's Shia community on Saudi Arabia's large minority Shia population in its Eastern Province. Saudi Arabia also has large economic interests in Bahrain, as it holds a 20% stake in Alba as well as being a major shareholder to some of Bahrain's offshore banks. Saudi Arabia also has ample capacity to support Bahrain: Saudi Arabia's foreign-exchange reserves stood at $526 billion at end-2016, compared to an estimated 2017 current account deficit of $552 million in Bahrain. It also has a track record, having supported Bahrain between 1997 and mid-2004 by allocating all revenue from the shared Abu Sa'afa oilfield to Bahrain.

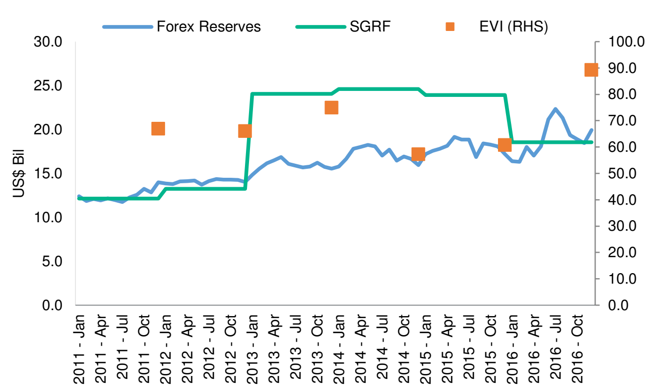
By contrast, Oman is larger and less strategic to other GCC countries, meaning support is less likely. Oman has maintained a neutral stance in recent regional conflicts, and the sultanate is the only GCC country that does not provide active support to the Saudi-led coalition in Yemen. Along with the UAE, Oman pulled itself from the proposed GCC monetary union. Although there were reports of deposits from Saudi Arabia in January, Oman has not received balance-of-payment support.

Exhibit 6
Bahrain's foreign-exchange reserves have dropped, increasing external vulnerability



EVI refers to the External Vulnerability Indicator: (Short-Term External Debt + Currently Maturing Long-Term External Debt + Total non-resident deposits over one year)/Official Foreign Exchange Reserves.
Source: International Financial Statistics, Moody's Investors Service

Exhibit 7
Oman's forex reserves are supplemented by SGRF reserves, but these have declined significantly



EVI refers to the External Vulnerability Indicator: (Short-Term External Debt + Currently Maturing Long-Term External Debt + Total non-resident deposits over one year)/Official Foreign Exchange Reserves.
Source: Central Bank of Oman, Moody's Investors Service

Regulatory regime changes mitigate peg's monetary policy restrictions

The US dollar peg constrains monetary policy flexibility. Yet, GCC inflation has been moderate on a global scale. Moreover, central banks' commitment to the peg seldom conflicts with their objective of ensuring price stability because most consumer goods are imported, and a strong dollar limits imported inflation.

Central banks have also developed other monetary policy instruments to regulate prices based on the experience of 2007-08, when a sudden spike in oil prices led to double-digit inflation in Oman, Qatar and the UAE. First, they have strengthened banking and real-estate regulations to prevent credit booms. For instance, in 2015 Qatar passed new regulations governing consumer loans and lending to government-related entities, following similar regulations in the UAE. Second, they have sterilized foreign-currency inflows by transferring surpluses to sovereign-wealth funds rather than increasing spending. As a result, inflation was less than 4% on average in 2012-14. Going forward, the lifting of subsidies and/or introduction of new taxes are only likely to contribute to moderate spikes in inflation.

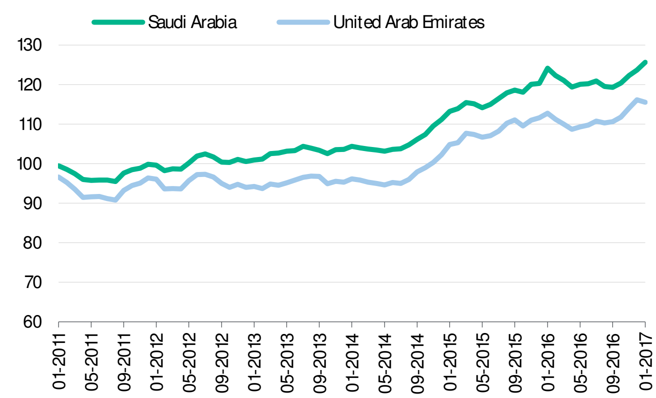
That said, GCC economies are negatively affected by the strengthening of the US dollar relative to other currencies. In the past three years, the real effective exchange rate in Saudi Arabia and the UAE appreciated by 20.3% and 20.1%, respectively (see Exhibit 8). While this dampens the price of non-dollar imported goods, it also reduces the demand for and competitiveness of GCC services, particularly tourism and transport. The opportunity cost of maintaining a peg is higher for Bahrain and the UAE, which have more diversified current-account receipts. Nonetheless, high trade openness and flexible labour markets allow for some adjustment in competitiveness.

We also expect rising interest rates will be mirrored in GCC countries, whether immediately or with a lag.[3] Nevertheless, GCC governments were able to issue debt in 2015 and 2016 at low rates to cover their fiscal and external borrowing needs. Moreover, they still have strong debt affordability ratios, with interest payments absorbing less than 5% of revenue in most countries. However, Bahrain is more exposed to an increase in interest rates, with a debt affordability ratio at 15% and gross borrowing requirements of 31% of GDP anticipated in 2017 (see Exhibit 9).

Exhibit 8

Real effective exchange rates have appreciated in GCC countries

Broad indices, 2010=100

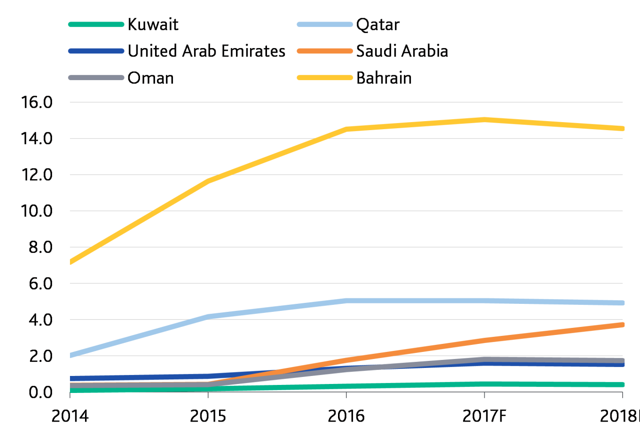


Source: Bank for International Settlements

Exhibit 9

Debt affordability is strong, but Bahrain is most exposed to an interest rate hike

Interest payments to revenue, %



Source: Moody's Investors Service

The authorities are unlikely to abandon US dollar pegs

Speculation has mounted that the GCC countries could preempt a deterioration in external positions by adjusting their exchange rate policies, which is reflected in volatile 12-month forward rates on some of the GCC currencies (see Exhibit 10). However, we do not think that this risk will materialize.

Pegs have strong support in all GCC countries in that they have bolstered macroeconomic stability and private sector confidence, lowered transaction costs, and helped to avoid the currency volatility experienced by most emerging economies. This commitment to the peg is supported by historical evidence. For instance, authorities maintained US dollar pegs in the 1990s, when oil prices were low for a prolonged period, foreign assets were close to zero and government debt was much higher.

Moreover, the benefits of abandoning pegs would be limited. Import and export volume elasticities to exchange rate adjustments are relatively low. Hydrocarbon exports made up an estimated average 56% of total merchandise exports in 2016 (from around 14% in the UAE to 85% in Kuwait), reducing the boost to export competitiveness from an exchange rate devaluation. The UAE is the exception as its exports are well diversified; nonetheless, most of its exports are re-exports. In addition, while a weaker currency would lift the local currency equivalent of hydrocarbon revenues, it would also increase the cost of imports and lead to higher inflation, which could trigger higher government spending on wages and salaries and government purchases of goods and services.

Kuwait's experience shows that the benefits of choosing a basket of currencies rather than just one currency are limited.[4] While it has helped Kuwait moderate inflationary pressures during the period of rising or high oil prices until mid-2014, average consumer price inflation levels were slightly higher in the past when compared to its GCC neighbors.

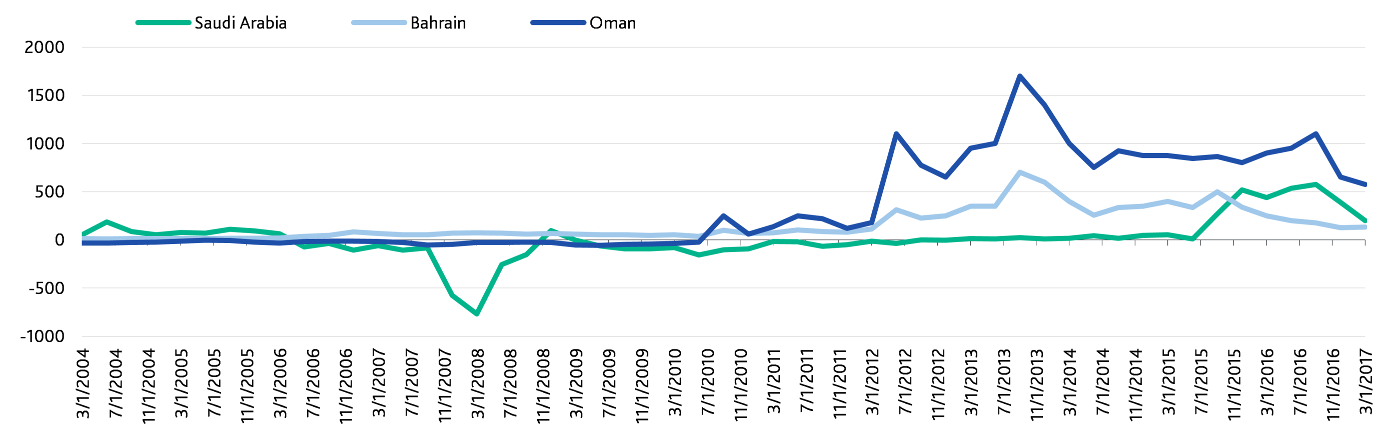
At the same time, the costs of de-pegging or devaluing the currency would be high, at least in the short term. First and foremost, there would be high inflationary pressures from a devalued currency given low levels of economic diversification and constraints substituting imports with domestic production. Moreover, increased revenue in local currency terms from hydrocarbon receipts denominated in US dollar would be offset by increased pressure on government current spending following higher inflation, and larger debt-service payments on external debt. Finally, one-off devaluations would inevitably undermine a peg's credibility and lead to what could become a self-fulfilling speculation about follow-up devaluations.

A change in exchange rate policies could occur if GCC rulers decide to revive the GCC monetary union project. The project was put on hold in 2010 after the UAE and Oman decided to opt out. Looking at the experience of other currency unions, the project is likely to stumble on the issue of fiscal transfers.

Exhibit 10

Investor confidence is reflected in forward rates, which have become volatile

12-month forward currency points



Source: Bloomberg

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Authors:

Mathias Angonin

Zahabia Saleem Gupta

Endnotes

1 Oil prices dropped by almost 16% year-on-year to an average of $44.1/barrel during 2016, from $52.4 in 2015 and $98.9 in 2014.

2 EVI measures a country's susceptibility to a withdrawal of liquidity or a 'sudden stop'. It is calculated as (Short-term external debt + Currently maturing long-term external debt + Total non-resident deposits over one year / Official foreign- exchange reserves).

3 For instance, in December 2016 Saudi Arabia, Kuwait and Bahrain raised interest rates immediately after the US Federal Reserve's decision to increase its benchmark rate by 25 basis points. Qatar and the UAE followed the next day. Oman's central bank began raised its overnight repo rate, following a formula based on LIBOR.

4 From 2003-07, the dinar was pegged to the US dollar with a margin of ±3.5%. From 1975 to 2003 and again since 2007, however, the Kuwaiti dinar has been pegged to a basket of currencies, which is believed to be heavily weighted in US dollar.

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