Unrest takes its toll

S&P RESEARCH ON 13 SOVEREIGNS REVEALS AN ELEVATED RISK ENVIRONMENT IN THE REGION. **PETER WILLIAMS** REPORTS.

The Arab Spring has enhanced the political and monetary flexibility risks in the Middle East and North Africa (MENA). A report by ratings agency Standard & Poor's examines 13 sovereigns in MENA, all with high political risks and limited monetary policy flexibility that depress their credit ratings.

The report suggests that the nature of political risk differs across the region and includes domestic political turmoil and succession as well as geopolitical risk. Institutional transparency and accountability are a further consideration in S&P's assessment of political risk. The limits to monetary policy flexibility in the region stem from fixed or heavily managed exchange rates, compounded by small and underdeveloped capital markets.

THERE IS A RISK THAT INTERNAL CONFLICT WILL BECOME THE NORM.

INDIVIDUAL OUTLOOKS Bahrain, Egypt, Jordan, Oman and Tunisia all have negative outlooks, indicating at least a one-in-three chance that S&P could lower the ratings on those sovereigns in the next one or two years. For all five countries the negative outlook reflects S&P's view that an escalation of political tensions could further weaken economic prospects or fiscal performance.

Abu Dhabi, Israel, Kuwait, Lebanon, Morocco, Qatar, Ras al-Khaymah and Saudi Arabia are all rated as having a stable outlook, which indicates that S&P does not expect to change the ratings over the 2012–13 horizon.

There is a significant divergence between the creditworthiness of those MENA sovereigns with a substantial hydrocarbon endowment and those without. The average rating for those with hydrocarbon endowments is currently close to A+; for those without it is closer to speculative-grade. The creditworthiness of countries with significant oil and gas reserves is supported by:

- the high income generation of the oil and gas sector;
- the ability to generate the receipts from abroad that are necessary to meet public and private sector obligations to non-residents; and
- the strong and sustained inflows to government revenues from the sector, which mostly results in strong surpluses, low financing needs, net asset positions and, in some cases, exceptional fiscal buffers against economic or financial shocks.

S&P says that it views political risk as a relative weakness for rated MENA sovereigns. Under its criteria, the primary factor for determining political risk is the effectiveness, stability and predictability of a sovereign's policymaking and political institutions. The Arab Spring popular uprising in eight MENA countries since January 2011 increased political risk in the region. Regimes have changed in Egypt, Tunisia and Libya – where S&P suspended its rating – and armed conflict continues in Syria and Yemen, both of which are unrated. S&P notes that Bahrain, Jordan and Morocco are facing rising public pressure to institute political and socio-economic change.

In some countries domestic interest groups and the population at large continue to make demands of their national government; some of the demands are irreconcilable and/or difficult to meet due to fiscal constraints. S&P forecasts that agitation for increased representation, a more even distribution of wealth, and radical changes to political systems could drag on for many years to come. There is a risk that internal conflict will become the norm, with government efforts to improve the macro-economic policy environment taking a back seat.

MENA sovereigns are broadly similar in terms of monetary policy flexibility, says S&P. With the exception of Israel and, to a lesser extent, Morocco, MENA sovereigns have limited flexibility as monetary conditions are largely determined by factors outside the control of the domestic monetary authorities. The effectiveness of transmission mechanisms is constrained by the small size and underdeveloped nature of local currency capital markets and, in some instances, relatively high levels of dollar use.

MENA sovereigns' exchange rate regimes are mostly conventional pegs fixed to the US dollar or a basket of currencies with a heavy US dollar weighting.

Efforts by MENA governments to stimulate domestic demand in response to the 2008 financial crisis and to address or pre-empt internal demands for improved living standards have concentrated on increased spending, particularly for those with large oil and gas reserves. Nevertheless, S&P concludes that the risk to these sovereigns' creditworthiness of a sharp sustained decline in the oil price has increased. The fiscal break-even price – the price at which general government spending balances at the given level and oil output – has generally increased.

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