MENA Advisors

How sustainable is debt in the GCC?

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- The GCC is issuing debt again, with Saudi Arabia raising $7.5bn in January and Qatar raising $12bn yesterday, with the largest order book ($50bn) of any debt issuance globally since it issued last year

- This raises the question, with sovereign vulnerability rising across the Middle East and wealthy GCC governments being called on to provide support, how long can the GCC go on issuing debt?

- The US dollar pegs make even the most modest yields in the GCC look attractive and international investors are likely to go on lending to the GCC until these pegs become unsustainable

- We have projected the net foreign assets of Middle East sovereigns over the next decade to ascertain the sustainability of their US dollar pegs

- This analysis suggests that if oil falls to $40 for a sustained period, which is not implausible, GCC support for weaker sovereigns would dry up, a sharp fiscal consolidation would be required and the risk of currency devaluations would increase

- For the region's largest economy, Saudi Arabia, a $40 oil price would significantly curtail its ability to afford large diversification and investment plans

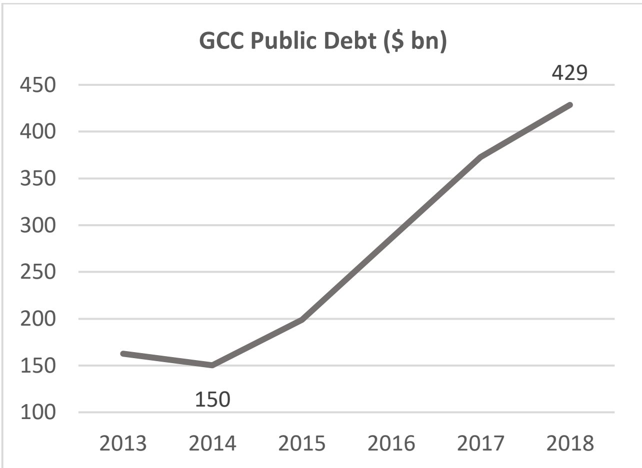
- We will periodically update this analysis to keep a track on the long-term outlook for debt affordability in the GCC, especially if oil prices begin to head south

GCC debt is getting more interesting

Debt is piling up and is being included on global bond indices, at a time when sovereign vulnerability is rising across the Middle East and wealthy GCC sovereigns being called on to provide support to their weaker neighbours.

Debt issuance has spiked

After oil prices collapsed in 2014, debt issuance in the GCC increased sharply to offset the loss in income and maintain counter-cyclical expenditure. As a result, public debt in the GCC has almost tripled in 4 years.



The rate of debt issuance is unlikely to ease much with budget deficits expected across most of the GCC in 2019, including the first UAE federal bond. Saudi Arabia issued $7.5bn of debt in January this year and Qatar issued $12bn in March. Other large issuances are expected from government related entities, notably an inaugural $10bn bond from Aramco and also issuances from several banks.

Entering global bond indices

The volume of GCC issuance in recent years contributed to JP Morgan's decision to add the remaining GCC states to its emerging market government bond indices (EMBI) in a phased introduction between January and September of this year (Oman was added in 2016). By the end of September, GCC bonds will account for around 11% of the JP Morgan EMBI indices, which are tracked by around $600bn to $700bn of assets. Actual passive and actively managed inflows into GCC debt markets as a result have been estimated within a range of $20bn to $60bn.

Sovereign vulnerability is rising

Although investment inflows are positive for the GCC and should help keep borrowing costs down, pegs in the region are becoming increasingly vulnerable to another drop in oil prices. Compared with 2013, debt levels are far higher, foreign exchange reserves are lower, political unity has been undermined and the number of countries relying on GCC support is growing (Bahrain, Lebanon, Jordan, Tunisia, Egypt and Turkey all come to mind).

All this has naturally piqued the interest of international investors.

How long can the GCC continue issuing debt?

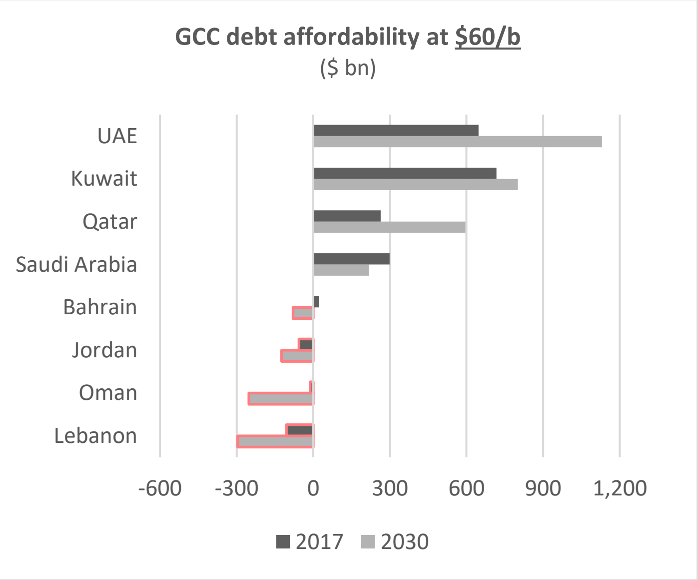
The US dollar pegs in the GCC make investing in these countries particularly attractive. Exchange rate risks are dramatically reduced and investors essentially get a higher yield for similarly rated lenders, as long as the pegs don't break. Therefore, the GCC is likely to continue receiving relatively good rates for its bonds as long as the outlook for the pegs looks solid.

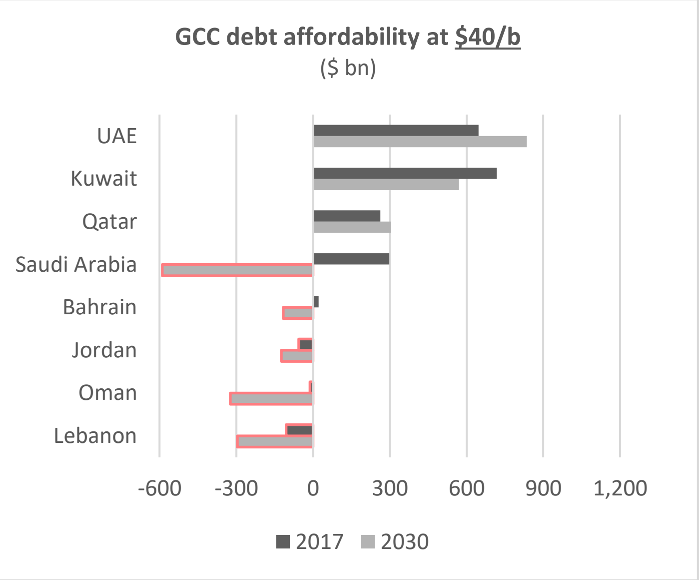
Our analysis suggests that oil prices of around $60/b would enable the GCC to maintain its currency pegs for the long term. However, if oil prices were to fall below $40 for a sustained period, GCC debt would look a lot less affordable and GCC sovereigns would be forced to take a number of remedial measures such as cutting support to weaker sovereigns, reducing spending, raising taxes and devaluing their currencies.

Net foreign assets and money supply

Looking at the net foreign assets of a country provides a good framework for assessing the sustainability of a currency peg and the affordability of its debt. If a sovereign has enough US dollar assets to buy all of the local cash and current deposits in the domestic banking system (M1), then its ability to defend the peg is relatively assured. However, if a country's net foreign assets are less than M1, it's ability to defend a pegged currency will begin to be called into question.

We have made projections out to 2030 for net foreign assets less M1, which we term "debt affordability" (please get in touch if you would like to know more about how these forecasts are constructed, the assumptions involved and the thinking behind this analysis info@mena-advisors.com). We have included Jordan and Lebanon in this analysis as they have pegged currencies and have received support from GCC sovereigns.





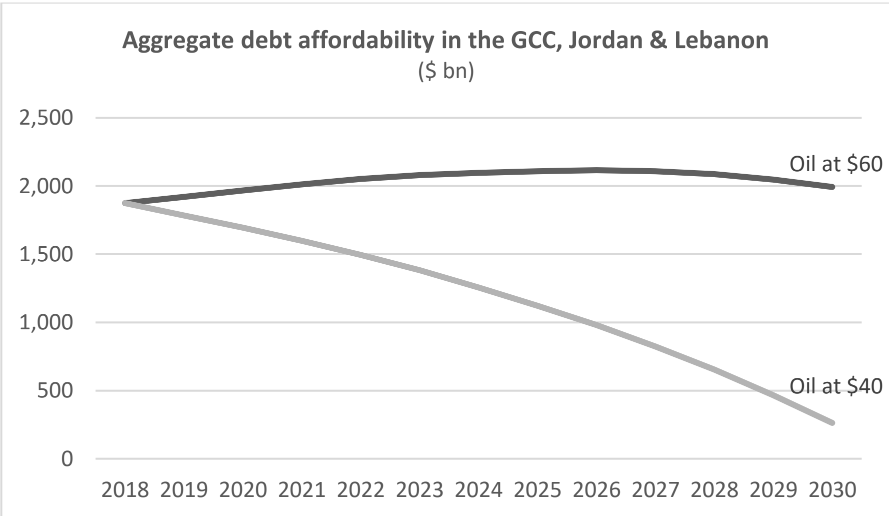
The analysis shows that, with oil at $60, the pegs in Bahrain, Jordan, Oman and Lebanon are already under threat and are likely weaken by 2030 under both scenarios. These countries would probably have already lost access to international debt markets and been forced to devalue their currencies if they had not received support from the larger GCC economies:

- Bahrain received support in October 2018, from Saudi Arabia, Kuwait and the UAE in the form of a $10bn aid package after investors began to worry whether it could service maturing debt. It earlier cancelled a bond issue in March 2018 amidst weak demand and was only able to make a $500m insurance in October by placing it with supportive Gulf banks.

- Jordan received a $2.5bn economic aid package from Saudi Arabia, Kuwait and the UAE in June 2018 and Saudi Arabia deposited $334m in the central bank in early March 2019.
- Oman has recently sharply cut back on plans to issue debt in 2019, switching to asset sales instead. While it has not received any recent aid, it did get US$10bn in GCC grants after the Arab Spring.
- Lebanon received $500m from Qatar this year and Saudi Arabia is expected to provide more than $3bn in aid.

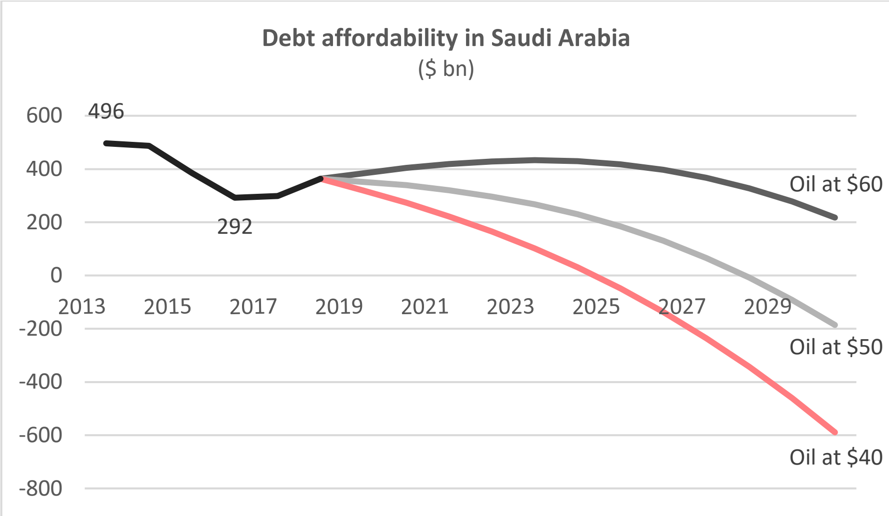
With oil at $60 the wealthier four Gulf states can probably continue to support the others out to 2030, providing political disputes don't get in the way. However, with oil at $40, Saudi Arabia's ability to defend even its own peg would be severely diminished by 2030, let alone its ability to provide support to other countries. UAE, Kuwait and Qatar are not threatened so much under the low oil price scenario because of their huge reserves, but they would have substantially less firepower with which to support other countries.

Looking at the region in aggregate (chart below), it is evident that the assets available to support the weak links among the region's pegged currencies would fall very sharply in the $40 oil price scenario to close to zero by 2030. In this scenario, access to international debt markets across the region could become restricted due to concerns about debt affordability. Qatar, Kuwait and the UAE would be the only economies likely to maintain access to international debt markets, but their ability to provide support to the rest of the region would be limited.



For the purposes of this exercise, in the $40 oil price scenario, we have assumed that spending plans and growth remain the same as in the $60 scenario. In reality, governments would likely cut spending and raise taxes, leading to lower imports, thereby helping conserve foreign assets. Over time, the likelihood of currency devaluations would increase, but this would probably be the last resort.

This analysis, therefore, provides useful insight into Saudi Arabia's ability to afford its ambitious spending plans to diversify the economy, such as the $426bn National Industrial Development Programme, for which $54bn in deals over 10 years were signed in January, or the $500bn new NEOM city on the Red Sea coast. With oil at $60, Saudi may have some capacity for such large spending plans (see chart below) but with oil at $50, spending plans would become severely restricted by 2028 and with oil at $40, Saudi only has around 5-6 years to implement its diversification plans. From 2013 and 2017, Saudi Arabia's net foreign assets fell by around $200bn. With debt affordability of around $300bn today, Saudi's spending plans would be dramatically curtailed if the recent oil price shock was repeated.



We may have witnessed a premonition of this scenario in the last few months. Saudi Arabia's most recent budget for 2019 was based on an oil price of approximately $80, which would have led to a deficit of around $30bn. With current oil prices closer to $60, the same spending plans would lead to a deficit nearer $70bn, which would have to be largely financed through debt. Saudi is likely to hold back on spending plans in order to achieve a lower deficit than this.

Conclusion

With oil at $60, the GCC is likely to comfortably retain access to international debt markets for the next 10 years and longer. However, oil prices at $40 for a sustained period would spell trouble for the GCC. Access to debt markets would become restricted, fiscal adjustments would be necessary and the risk of currency devaluations in the region would increase substantially.

This scenario is not inconceivable with new technology, such as electric vehicles and renewable energy, likely to have demand and supply impacts that are negative for oil prices. On the demand side, the accelerating adoption of electric vehicles and efficiency gains across the transport sector are likely to lead to a plateau in demand in the best case. Meanwhile, improving extraction techniques could make new sources of oil available at low prices.

We plan to periodically update this analysis to keep a track on the long-term outlook for debt affordability in the GCC, especially if oil prices come under sustained pressure.