Market Insights & Strategy
Global Markets

The Saudi Arabian Riyal Conundrum
Time To De-Peg Or Not?

Offshore speculation that Saudi Arabia may soon have to either abandon, or at the very least loosen its currency's long-standing peg to the US dollar has increased considerably over the past 12 months, driven in the main by concerns that the sharp fall in oil prices and its consequent effect on the Kingdom's economy would eventually force such a move in order to prevent a dramatic fall in FX reserves. This view is understandable when you consider the fact that the country recorded a budget deficit last year of 16% of GDP, that its break-even price of oil was around US$100 per barrel in 2015 against US$65 in 2012, and that in Real Effective Exchange Rate Terms (REER), the Riyal is overvalued by around 16% in comparison to the currencies of Saudi Arabia's main trading partners. Thus this speculation, which gathered pace recently due to geo-political concerns following a jump in tensions between Saudi Arabia and Iran last week, is likely to continue for the time being, especially as the outlook for energy prices this year remains bleak.

The overall size of the market's short SAR positions currently is difficult to estimate exactly; however volumes whilst still large do not yet appear to be quite as big as those we saw during 2007 when players were betting on a revaluation rather than a devaluation of the SAR. Speculators are also forced to access the offshore SAR market for liquidity as offshore banks are not able to buy or sell USD/SAR at the official rate of 3.7400/3.7500, and more punters are using options to place their bets this time around, rather than holding outright forward FX positions.

So the question is could a devaluation or "de-pegging" occur? From our point of view we do not anticipate either event in the near to medium term, the Central Bank still has a considerable war-chest of reserves to defend the currency for an extended period of time and as per a strongly worded statement published on the Saudi Arabian Monetary Authority's website earlier today, has publically committed to do so. In addition to this the country's debt to GDP ratio is very low (2%) and more importantly it also has various other resources (aside from bond issuances) which it can utilize to ensure that the budget deficit is contained, such as the sale of state-owned assets, the implementation of taxes, and a reduction in public spending including subsidies. In fact these very important policy steps have already begun to be implemented and discussed, highlighted by the decision late last year to hike petrol prices by 50% from SAR 0.60 per to 0.90 per litre and last week's semi-official confirmation that certain downstream subsidiaries of its crown jewel, Saudi Aramco may soon be listed. Such decisions should also help the country maintain its AA investment rating.

In conclusion while the peg should remain unchanged this year (as it has done since 1986), speculation will most probably continue and so the forward curve in particular is likely to remain under pressure. So far the 1 year USD/SAR FX swap points have traded as high as 1000 (see graph on following page) before dipping back again, but another attempt at this level in the days and weeks to come is likely.

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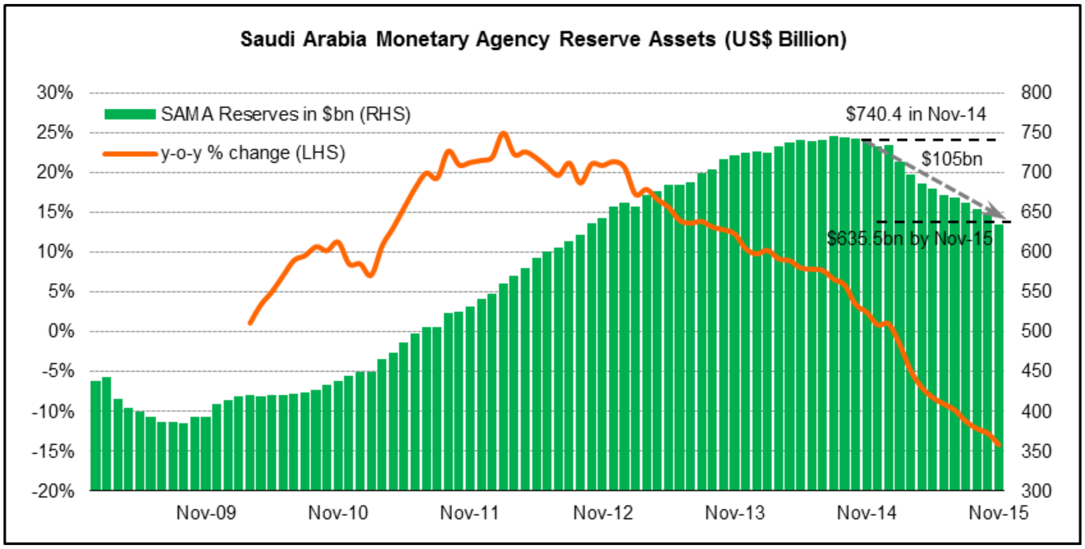
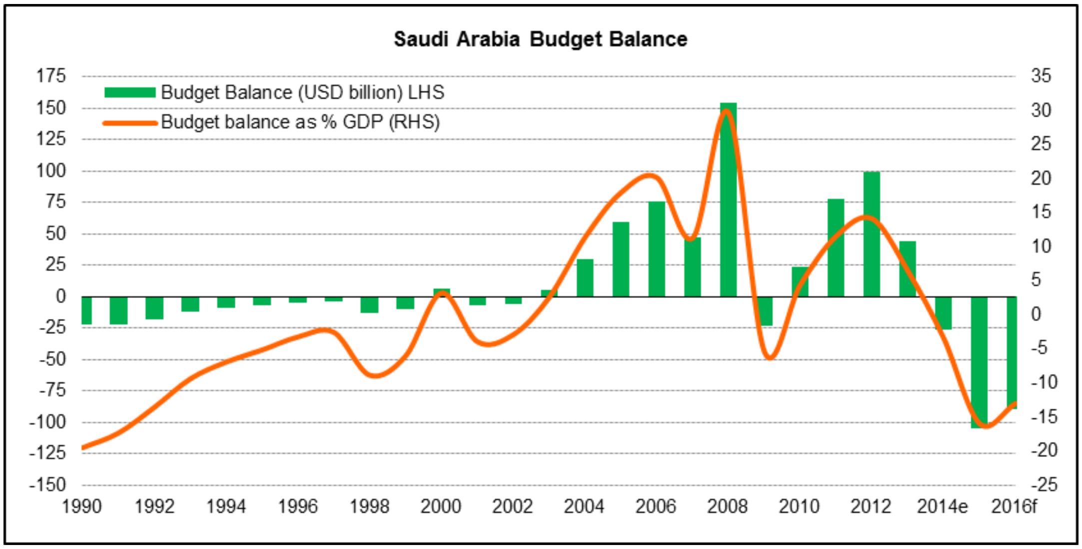
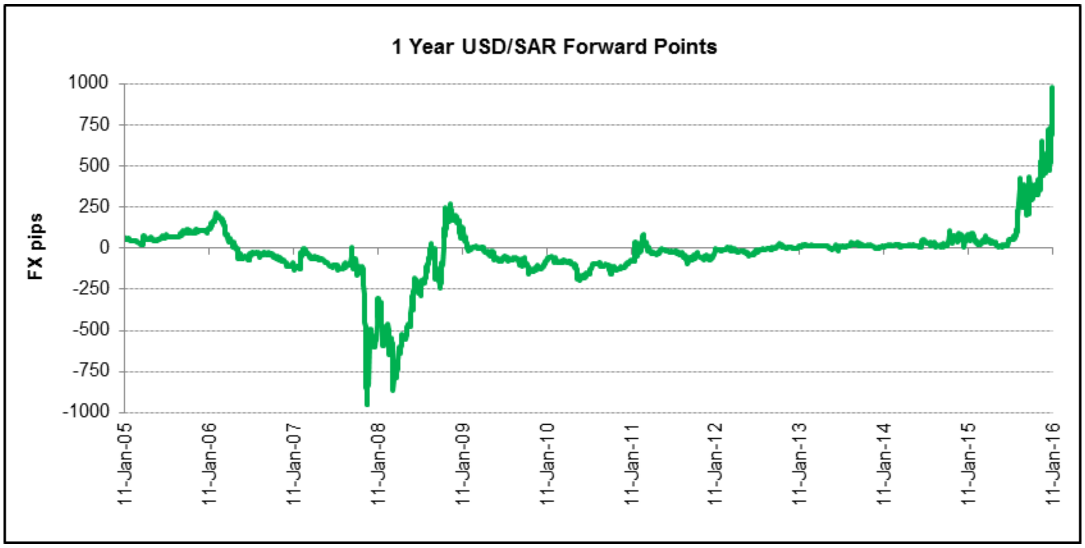

Saudi Arabia Monetary Agency Reserve Assets (US$ Billion)
SAMA Reserves in $bn (RHS)
y-o-y % change (LHS)
$740.4 in Nov-14
$105bn
$635.5bn by Nov-15
30%
25%
20%
15%
10%
5%
0%
-5%
-10%
-15%
-20%
800
750
700
650
600
550
500
450
400
350
300
Nov-09
Nov-10
Nov-11
Nov-12
Nov-13
Nov-14
Nov-15


Saudi Arabia Budget Balance
Budget Balance (USD billion) LHS
Budget balance as % GDP (RHS)
175
150
125
100
75
50
25
0
-25
-50
-75
-100
-125
-150
35
30
25
20
15
10
5
0
-5
-10
-15
-20
-25
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008
2010
2012
2014e
2016f


1 Year USD/SAR Forward Points
FX pips
1000
750
500
250
0
-250
-500
-750
-1000
11-Jan-05
11-Jan-06
11-Jan-07
11-Jan-08
11-Jan-09
11-Jan-10
11-Jan-11
11-Jan-12
11-Jan-13
11-Jan-14
11-Jan-15
11-Jan-16

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