FX

TRADING IN THE MIDDLE EAST

2016 REPORT

Bloomberg


PAK DATA

MIDDLE EAST FOREX: AN EVOLUTION

The region's nascent forex sector has enjoyed massive growth in recent years, but obstacles – such as the current liquidity crunch – remain

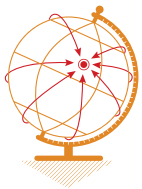
The Middle East's foreign exchange industry has evolved rapidly over the past few years. Starting from a rather negligible base, the sector has thrived thanks to a low-yield environment and growing investor appetite.

According to figures from the Bank for International Settlements (BIS), trading in forex averaged $5.3 trillion per day in April 2013, with the Middle East's retail currency market accounting for 8 per cent of the global amount.

It is a significant share given the region was a late adopter of forex as an asset class. The industry was still in its infancy just a decade ago, with investors looking primarily to real estate and equities to hedge deal transactions.

With the rise of the regional equity markets, which served as the foundation for alternative investment products in the Gulf Cooperation Council (GCC) region, interest in forex began to take hold. But it was only after the 2008 global financial crisis that investors recognised that forex provided better returns than other asset classes.

"The number of users of FXGO, our electronic trading platform for FX, increased by 30 per cent in the Middle East in 2015," says Tod Van Name, global head of FX and commodities electronic trading at Bloomberg. "By comparison, our global user base increased by 16 per cent year on year to over 10,000 users. We have also seen high double-digit growth in volumes in the Middle East, with an 80 per cent increase in the number of trades over the past two years."



$5.3

trillion: daily trading levels in forex, of which the Middle East accounts for 8% (April 2013)

Source: Bank for International Settlements

80%

trade volume growth in the Middle East, on FXGO over the last 2 years

Source: Bloomberg

> **Growth has been driven by increased investor awareness and the region's strategic location between Asia and Europe**

Strategic growth

While forex inflows and outflows did not account for much five years ago, today, traders across the GCC trade the same products as their counterparts in London or New York. The sector has experienced trade volume growth of more than 50 per cent year on year since 2011.

"The Middle East's importance is rapidly growing in the global forex market, especially with its retail segment, compared to a relative slowdown and decline in other global markets," says Anthony Hobeika, chief executive officer at MENA Research Partners.

This growth is largely driven by increased investor awareness of the opportunities available in forex as well as the region's strategic location between Asia and Europe. The local time zone enables it to capture market opening hours in the Far East as well as US closing hours in the same working day, giving it better access to the wider global market, particularly the G7 currencies.

"The GCC is a major corridor for global FX flows and we have seen an ever-increasing number of players in the market, as well as consistent growth in the number of people transacting in FX," says

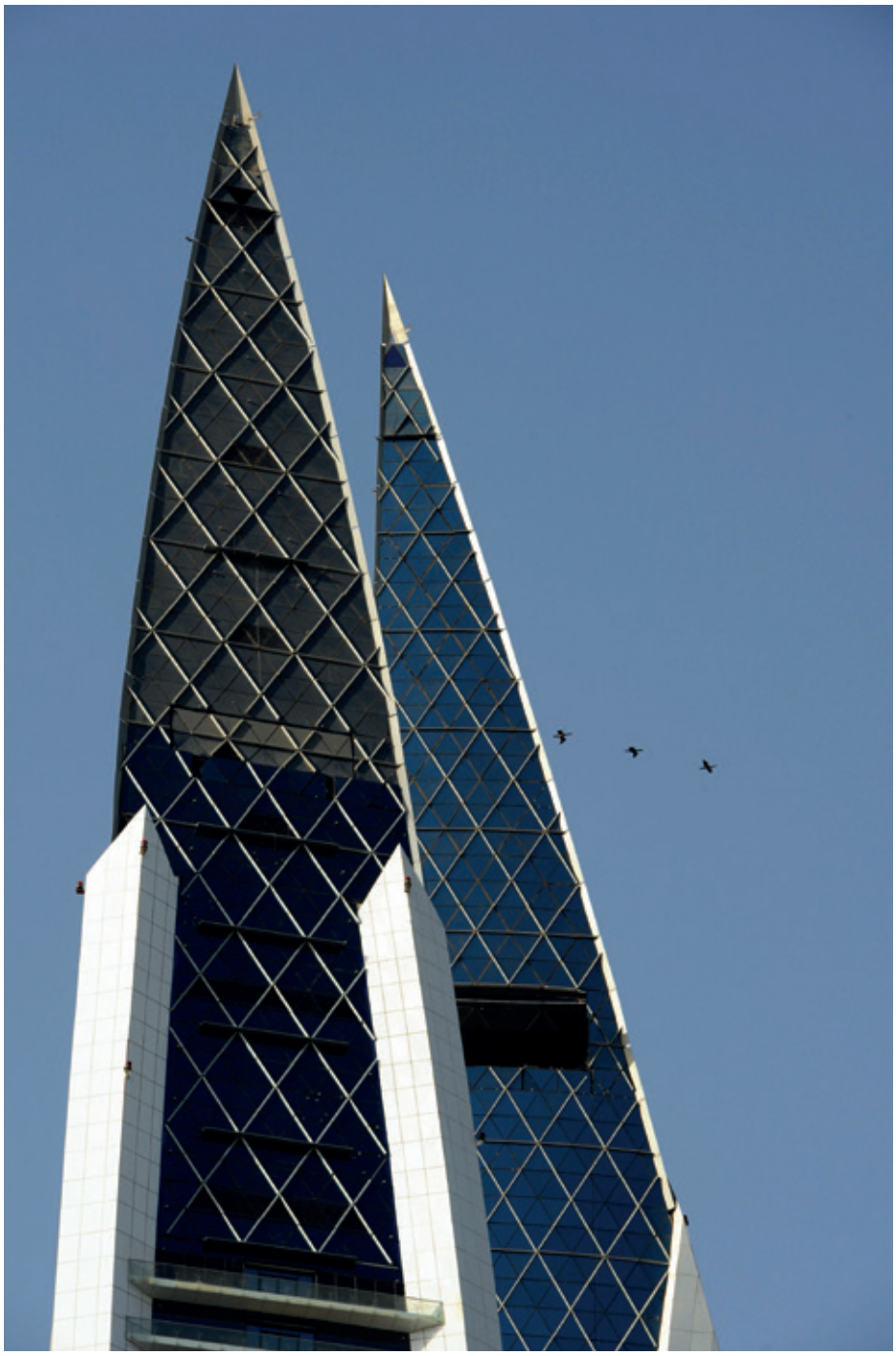
Gifford Nakajima, head of wealth development for Middle East and North Africa at HSBC.

Dubai essentially led the way in establishing a burgeoning forex market, investing in the necessary infrastructure and creating a financial sector that has come to serve as a regional hub for many international institutions. The creation of the Dubai Gold and Commodities Exchange (DGCX) helped cement the emirate as the regional centre for financial trade and has attracted many international investors and firms.

"Given the strong growth of the UAE economy and the increasing number of expats coming to live and work here, we have seen FX transactional flows rising, both in and out of the country," says Nakajima. "Even in terms of the broader region, Saudi Arabia and the UAE are among the top three remittance markets globally."

DGCX is now the biggest pool of the Indian rupees (INR) offshore futures market, with the value of the INR traded on the exchange exceeding $1.5 billion per day in 2015.

Compared to other markets, the region's low-yield environment combined with low risk appetite has attracted more investors towards forex, mainly safe-haven currencies such as JPY and XAU (gold). The most popular currency pairings in the region are EURUSD, GBPUSD, XAUUSD, EURJPY and XAGUSD.



Liquidity concerns

However, the region is currently facing a liquidity crunch. With economies heavily dependent on oil, the volatile price over the past 18 months has affected both the equity markets and the local banking sector, which are now allocating risks to asset classes away from forex.

The geopolitical situation in the Middle East is causing a great deal of uncertainty, as are issues in the Eurozone and the possibility of a Brexit, which are impacting both the Euro and British sterling. Last year, the Swiss National Bank's decision to stop supporting the Swiss Franc sent shockwaves around global forex markets, including the Middle East.

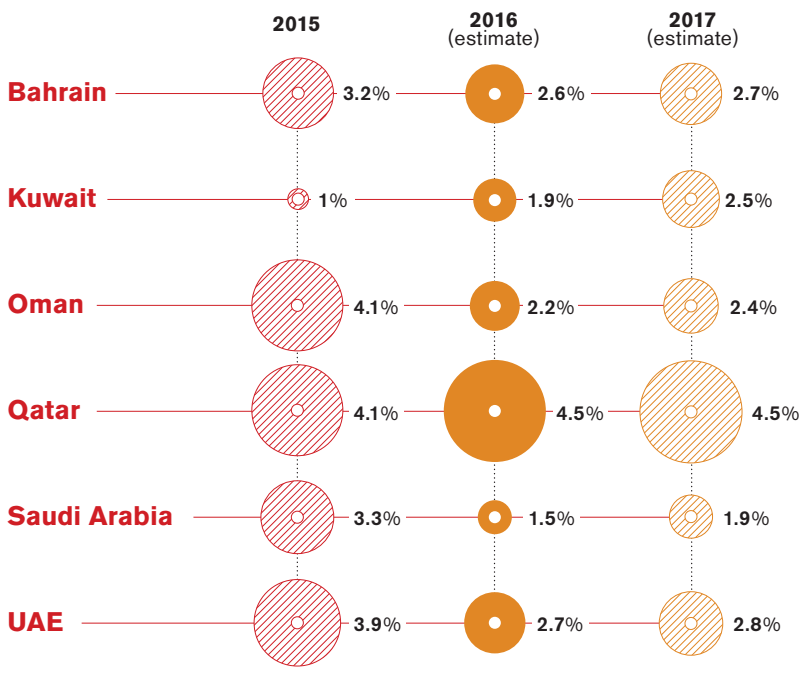
The failure of the participants of the Doha Accord to reach an agreement on capping oil production has led to further drops in the price per barrel and will increase pressure on the regional forex pegs. But besides the volatility in oil prices, the lack of new deposits in local banks and enforcement of US regulations to prevent tax avoidance and money laundering have fed into the liquidity crunch, limiting access to USD in the local currency markets.

> **"The region's low-yield environment combined with low risk appetite has attracted more investors towards forex"**

Moreover, US banks have declined business with foreign institutions to prevent these extra costs, which prompted the central bank governors of the UAE and Bahrain to publicly state that it has become more difficult for some local banks to conduct US dollar transactions.

Saudi Arabia and Kuwait's move to stifle speculation against the riyal and dinar respectively in the forwards market also fed into the liquidity

REAL GDP IN THE GCC (YOY%)



Source: Bloomberg

issues. In January, Saudi's central bank urged banks to avoid conducting derivatives trades that would pressure the riyal. Then in February, Kuwait's central bank stepped in to manage movements in its daily dinar fixing to deter speculation. These measures led to a dip in forex trading activities as speculation fell and foreign banks began to supply fewer dollars.

Call to depeg

Such pressures have led to calls to depeg local currencies from the dollar. Currently all GCC countries except Kuwait have their currencies pegged to the dollar. The peg previously enabled a low-yield environment, which promoted safer investment and encouraged growth of the forex sector.

But the current economic and geopolitical environment has resulted in an instability that threatens the peg's future.

"With many oil-rich governments drawing on their foreign reserves, defending the currency pegs could become – although a long way still lays ahead – at stake more than ever," says Hobeika. "This is creating a number of opportunities of actively trading the regional currencies and furthering the depth of its market."

The peg has enabled the region to keep inflation low, simplify trade and financial transactions, and reduce uncertainty during times of volatility, both politically and economically.

"We think that there are three aspects to consider when evaluating the future path of FX policy in the GCC: willingness, desirability and ability to maintain the USD pegs," says Jean-Michel Saliba, Middle East and North Africa economist at Bank of America Merrill Lynch. "We believe all GCC countries share a willingness and commitment to maintain FX policies."

The USD peg has served the GCC well for decades by "providing a nominal anchor to the economy and expectations," Saliba adds. "The literature suggests the optimal choice of an exchange-rate regime should yield external and international stability, preserve monetary credibility and competitiveness and reduce balance-sheet risks and transaction costs."

So while it is becoming costly to maintain the peg, it is providing a level of stability for the wider economy, while many of the GCC member states have enough foreign assets and reserves to mitigate the pressures of the peg.

Ongoing challenges and opportunities

While growth is still expected, the industry is facing many challenges and there is a need for more market regulation. For now, the lack of liquidity and central bank interference remain the biggest threats.

But there is hope by way of economic diversification. Over the past few years the GCC has invested billions in making their economies less reliant on oil. The UAE – in particular, Dubai – is the most convincing example.

"The fall in oil prices has had an impact, which has been mitigated by the continued growth of other sectors of the economy such as manufacturing, construction and tourism," says HSBC's Nakajima. "The countries receiving remittances from the UAE have benefited from lower oil prices and the corresponding strength of the US dollar has resulted in an increase in real estate investments abroad as well."

Investment in technology and electronic forex platforms also provide local investors access to both international and regional liquidity, moving away from local banks that have come up against deposit outflows.

Just as equity markets have developed a range of linked investment vehicles, the same, it seems, is happening in forex, as interest grows and new products are bound for the region.

Another growth area is in Sharia-compliant forex trading, amplified by the increased availability of Islamic trading products.

"For example, swap-free accounts are considered Sharia-compliant, giving access to forex trading without compromising Islamic principles," says Hobeika.

Demand for Sharia-compliant products comes mostly from the retail sector. But it is still in its infancy when compared to Islamic banking and may take many more years before it can compete with conventional forex in the region. ◆

For now, the lack of liquidity and central bank interference remain the biggest threats

THE STATE OF FX IN THE MIDDLE EAST: WHAT NEXT?

The low oil price combined with tying GCC currencies to the dollar is proving ever more costly for Gulf states. What are their options?

This June, Saudi Arabia will mark the 30th anniversary of tying its currency, the riyal, to the US dollar. The kingdom's peg has endured two periods of plenty: from 1973 to 1979, when OPEC discovered its power to set prices; and 2003 to 2014, when China's demand for commodities sustained growth in oil prices. It has endured one era of low oil prices, from 1986 to 2001, by tightening its belt and committing solidly to the riyal.

Dollar dolour

But this time could be different. The collapse of the oil price, from a peak of $110 per barrel (WTI) in June 2014 to below $30 early in 2016, has touched every aspect of economic policy in the Gulf. According to the International Monetary Fund (IMF), the region lost more than $360 billion in government revenues in a single year due to the oil price tumble. That's likely to get worse this year.

"The Gulf is passing through the biggest trade shock it has ever experienced," says Simon Williams, chief economist for central and eastern Europe, Africa and the Middle East at HSBC.

Current account surpluses are turning to deficits as the revenue earned from oil sales falls. That's leading to net outflows of foreign exchange, as importers trade domestic foreign currency holdings for goods.

Meanwhile, the US Federal Reserve has increased interest rates to 0.5 per cent and expects to lift the cost of borrowing further to 1.375 per cent by the end of 2017. That is increasing borrowing costs in the Gulf states, which are forced to raise interest rates in line with it. Local banks are already struggling as government-related entities withdraw deposits. That is making Gulf banks less willing to extend credit, according to Standard and Poor's (S&P). The economic cycles of the US and the Gulf are out of sync, with the US economy recovering slightly while the Gulf edges closer to recession.

$360
billion: lost government revenues due to fall in oil prices in 2014

$115
billion: value of forex sold by SAMA from beginning of the oil price fall

Source: Bloomberg

"Since monetary policy has to take into account the peg to the dollar, it cannot be used as effectively to address the needs of the domestic economies," says Christian Esters, senior director of S&P's sovereign ratings group.

Despite an agreement between Saudi Arabia and Russia to maintain oil production at current levels, the oil market is unlikely to rebound much. Haemorrhaging cash to defend the overvalued Gulf Cooperation Council (GCC) pegs has therefore come into question.

The riyal unbound

Countries that run successive current account deficits while keeping their currencies fixed have a choice: they can spend foreign exchange reserves to prop up the value of their domestic currency, or they can reprice their currencies and stop the outflow of foreign assets. The Saudi Arabian Monetary Agency (SAMA) has pursued the former course, and has sold at least $115 billion of forex since the beginning of the oil price fall, according to central bank data.

"Maintaining a fixed exchange rate against the dollar has become, more than ever, a costly option for the GCC governments," says Anthony Hobeika, chief executive of MENA Research Partners. "Their large accumulated foreign currency reserves could dry up quicker than expected if low oil prices remain over a longer period of time."

Devaluation would help to back the outflow of central bank-held dollars and would increase government revenues, reducing the need to draw down on the Gulf's foreign assets. With most Gulf states set to run double-digit fiscal deficits this year, that could be much more attractive than transferring cuts to public spending. Oil sales are priced in dollars, and a cheaper domestic currency would mean that oil revenue would go further.

"As the bulk of government revenues in the GCC are derived from oil, which is sold in US dollars, devaluation would raise the local currency value of the Government's receipts," says Jason Tuvey, emerging markets economist at London-based research house Capital Economics. "All else equal, this would narrow budget deficits and ease pressure on policymakers to tighten fiscal policy."

It would also help to cut down on imports, while increasing the competitiveness of exports, Tuvey says. In the long run, this could help Saudi Arabia's diversification efforts, which have so far been "limited", in the view of the IMF. The kingdom has diversified into downstream petrochemicals and minerals – the price of which also moves in step with the oil price, meaning that these sectors do little to end dependence on commodity cycle fluctuations.

They meant it first time

Despite financiers' willingness to hedge against devaluation on riyal forwards markets, economists do not seem to think that Gulf states would benefit much from devaluing their currencies.

"Currency pegs are going nowhere," says Williams. "My strong expectation across the GCC is that you will see no change in the nature of the currency regimes, either in terms of the peg or the value of the peg."

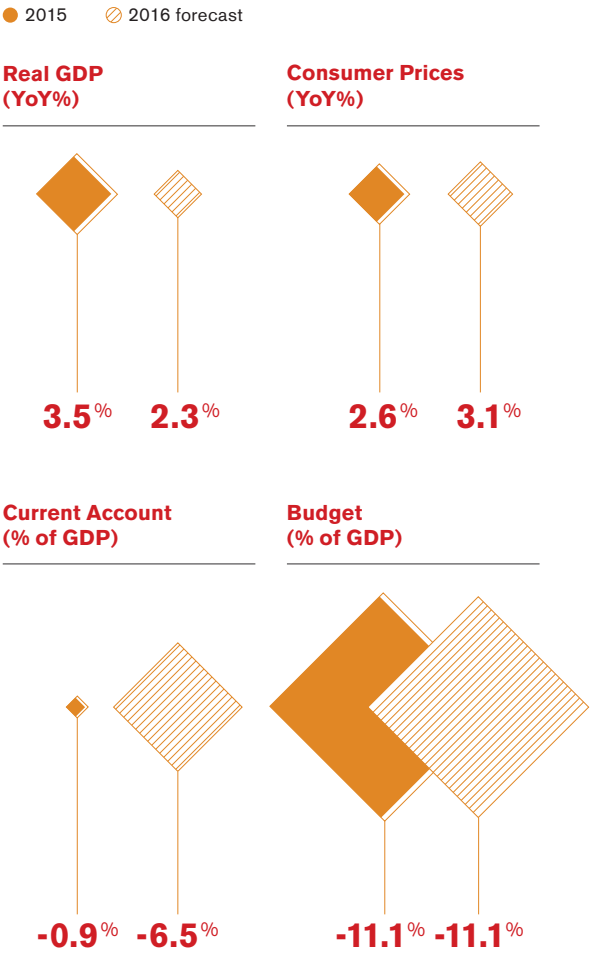
The reason for this, he says, is that all the other options are worse. "Policymakers in the Gulf look at the experiences of Russia, Turkey and South Africa", where floating currencies have coincided with major drops as commodity prices fall, "and the peg gives them significant advantages in comparison".

If the Gulf states abandoned the peg during a time of low oil prices, the credibility of governments' commitment to their currencies would be questioned when economic circumstances changed.

"The next time oil prices rise or fall there would be expectations of further adjustment," Williams says. "That would lead to expectations from offshore and great uncertainty at home."

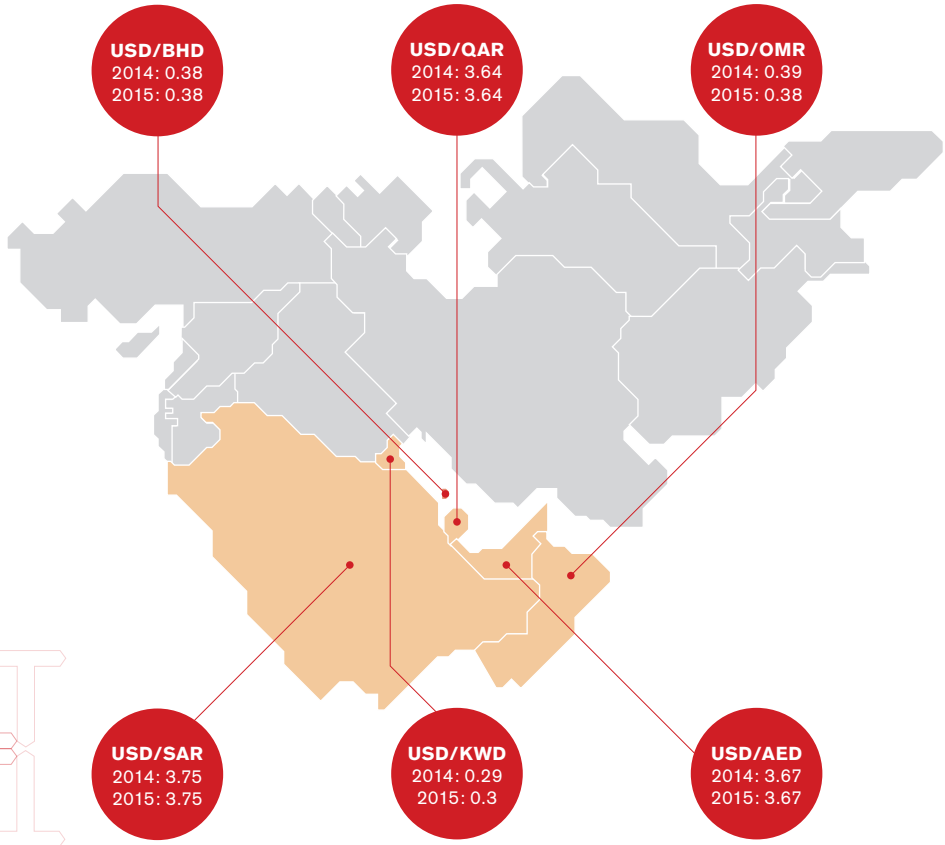
> **The Gulf is passing through the biggest trade shock it has ever experienced**

GCC REGIONAL COMPARISONS



Source: Bloomberg

GCC EXCHANGE RATES AT A GLANCE



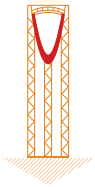
Source: Bloomberg

The peg therefore provides predictability and certainty for investors and policymakers. A fixed currency means Gulf states can read off their future budget revenues from the oil price – so if oil is at $50, Gulf states know exactly what oil revenues will be.

Moving away from the peg would have "material negative effects on the stability of Gulf economies," says Hobeika, by undermining the credibility of their future monetary policies and encouraging high domestic inflation as import prices rise.

"Investor appetite towards both the GCC and the Middle East would likely come under severe threat, and there could be political implications too if the currency peg was abandoned," says Jameel Ahmad, vice president of corporate development and chief market analyst at FXTM. There would be the potential for "aggressive punishment" in the regional equity markets, which would weaken the local currencies and drive up costs and inflation.

While GCC countries are spending large amounts to shore up their currencies, they can afford to do so. Saudi Arabia still has $600 billion in foreign reserves, despite burning through $115 billion in 2015 alone. The UAE holds foreign assets equivalent to more than 225 per cent of its gross domestic product (GDP), according to the Sovereign Wealth Fund Institute. Qatar, the world's largest liquefied natural gas exporter, continues to run current account surpluses. Kuwait, having abandoned its peg in 2007, is not under pressure to switch away from its trade-weighted currency basket.



$600

billion: value of Saudi foreign reserves current value

Source: Bloomberg

> **Maintaining a fixed exchange rate against the dollar has become, more than ever, a costly option**

It is only Oman and Bahrain, which lack the vast foreign holdings of their peers, that have greater need to worry. Though Saudi riyal forwards markets have calmed following SAMA's request to lenders to stop selling options in the currency, Omani rials have now become the focus of financiers. S&P has described Oman and Bahrain as the two states most vulnerable to the oil price drop.

For them, says Tuvey, the question is less about the desirability of the peg, and more about economic reality.

"Devaluation wouldn't produce much benefit," he says. "Whether they get pushed towards it is another matter. If there was any sign that they were in severe trouble, other Gulf states would step in with some form of financial support."

Oman and Bahrain have already been promised $10 billion in aid, agreed during the Arab Spring, to be distributed up to 2021. For now, both are hoping that the strongly worded statements of their central bank governors will prevent speculators from rounding on their currencies.

But, as the situation currently stands, Oman is the weakest link in the GCC and its peg may come under pressure at some point this year. ◆

The options

Devaluation
Gulf states could reduce the value of their currencies relative to the dollar. This would boost oil revenues, encourage exports, cut the rate of foreign asset depletion, and encourage diversification. But Gulf states worry that this would undermine the credibility of future currency pegs.

A basket of currencies
The Kuwaiti dinar, the only currency in the region that is not pegged exclusively to the US dollar, is tied to a basket of currencies. Its value fluctuates in line with the dollar, euro, yen and pound. The dinar has not appreciated as quickly as the dollar, meaning that currency effects have offset some of the collapse in oil prices. This approach means that final oil revenues may vary depending on currency prices, which makes budget planning harder.

Floating rate
Currencies that may freely change in value should never require central bank intervention. They should help to move current account deficits and surpluses to balance, while keeping exports competitive. But they are prone to sudden fluctuations, which can have big domestic consequences. Local asset prices will change in line with the currency, which can be bad news if oil prices move significantly.

ISLAMIC FINANCE: TRADING ISLAMIC DEPOSIT AND THE LOWER COST OF FUNDING

As traditional banks in the GCC are increasingly stymied by the region's economic woes, many investors are turning instead to Islamic finance

The Gulf Cooperation Council (GCC) is facing a tightening liquidity problem. Fiscal deficits across the region are expected to grow this year as uncertainty over the oil price continues. And yet despite the waning economic outlook, Islamic finance is set to grow this year, albeit slower than before.

According to Standard and Poor's (S&P), Islamic finance assets worldwide currently exceed $2 trillion with the GCC accounting for 70 per cent of that. Within the next decade, this value is expected to grow to $3 trillion. Growth has averaged 10 to 15 per cent over the past ten years. But this pace will prove to be unsustainable as oil prices remain depressed, changes in global regulatory framework for banks and insurance companies take place, and the fragmented nature of the industry itself prevents it from achieving true global coverage.

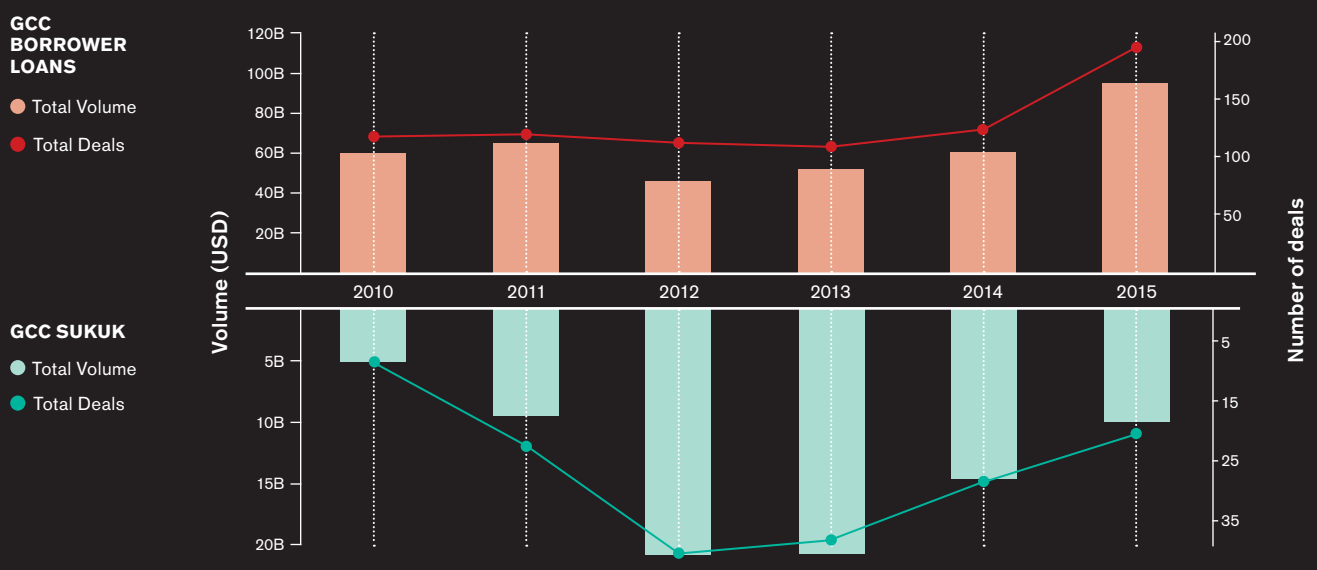
> **Islamic banks have been able to rely on their retail customer base, which is proving to be a more stable source of deposits**

"We expect liquidity to drop in 2016 in the GCC and that goes for Islamic banks and conventional ones," says Mohamed Damak, global head of Islamic finance at S&P. "The reason why is the Government and government-related entities are among the top depositors in the GCC banking system."

Given the falling oil price, which dropped from about $100 to $30 in the space of 18 months, there has been a reduction in the inflow of deposits from such government entities into the banking system.

"This will result in scarce liquidity in the system and it will probably increase the cost of funding for corporates and result in higher selectiveness

GCC SUKUK VS BORROWER LOANS



Source: Bloomberg

from banks, especially for long-term projects," says Mr Damak.

Islamic banks' advantage

The major conventional banks in the region have been hit hard with state withdrawals over the past few months to bridge budget shortfalls. But the Islamic banks have been able to rely on their retail customer base, which is proving to be a more stable source of deposits for now.

"Islamic banks, in comparison to conventional banks, do not borrow in interbank markets," says Mamoon Abdel Kader, head of Islamic banking at CBI. "Instead, their funds come from their own deposits… [and they] have not been engaged in collateralised debt obligations to hold interest-bearing securities."

This makes Islamic banks more attractive to investors, especially since they have more resilience to liquidity crises, given the lack of exposure to non-value assets. Islamic products and investment, when compared to their conventional peers, are relatively secure.

Moreover, the GCC countries are under pressure to maintain their capital spending and in doing so could look for alternative financing options. Islamic finance is well suited for infrastructure financing.

"We continue to see Islamic banks being active on real estate and construction financings, which are well suited for Sharia-compliant finance structures," says Sandeep Puri, partner at law firm Baker & McKenzie.

This has resulted in an increase in issuance of sukuk or Islamic bonds, which is one way to deal with the liquidity issues. Islamic accounts tend to buy and hold, and benefit from a strong secondary market performance that is less immune to sell-offs when compared to conventional bonds. In volatile markets, such a steady secondary market is advantageous. Sukuk can target better pricing of 5–10 basis points compared to bonds.

"What we have seen in the last couple of years is Islamic banks shoring up their tier-one capital through the issuance of sukuk to bolster their capital base," says Puri.

The likes of Majid Al Futtaim and Arab Petroleum Investments Corporation (APICORP) were able to raise vast funds through sukuk issues. Qatar Islamic Bank managed to raise $1.75 billion for its $750 million five-year deal in October last year. Most recently, APICORP celebrated its $500 million sukuk listing on the Dubai Nasdaq for its $3 billion sukuk programme.

One advantage that Islamic banks offer is being able to draw from two separate investment pools. As liquidity problems increase the cost of funding, many will be driven to diversify their funding and issue sukuks. Islamic bonds are currently capturing some 50 per cent of the regional fixed-income issuances.

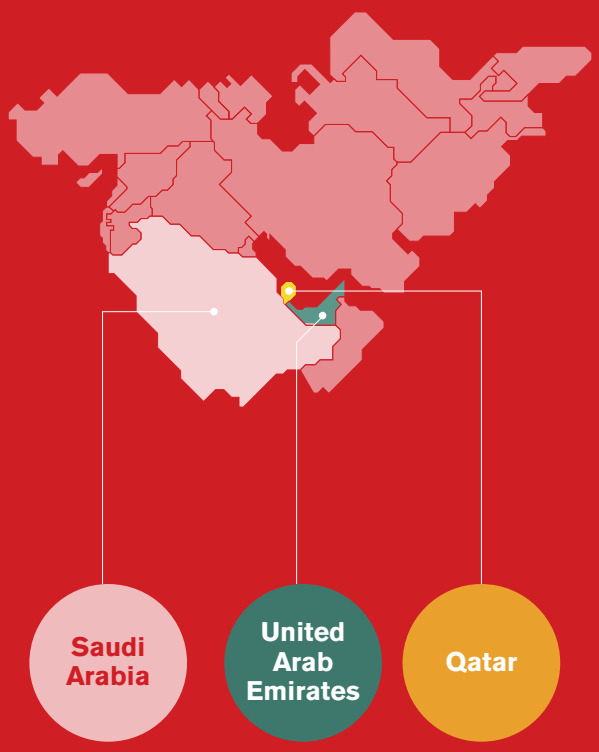
But the sector is not entirely immune. The global economy and local markets continue to change, which is having an impact on the banking sector.

"We have certainly seen some changes in lending trends over the last few months," says Puri. "The global economy and markets are changing and that's having an impact on the regional and local banks and economy, and I expect we will see further changes this year." ◆

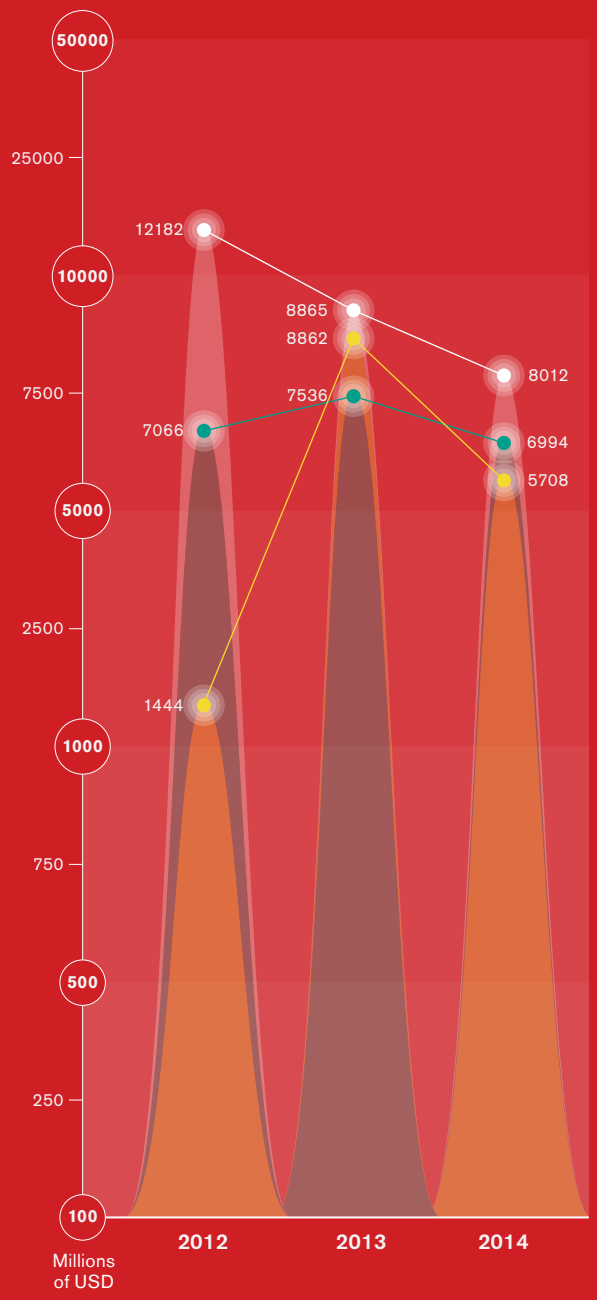
over $2 trillion: Worldwide Islamic finance assets
Source: KFH Research Limite

Islamic bonds are currently capturing some 50 per cent of the regional fixed-income issuances

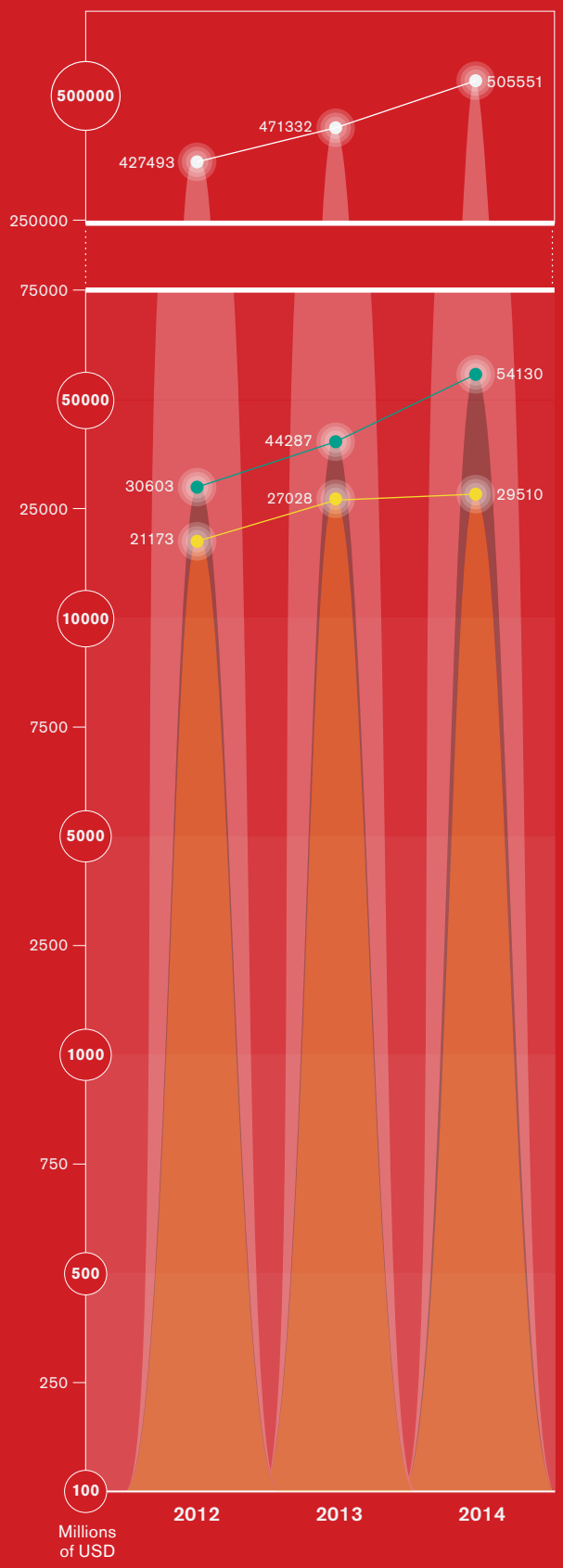
MAPPING REGIONAL ECONOMIES



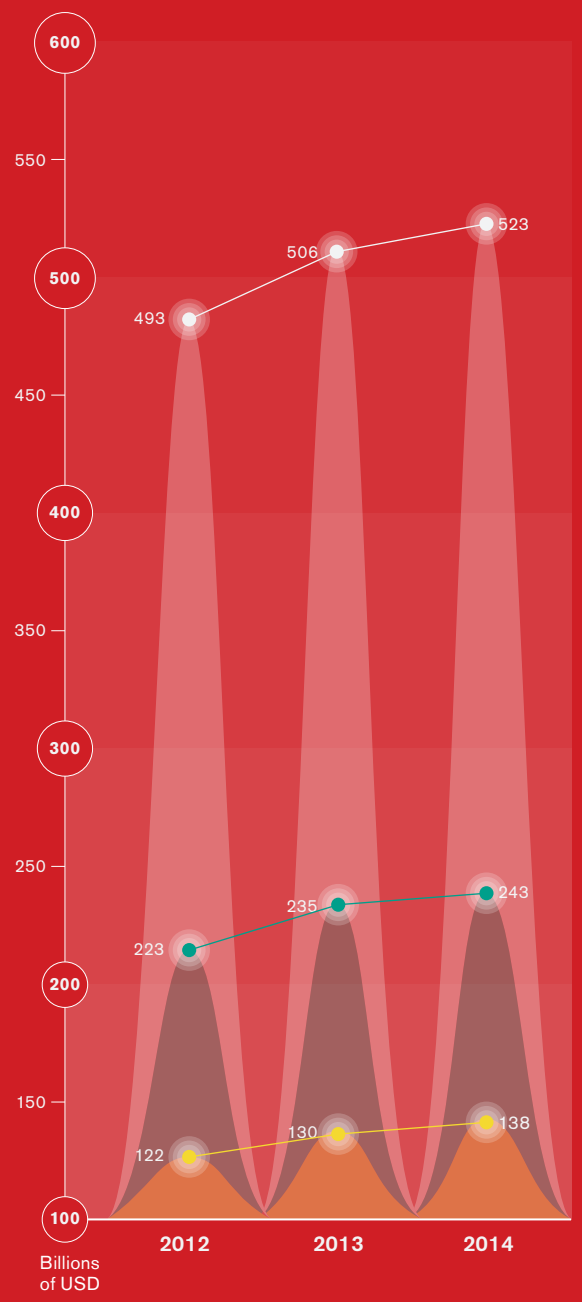
FOREIGN DIRECT INVESTMENT FLOW



INTERNATIONAL RESERVES



GDP



Source: Bloomberg

SAUDI ECONOMY IN THE BALANCE

The Saudi economy is likely to experience an economic downturn in 2016 and 2017 as the Government seeks to adjust its spending to lower oil revenues. While the authorities will continue to run down external assets to fund the budget, they are also seeking to reduce the fiscal deficit to support longer-term sustainability

Key Points

- Oil production should give less support to growth in 2016, while fiscal consolidation is likely to weigh on the non-oil economy.
- As a result, real GDP growth in 2016 may drop sharply from an estimated 3.4 per cent economic expansion in 2015.
- Boosting energy efficiency, increasing labour force participation and raising productivity are among measures that could be taken to boost growth.

A sharp fiscal contraction could push the Saudi economy into a recession in 2016, especially if it is combined with a decision to support oil prices through a cut to output. However, there are measures the Government could take to improve the longer- term outlook for growth and fiscal sustainability. These include improving energy efficiency, raising labour-force participation, boosting productivity and devaluing the riyal.

The Saudi economy is likely to suffer significantly this year as oil production stagnates and fiscal consolidation weighs on domestic demand. Should the majority of cuts to government spending presented in the 2016 budget be implemented, as seems likely, this could push the economy into its first contraction since 1999. The risk and severity of the economic downturn could increase if Saudi Arabia agrees with OPEC partners and Russia to reduce oil production, instead of only freezing production as currently proposed.

15-16%
of GDP projected 2015 budget deficit in Saudi Arabia
Source: Bloomberg

Pressure on non-oil growth

Even if oil production only stagnates, rather than declines, it will still increase the burden on the non-oil sector to bolster economic activity at a time when the Saudi Government is set to cut back sharply on its free-spending ways. Oil has accounted for 80–90 per cent of government revenue over the past five years, according to the International Monetary Fund, and the drop in crude prices has prompted the fiscal adjustment.

While government spending began falling in nominal terms in the second half of last year, the 2016 budget signalled a more concerted effort by the authorities to adapt to a new era of lower oil prices. The Government is planning to reduce spending by 13.8 per cent, compared with 2015, to 840 billion riyals ($224 billion), with revenue expected to drop by 15 per cent to 514 billion riyals.

Part of the savings are to be achieved through cuts in capital spending. However, subsidised fuel prices were also increased by 40 per cent to 0.9 riyals per litre ($0.20) in January, which should reduce recurrent expenditure. The subsidy cut in itself is unlikely to have a significant impact on private consumption. Fuel prices in Saudi Arabia are still the second-cheapest in the world after Venezuela's and do not constitute a significant outlay for consumers.

The budget deficit is projected to shrink to 326 billion riyals in 2016, from a record of 367 billion riyals in 2015, or 15–16 per cent of GDP. While the Government is seeking to increase revenue from the non-oil sector, oil production and price levels will remain the key metrics for revenue for the foreseeable future, meaning that the budget deficit will be a moving target.

As outlined previously by Bloomberg Intelligence (BI) Economics, the Government is likely to continue drawing down on foreign assets in the near term. However, it seems likely that the authorities will seek to meet the fiscal deficit

> **The Saudi government appears to be committed to bolstering longer-term fiscal sustainability, even at the cost of short-term economic pains**

target in the 2016 budget, although this could change if they decide to cut oil production. The Government appears to be committed to bolstering longer-term fiscal sustainability, even at the cost of short-term economic pains and some rumbles of discontent within the extended ruling family and the general population. The planned fiscal tightening would weigh heavily on domestic demand and would be likely to push the economy into its first economic contraction since 1999.

The authorities have already floated some measures to improve longer-term fiscal sustainability. These includes plans of introducing a value-added tax by the end of 2016 or 2017, following in the steps of the United Arab Emirates, which has discussed but not yet implemented similar measures.

Rating downgrades

The announced measures have not been sufficient to stave off credit rating downgrades. Standard and Poor's has been most aggressive, downgrading Saudi Arabia's debt by three levels from AA- to A- between October and February, citing expectations for GDP per capita to decline and the public debt burden to rise.

Nonetheless, foreign assets held by the Saudi Arabian Monetary Agency, the kingdom's central bank, amount to about $600 billion, approximately 95 per cent of GDP (2015 estimated). Public debt, at 10 per cent of GDP, is also significantly lower than the level of about 100 per cent recorded in the late 1990s, during the most recent extended downturn in oil prices.

While Saudi Arabia's external debt is low, this could change if the Government ramps up foreign borrowing as planned. However, with borrowing costs only a very minor issue for the kingdom, the risk of further rating downgrades is unlikely to be a major factor for fiscal policy.

A few cards still to play

While the situation in the near term is likely to remain grim, the medium-term outlook is not necessarily quite so bleak. There are reforms that could be implemented, such as achieving higher energy efficiency and increasing labour-force participation, that could bring sizeable economic gains over the medium to long term.

Improving energy efficiency: In line with its oil-producing neighbours, Saudi Arabia has historically subsidised fuel and other energy products for domestic consumers. Fuel has often been cheaper than bottled water. This has contributed to Saudis diverging from the global trend toward using more fuel-efficient cars and contributed to domestic consumption of petrol and diesel rising by 60 per cent since 2005, exceeding domestic refinery capacity. Domestic demand consumes about one-third of the ten million barrels a day produced from Saudi oil wells. However, the authorities are now seeking to pare back the cost of subsidies, with the prices of natural gas, ethane, diesel, kerosene, electricity and water all to be raised as part of the Government's five-year plan. Apart from the direct reduction in consumption, the increased prices should spur investment in more energy-efficient vehicles and products over time. This should allow for more crude oil to be exported, raising GDP and increasing government revenue.

Relying heavily on foreign workers

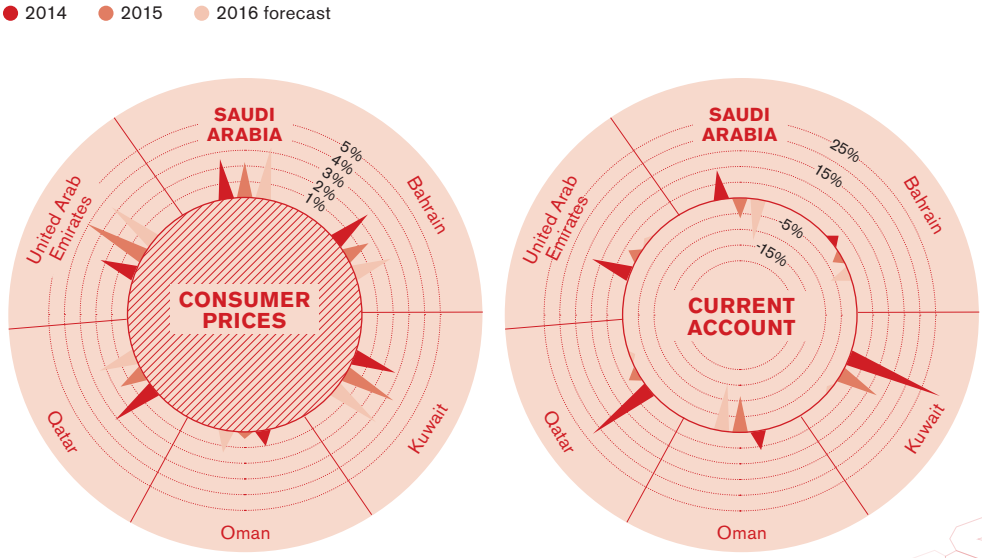
Increasing labour-force participation:

5.8%
of GDP: level of public debt , down from 100% in the late 1990s

$36
billion: Saudi outward remittances in 2014

Source: IMF estimate

CONSUMER PRICES AND CURRENT ACCOUNT (SAUDI ARABIA VS GCC)



Source: Bloomberg

Only 18 per cent of Saudi women were active in the workforce in 2014, with one-third of those unemployed, compared with a participation rate of 65 per cent for adult men, according to McKinsey. This to a large extent reflects gender norms and the reliance on foreign workers in the private sector, both for low-skilled jobs in retail and construction as well as more skilled positions, with Saudi nationals mainly employed in the public sector. Outward remittances amounted to $36 billion in 2014, close to 5 per cent of GDP, according to the IMF. Increasing domestic labour-force participation could help to revive economic growth and maintain living standards.

Productivity growth: An increase in the labour-force participation of Saudi nationals could also prompt employers to increase on-the-job training and raise overall worker productivity, since domestic employees could be expected to be more permanent than expatriate staff. This could help Saudi Arabia catch up in terms of productivity, an area where it has outpaced other countries in the Gulf Cooperation Council but fallen significantly behind peers over the past decade, according to the IMF.

Devaluation: Productivity growth and a devaluation of the Saudi riyal could work together to promote domestically produced alternatives to goods that are currently imported. A devaluation would also have the benefit of reducing the budget deficit, as the majority of government income is from dollar-denominated oil revenue, while expenditure is in local currency. And it would increase the local-currency value of the Saudi government's external assets and reduce the urgency of reducing the budget deficit. While this does not appear to be seriously considered by the authorities at the moment, possibly because it would dent living standards, the appeal of this option could grow over time. ◆

18%

Saudi women active in the workforce in 2014

Source: McKinsey

Achieving higher energy efficiency and increasing labour-force participation could bring sizeable economic gains over the medium to long term.

STRUCTURED PRODUCTS AND DERIVATIVES

The Gulf has seen an explosion in the market for structured products and derivatives of late. What's behind this dramatic growth, and where will the market go next?

Along with financial markets the world over, many of the ambitious plans for developing the Gulf exchanges were shelved when the global financial crisis hit in 2008.

This was particularly the case for planned offerings of structured products and derivatives in the region. The systemic role played by credit derivatives in triggering the financial meltdown meant that any appetite – international or local – for rolling them out onto essentially nascent and untested markets dried up almost overnight.

However, in line with the recovery in economic growth and investor confidence over the last few years, there is now a renewed focus on offering these products.

New platforms, new products

"In terms of product allocations by GCC market segment, structured products and derivatives market witnessed a 12 per cent compound annual growth rate in 2015, up from 6 per cent in 2013," says Hela Romdhani, an equity research analyst at Tunisia-headquartered financial services company AlphaMena.

"In recent years, many banks in the GCC countries have created their own trading platforms to be able to share transactions within these institutions and provide inter-bank information. This accelerated the collaboration between the derivatives and financial markets, pushing the markets to become far more transparent and a lot more commoditised and competitive."

Hein van der Wielen, executive director of global markets at National Bank of Abu Dhabi (NBAD), shares this viewpoint: "Products have become more vanilla, with less bells and whistles, and therefore more competitive and transparent," he says. "Banks have invested heavily in people and infrastructure to make sure the right products are offered to the right clients."

Indeed, structured products have become more transparent and competitively priced over the last few years thanks to improvements in all processes leading to the final product.

In terms of product development, most private banks and distributors in the region operate open-architecture models, thereby allowing more competition between providers in terms of ideas and pricing. In parallel, distributors are constantly working on improving their internal risk and compliance processes to ensure product suitability.

On the institutional side, regional heavyweights such as NBAD, Abu Dhabi Commercial Bank, Dubai's First Gulf Bank, Bahrain's Gulf International Bank and Saudi Arabia's National Commercial Bank are actively trading derivatives for hedging and for asset and liability management purposes.

These banks are highly sophisticated and are obtaining very competitive pricing on derivatives from other marketmakers.

> **Structured products have become more transparent and competitively priced over the last few years**

Islamic banks such as Noor Bank and Dubai Islamic Bank are also catching up quickly in terms of sophistication and ability to transact derivatives efficiently in a Sharia-compliant format. Most of these banks execute derivatives for hedging their own balance sheet interest rate risks, but also for their corporate and high-net-worth clients.

Drivers of growth

The unprecedented double-digit growth rates across all sectors of the Islamic finance industry over the last decade and the development of Sharia-compliant derivatives and structured products is creating significant opportunities.

Meanwhile, as GCC-based sovereigns, banks and corporates have become more actively involved in global markets, the need for derivatives to hedge their exposure has been instrumental.

And as the markets become more developed, clients are becoming more knowledgeable on the components in the derivative structures that allow them to challenge the pricing level.

The drop in the oil price over the last couple of years, from $115 a barrel in June 2014 to less than $28 a barrel in January 2016, and today standing at roughly $45 a barrel, has also been a factor in the growth of the regional derivatives market. "That has led to a substantial increase in players hedging their Saudi Arabian riyal currency exposure," says van der Wielen.

"Another driver has been structured deposits and notes. We have seen great investor demand out of Asia, whereby NBAD is the issuer of these notes. In June this year we will have a specific Global Markets EMTN [European medium-term note] programme that will allow us to issue better-tailored payoffs on more underlying assets."

Market leaders

The UAE is now considered the most sophisticated market within the Gulf in terms of its development and offerings of structured products and derivatives, with significant progress having been made over the last three years. The uptake from investors using these instruments during this period has grown faster in the UAE than in any other Gulf market.

In November 2015, the Dubai Gold & Commodities Exchange celebrated its tenth anniversary. It has played a pioneering role in developing the regional market for derivatives and

> **Regional investors are predominantly using structured products to enhance yield on their surplus liquidity**

remains the only exchange allowing participants to clear and settle transactions within the Gulf region.

High trading volumes growth – up 42 per cent in February 2016 compared with the same period in 2015 – proved to be indicative of the exchange's success over the past decade. During the same month, the exchange launched 15 single-stock futures, 10 Indian stocks and 5 US stocks.

"The structured product landscape in the Gulf has evolved in many ways over the last few years," says Kamal Benkabbou, director within Citi's Middle East and North Africa investor sales team.

"Investor appetite has gradually been shifting geographically from developed markets such as US and Europe to GCC and Indian markets, which Gulf investors tend to have more insight into from an investment-outlook perspective."

Furthermore, in the current low-interest-rate environment, coupled with a widening of regional credit spreads, investors have been favouring credit as the main asset class to achieve yield enhancement.

"Regional investors are predominantly using structured products to enhance yield on their surplus liquidity as an alternative to fixed-income instruments or term deposits with regional bonds," Benkabbou explains. "Typically, they would favour direct investments in real estate or equities instead of structured products to achieve growth."

There has also been an increased appetite for participatory notes, commonly known as p-notes, which are equity-linked certificates that allow foreign companies to invest in stocks without being licensed to trade there.

"In the Middle East, we've been issuing p-notes for foreign institutions since 2007," says Anis Akl, managing director at Credit Suisse. "Most international investors gain exposure to local shares through banks' p-notes. Those are fully funded delta-one products. We occasionally offer financing against local shares as well, in the form of loans or other products.

"The major opportunities for banks like CS are in advising local investors on their international portfolios, offering them ways to enhance their returns or alternatively hedge their exposure," says Akl. "We see demand from different types of clients, from ultra-high-net-worth individuals to family offices or sovereign wealth funds who have very large portfolios of foreign equities."

Upgrades and liberalisation

The region's markets have also received a considerable boost from some notable landmark decisions over the last few years.

In May 2014, following five years of review, MSCI, whose equity indexes are tracked by investors with about $7 trillion in assets, upgraded both the UAE and Qatari stock markets from "frontier-market" status to "emerging".

The upgrades have the potential to draw $800 million of new funds into Qatari and UAE shares, according to HSBC. With that comes a depth and breadth of liquidity. Derivatives help to accelerate the time it takes for regional markets to become better integrated into international markets and that progress has been aided further by the upgrade.

Saudi Arabia's stock market, the Tadawul, also recently took a long-awaited step towards liberalisation. Whereas previously foreigners could only invest indirectly using derivatives sold by Saudi intermediaries, in June 2015 the Government relaxed the limits on qualified foreign investment, allowing foreigners to buy shares directly in the Middle East's largest exchange.

Some of the major western banks are now keen to find out when they can start trading over-the-counter (OTC) derivatives contracts in the kingdom, or derivatives based on crude oil production.

42%

Year on year growth in trading volumes on Dubai Gold & Commodities Exchange (DGCX) as at February 2016
Source: Bloomberg

$800

million: potential new funds available after MSCI upgrade
Source: HSBC

Derivatives market launch

Meanwhile, in August 2015, the Abu Dhabi Securities Exchange (ADX) announced plans to launch a derivatives market in the next few years to diversify the products that are listed locally.

GCC countries had originally been planning to set up a regional derivatives exchange in 2010 but the plans were delayed indefinitely due to the global financial crisis.

Currently, most of the listed equities on the ADX are not very liquid and it is clear that the only way for the exchange to increase its volume is by including different asset classes.

The ADX hopes that the derivatives market will lead to equities with bonds and sukuk, exchange-traded funds being strengthened, rights issues being implemented more and rates being available to the exchange.

"I think it is very likely that a derivatives market could be launched in the next few years," says van der Wielen. "It will help boost liquidity in local markets' products such as equity options on UAE names. In this regard, NBAD will start actively making a market on equity options on selected UAE equities such as First Gulf Bank and Etisalat in June 2016."

However, the UAE currently lacks an appropriate legal framework for the planned exchange, mostly as a consequence of outdated bankruptcy laws, and therefore new legislation will be required to ensure it can be properly regulated.

Meanwhile, the main regulatory hurdle on the horizon for Gulf markets lies in gearing up for the introduction of Basel III, which has a final implementation deadline of March 2019.

"Basel III has created a lot of changes in this space," says AlphaMena's Romdhani. "One of the most significant is the exposure or risk measure criteria and the minimum levels required for performance ratios."

On the whole, GCC banks are in a good position to meet the enhanced capital requirements of Basel III, but the new liquidity rules will be one area where they will feel the impact.

Gulf debt markets are not as deep or varied as developed markets, which means banks have a limited choice of liquid instruments that they can use locally. The challenge for regional regulators, therefore, will be in finding and introducing new liquidity tools in the coming years. ◆

GCC SWF/ CENTRAL BANKS WHERE IS THE MONEY COMING FROM?

As oil revenues tumble, Gulf states are increasingly turning to sovereign wealth funds to plug fiscal gaps. But where is the money coming from?

From 2003 to 2014, as oil prices steadily increased, the Gulf's sovereign wealth funds (SWFs) swelled in size, but now, growth has slowed. SWFs are retreating from international markets and returning cash back home, as Gulf governments with widening deficits call on them to plug the gaps.

"The collapse in oil prices has shifted the Gulf from large current account and budget surpluses to large fiscal surpluses," said Jason Tuvey, emerging markets economist at London research house Capital Economics. Though Gulf Cooperation Council (GCC) governments promised to wean their economies off hydrocarbon sales during the decade of high oil prices, they have made little progress. The GCC ramped up public spending after the 2011 revolts that hit the Arab world, while budget break-even points steadily increased above levels seen in today's oil market. SWFs are stepping into the gap.

What's the problem?

With around $1 trillion in capital managed across its SWFs, Abu Dhabi has a good claim to be the SWF capital of the world. The Abu Dhabi Investment Authority (ADIA), the world's second-largest SWF with estimated assets under management of $773 billion (according to the Sovereign Wealth Fund Institute, or SWFI), is the largest of four major SWFs, and is mandated to conservatively defend the wealth of the emirate. It holds around 60 per cent of its assets in passive index tracker funds, according to the SWFI.

But with the collapse in oil prices, the Government has called on ADIA to help out. Abu Dhabi has been placed on negative ratings watch by Moody's, the ratings agency. Oil has fallen from June 2014 peaks of $110 a barrel, and Moody's now expects an average oil price of $36 a barrel this year. Details of Abu Dhabi's fiscal budget have not been published, but ratings agency Fitch estimates that the emirate will run a budget deficit of 11.6 per cent of GDP in 2016, after running a 13.2 per cent deficit last year.

ADIA is required to help the emirate of Abu Dhabi fund its fiscal deficits. "Withdrawals have occurred infrequently and usually during periods of prolonged or extreme weakness in commodity prices," ADIA said in its 2014 annual report. Fitch, which places ADIA's 2014 assets at $502 billion, expects its total assets to fall 5 per cent this year as the emirate calls on ADIA for cash.

ADIA's reports offer very few specific details on how, if at all, it has adjusted its asset allocation strategies in response. In November last year, ADIA, which is a major investor in infrastructure assets in the UK, shut down its London office, but said that the move would have "no impact on our investments in, and commitment to, the UK, which will continue as

> **It remains unclear in some cases exactly how government deficits will be financed, in terms of the mix between asset drawdowns and debt issuance**

$1 trillion: Capital managed across Abu Dhabi's SWFs
Source: Council of Foreign Relations (CFR)

before". Technology had reduced the need for ADIA to maintain a local presence, one source told Sky News.

Compared to its regional peers, ADIA has got off lightly. Asset depletion has been worst at the Saudi Arabian Monetary Agency (SAMA), which serves as both the kingdom's central bank and its SWF. SAMA Foreign Holdings, its asset management arm, saw its reserves tumble by just under $100 billion in 2015, falling to $598 billion from a peak of more than $700 billion in 2014. Jadwa Investment, a Saudi investment bank, estimates that the kingdom will see its reserves fall to $500 billion by the end of this year.

Bahrain's Mumtalakat is "becoming a lot more strategic", says Michael Maduell, president of the SWFI, while Abu Dhabi's Mubadala is disposing of several assets. The Qatar Investment Authority, with its sale of Miramax and several real estate assets, is looking to "dispose of non-core assets", Maduell adds.

The GCC has lost an aggregate of $360 billion in hydrocarbon revenues as a result of the collapse of the oil price, the International Monetary Fund (IMF) estimates. That will lead Gulf SWFs to pull an estimated $400 billion out of equities markets this year, if the oil price remains below $40 a barrel, the SWFI expects. This would follow a year in which $213 billion was pulled out of equities markets by sovereign funds. That has been led by both a shift into short-term assets, as SWFs seek to become more liquid, and necessitated by shrinking balance sheets, Maduell says.

Saudi Arabia, Oman and Bahrain all ran double-digit fiscal deficits in 2015, according to the IMF, while Qatar, the UAE and Kuwait each saw their fiscal balances plunge into the red. Markaz, a Kuwaiti investment company, estimates that the GCC will need around $150 billion to finance its deficits this year.

"The era of petrodollar-filled wheelbarrows being dumped into giant vats seems to be numbered," the SWFI said in a recent report. "Commodity wealth funds have to be concerned about the state of their country's finances, since many were created to either be stabilisation funds, intergenerational savings vehicles or a combination thereof."

SAMA FOREIGN RESERVE VALUE

2014 $700 billion

2015 $598 billion

Source: Jadwa Investment

> **IMF chief Christine Lagarde embarked on her first visit to the UAE with a simple message: it's time for taxes**

So, what are the options?

For Gulf states, depletion of SWF assets is only one possible way to counteract the fall in oil revenues, says Trevor Cullinan, sovereign analyst at Standard & Poor's (S&P). "The financing needs of some GCC governments are apparent, but it remains unclear in some cases exactly how the deficits will be financed, in terms of the mix between asset drawdowns and debt issuance."

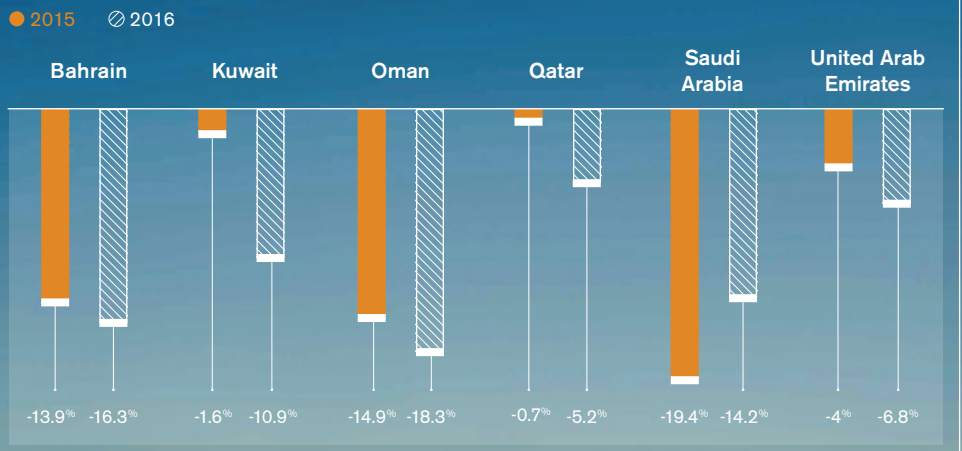
Gulf states don't have to draw down on their SWFs, and most analysts believe that this will only be a short-term solution. Governments and economists are instead looking towards new debt, public spending cuts and taxes as a means to close their deficits.

Plans for new bond issues are in the works in many of the Gulf states. S&P expects $45 billion of issuance from the GCC. Most of this will be from Saudi Arabia, which has already issued $27 billion of domestic bonds and is looking to tap international debt markets. Such a move could see the kingdom's debt-to-GDP ratio rise from the lowest in the world, at less 5 per cent, to around 50 per cent.

In February, Bahrain cancelled a $750 million bond sale after it saw its credit rating cut to junk by S&P, before reopening the issue at the reduced value of $600 million. The UAE plans to issue international bonds of between 80 and 100 billion dirhams (between $21 and $27 billion), but must first pass a debt law granting the country's central bank the legal power to tap into global markets. Oman issued its debut sukuk in October last year, a five-year, $500 million Islamic bond aimed at helping to finance its budget deficit.

Public spending cuts are also well underway, with Gulf states slashing capital expenditure in a bid to bring their budgets into balance and staunch asset depletion. The UAE cut public spending by 21 per cent in the 12

BUDGET FORECAST GCC (% OF GDP)



Source: Bloomberg

months to September 2015, the last period for which data is available. Saudi Arabia plans to cut spending by 14 per cent in 2016, while still running a deficit of around 11 per cent, according to an estimate from Abu Dhabi Commercial Bank. Mohammed bin Salman, Saudi Arabia's deputy crown prince, has also mentioned future privatisations, including a sale of a stake in state oil giant Saudi Aramco.

New taxes have been mooted, with IMF chief Christine Lagarde embarking on her first visit to the United Arab Emirates with a simple message: it's time for taxes. "The size and likely persistence of this external shock means that all oil exporters will have to adjust by reducing spending

and increasing revenue," Ms Lagarde said in a speech in Abu Dhabi in February. "Most members of the GCC are in a position where they can pace their adjustment over several years and therefore limit their impact on growth. GCC economies have made large fiscal adjustments in the past – and I am confident that they can do it again," she said.

Lagarde's visit coincided with an announcement by Gulf ministers that a regional sales tax, or value-added tax, had been agreed by GCC governments. States will have until 1 January 2019 to introduce the tax, which will be set at 5 per cent. That would bring in some $6.5 billion to the UAE, according to estimates from the National Bank of Abu Dhabi.

A move towards personal income tax is unlikely, however, according to Tuvey of Capital Economics. "It has taken a decade and the oil price to push the Gulf into introducing new taxes. Any move towards income tax will be very gradual and a long way off. There is plenty of low-hanging fruit to grab," he says.

The extent of further drawdowns on sovereign funds will depend on the oil price, and just how willing Gulf states are to take on new debt, says SWFI's Maduell. "What if Gulf countries were to legitimately raise sovereign debt? And what if oil comes in above $40 this year? Both of those might change the whole scenario." ◆

"The extent of further drawdowns on sovereign funds will depend on the oil price, and just how willing Gulf states are to take on new debt"

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