Saudi Riyal: A Repeat Tale
To keep the peg, or not to

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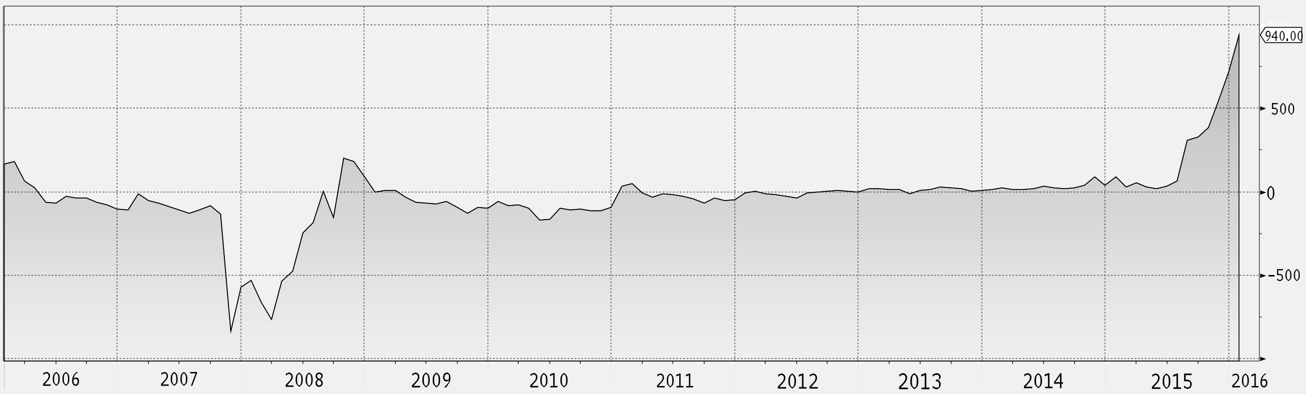
Today, the Saudi Riyal hit a record low in the Foreign Exchange Forwards market. It breached a key 1000 point mark, and hovered around it, following the fresh slide in oil prices: Effectively this means that anyone who locks in a price today for selling USD and buying SAR in one year's time would be able to benefit from receiving a substantial premium over the pegged Spot FX price of 3.75 SAR to the USD.



SAR 12 month Forward curve for the past 10 Years. **Source Bloomberg.**

This move in the Forwards Market is clearly speculative and a recurring one over the past few years. This is despite comments from Saudi Arabia's Central Bank Governor, as recent as last Monday that they remain committed to the peg. This time, the move is further exacerbated, given the fact that 80% of Saudi Arabia's revenues come from Oil Sales and Oil prices have just hit a 12 years low. With that income dropping, the government gets less USD and hence less SAR to put in its coffers to balance the state budget. The speculators are betting on the possibility that the Saudi Authorities may abandon or more likely devalue the SAR to the USD and fix the peg at a higher level. In effect, this would mean that the same amount of USD the Government would earn from Oil Sales abroad could be translated to more SAR for the country.

However, the positive effect of such a move would be felt mostly in the short term. Yes, it would fetch more SAR for the Government in revenues coming from Oil Sales in USD. At the same time one has to take into account that this benefit would be more than countered by a rapid increase in the cost of imports and inflation: The Kingdom is a net importer of a wide array of goods, the prices of which would shoot up quickly by at least the same percentage as would be the devaluation.

To get a clearer picture, let's take a snapshot of Saudi Arabia's finances: In 2015 it is estimated Saudi Arabia spent about USD 260 bio in its budget. With Oil prices around $30 / barrel and an average oil production of 10 mio barrels per day, the estimated annual revenue is roughly USD 109.5 bio. Keeping in mind this revenue accounts for about 80% of the Kingdom's revenues, the concentration risk on Oil revenues is fully apparent.

Meanwhile, SAMA's Net Foreign Assets stood at $ 628 bio as per November end 2015. Hence, taking account this difference between spending and earning, and the reserves available, Saudi Arabia could continue to fund a budget deficit for up to five more years at present levels.

However, Saudi Arabia could boost its revenues by raising additional debt, taking into consideration it has very little public debt. Revenues could also be increased by proceeding with privatizations, some of which have already been announced to go ahead in 2016. Not to mention the recent discussions on a potential privatization of Saudi Aramco, with an estimated value of at least USD 2.5 trillion, where even a partial privitization would alone fetch enough cash to boost the reserves for years to come. Saudi Arabia can additionally explore alternative sources of income such as taxes and fees. In effect, despite all the recent market turmoil, there are more than enough options in SAMA's war chest to help it defend the USD /SAR peg.

Taking into account the fine, delicate, yet entirely plausible act of funding Saudi Arabia's budget for the next 5 + years using a combination of the afore mentioned options, the oil price trajectory and potential inflation concerns, it looks that the pros of devaluing are outweighed by the cons. In addition, Saudi Arabia, despite oil dropping more than 50% in the last 12 months, still has great -albeit diminished- firepower to combat the speculative moves on its USD/SAR peg. Despite what the Forwards Market currently indicates, it seems that the Kingdom will fight back and it has plenty of the right tools to persevere.

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