The Telegraph

Saudi riyal in danger as oil war escalates

“If anything happens to the riyal exchange peg, the consequences will be dramatic," warns the country's exchange rate guru

The Saudi riyal is under serious speculative attack

By Ambrose Evans-Pritchard

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Saudi Arabia is burning through foreign reserves at an unsustainable rate and may be forced to give up its prized dollar exchange peg as the oil slump drags on, the country’s former reserve chief has warned.

“If anything happens to the riyal exchange peg, the consequences will be dramatic. There will be a serious loss of confidence,” said Khalid Alsweilem, the former head of asset management at the Saudi central bank (SAMA).

“But if the reserves keep going down as they are now, they will not be able to keep the peg,” he told The Telegraph.

His warning came as the **Saudi finance ministry revealed that the country’s deficit leapt to 367bn riyals (£66bn) this year**, up from 54bn riyals the previous year. The International Monetary Fund has suggested Saudia Arabia could be running a deficit of around $140bn (£94bn).

• Saudi Arabia unveils record deficit as it succumbs to oil price rout

Remittances by foreign workers in Saudi Arabia are draining a further $36bn a year, and capital outflows were picking up even before the oil price crash. Bank of America estimates that the deficit could rise to nearer $180bn if oil prices settle near $30 a barrel, testing the riyal peg to breaking point.

Dr Alsweilem said the country does not have deep enough pockets to wage a long war of attrition in the global crude markets, whatever the superficial appearances.

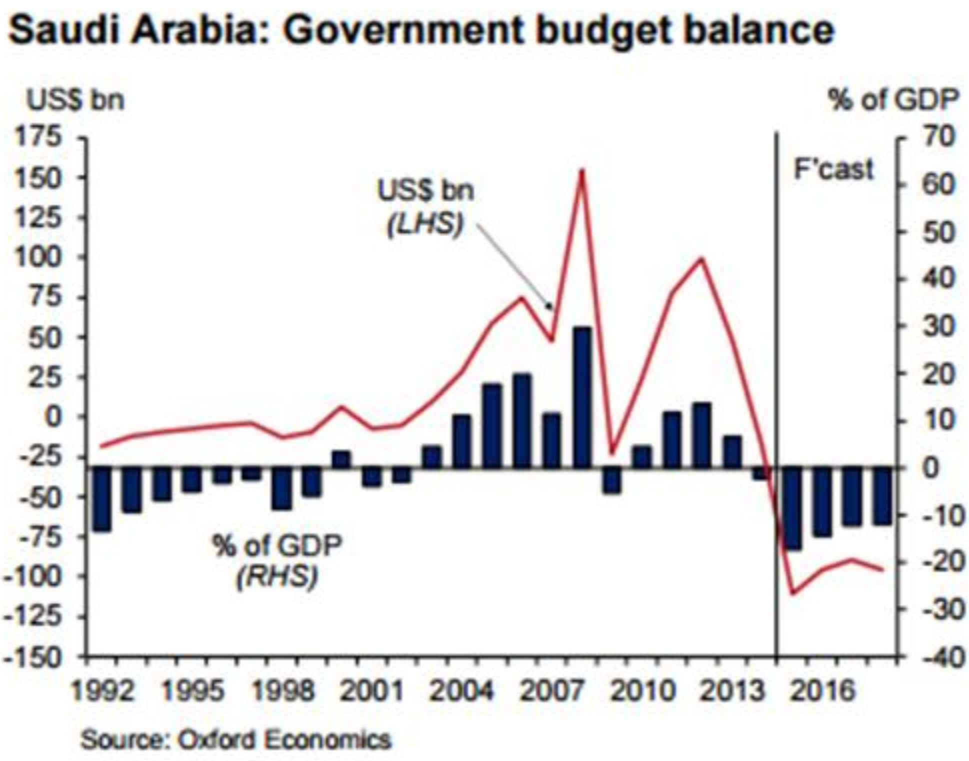
Concern has become acute after 12-month forward contracts on the Saudi Riyal reached 730 basis points over recent days, the highest since the worst days of last oil crisis in February 1999.

The contracts are watched closely by traders for signs of currency stress. The latest spike suggests that the riyal is under concerted attack by hedge funds and speculators in the region, risking a surge of capital flight.

A string of oil states have had to abandon their currency pegs over recent weeks. The Azerbaijani manat crashed by a third last Monday after the authorities finally admitted defeat.

The dollar peg has been the anchor of Saudi economic policy and credibility for over three decades. A forced devaluation would heighten fears that the crisis is spinning out of political control, further enflaming disputes within the royal family.

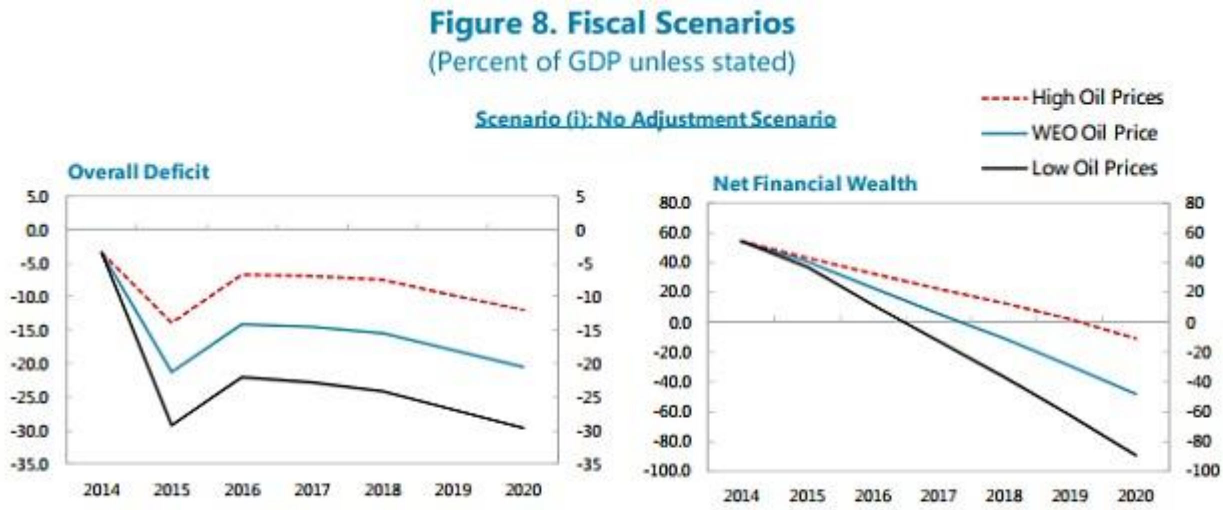
Foreign reserves and assets have fallen to $647bn from a peak of $746bn in August 2014, but headline figures often mean little in the complex world of central bank finances and derivative contracts.



Dr Alsweilem, now at **[Harvard University's Belfer Centre]**, said the Saudi authorities have taken a big gamble by flooding the world with oil to gain market share and drive out rivals. "The thinking that lower oil prices will bring down the US oil industry is just nonsense and will not work."

The policy is contentious even within the Saudi royal family. Optimists hope that this episode will be a repeat of the mid-1980s when the kingdom pursued the same strategy and succeeded in curbing non-OPEC investment, and preperaring the ground for recovery in prices. But the current situation is sui generis.

The shale revolution has turned the US into a mid-cost swing producer, able to keep drilling at $50bn a barrel, according to the latest OPEC report. US shale frackers can switch output on and off relatively quickly, acting as a future headwind against price rises.



The energy intensity of global GDP is falling rapidly. Renewable technology and energy efficiency have both made huge strides. The latest climate accords in Paris imply some form of carbon tax that will ratchet upwards over time, slowly changing the cost calculus for oil use.

“There is an overwhelming feeling among many in Saudi Arabia that this crisis is just cyclical and that it will reverse soon, so everything will be OK. But the danger is that what is happening is structural, and that means a country like Saudi Arabia can’t just sit still,” said Dr Alsweilem.

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Khalid Alsweilem

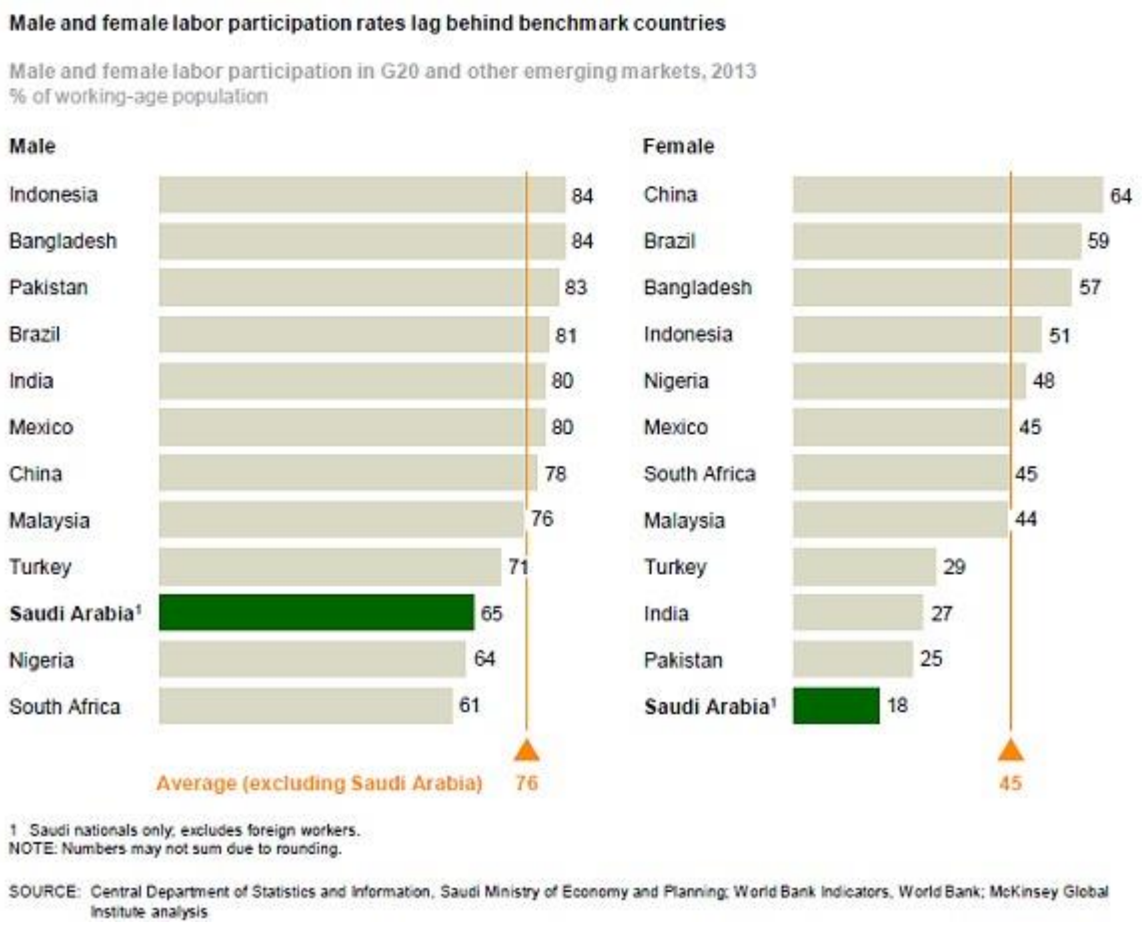
The Saudi government may have unveiled an austerity package of spending cuts and increased taxes, and be looking to slash electricity and water subsidies for the wealthy. But Riyadh has to tread with care. The country’s cradle-to-grave welfare system is what keeps a lid on dissent and binds the country’s fissiparous tribal polity.

Prince Mohammed bin Salman, the 30-year old deputy crown prince now running the country, is trying to push through radical reforms, firing princelings from sinecure positions and bringing in an elite team of technocrats to transform Saudi Arabia’s archaic oil-based economy.

He is drawing on a McKinsey study – **‘Beyond Oil’** - that sketches how the country can break its unhealthy dependence on crude, and double GDP by 2030 with a $4 trillion investment blitz across eight industries, from petrochemicals to metals, steel, aluminium smelting, cars, electrical manufacturing, tourism, and healthcare.

The underlying message of the report is that Saudi Arabia faces disaster unless it can overcome its resources curse - and reinvent itself fast, and this includes an acceptance that women must be drawn fully into the workforce.

The warnings have been seized on with alacrity by Prince Mohammed to confront vested interests. The public debt to GDP ratio will reach 140pc by 2030 and the deficit will still be in double digits, if only partial reforms are pushed through. That course implies bankruptcy.



Dr Alsweilem said Saudi Arabia is now paying the price for failing to establish a proper sovereign wealth fund during the fat years along the lines of the **Norwegian Pension Fund** or the Abu Dhabi Investment Authority. “What matters is a credible long term-fiscal strategy rather than short-term measures. The IMF has warned them repeatedly on this,” he said.

The Saudis can disguise the effect of reserve depletion by issuing bonds to raise money but this is mere legerdemain under the current monetary structure. “It is completely wrong to think the Ministry of Finance can protect foreign assets by borrowing in riyal instead of selling reserves. This does not help at all. There is a one-for-one outflow from savings accounts,” said Dr Alsweilem.

Saudi Arabia has taken a diametrically different route to Russia in the gruelling price-war between the two petro-powers, as each knuckles down in the hope that the other will crack first.

Russian President Vladimir Putin shakes hands with Saudi Arabia's Defense Minister Prince Mohammed Bin Salman Photo: Rex

The Kremlin has stopped running down reserves and has instead allowed the rouble to fall by 60pc against the dollar. This is painful for Russian consumers but protects the internal budget from the immediate shock of collapsing oil revenues.

Both face crises, but each of a different character. What is clear is that Russia and Saudi Arabia will both be in deeper trouble by 2017 unless they can agree to cut crude production and eliminate the global glut. No such concordat is yet on the cards.