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Huxham, Grant T.

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FEATURED | Real Interest Rates, Oil, and Inflation: Implications for Saudi Arabia and the Emirates

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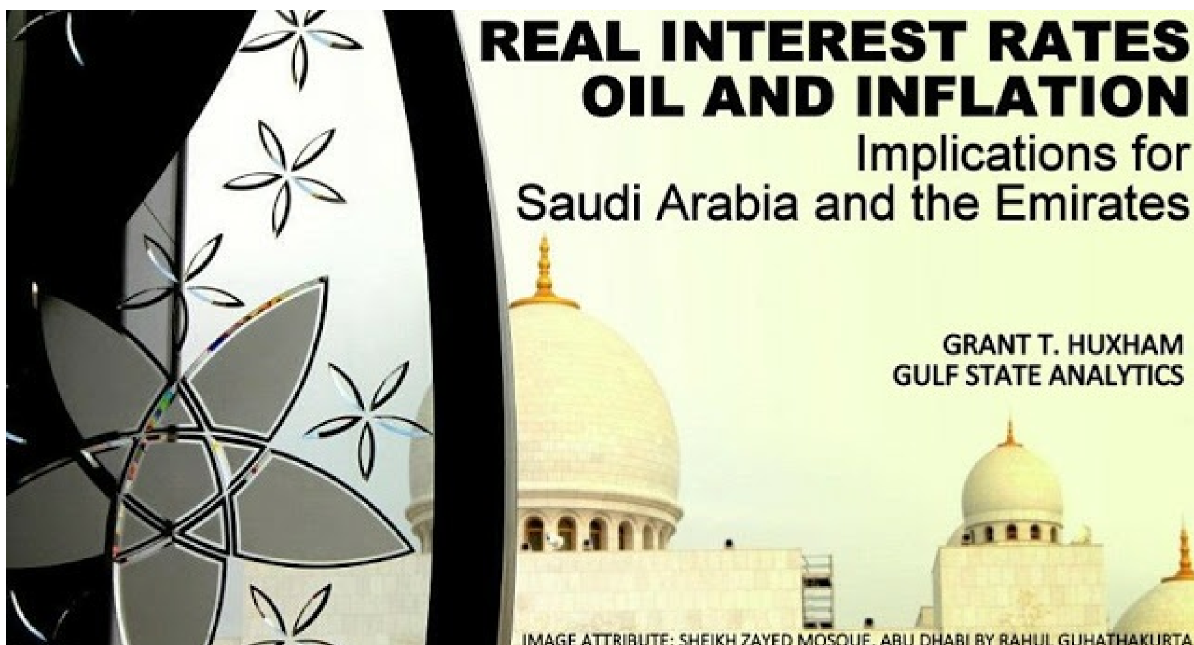
By Grant T. Huxham

Senior Advisor, ***Gulf State Analytics***



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The recent decision by the Governor of the Bank of England, Mark Carney, to support monetary policies that effectively deliver negative real rates of return on U.K. gilts, coupled with Janet Yellen's consideration of negative interest rate policy (NIRP), suggest that the 'powers-that-be' in the West are cautiously revisiting the requisite monetary and fiscal economic policies to be applied against three distinct economic scenarios: recession, deflation, and stagflation.

Key factors to be evaluated in a discussion of this shift include the broader economic malaise that appears to have set into the Eurozone, the fears regarding a "deflationary trap in China", the possible end of the Japanese recovery under Abe-nomics, and the less than stellar recovery by the U.S. from the events of 2008 and 2009. This article will explore the implications of recession, deflation, and stagflation as they relate specifically to the United Arab Emirates (U.A.E) and in general to the entire Gulf Cooperation Council (GCC). The three scenarios can be termed "the Good, the Bad – and the Ugly".

This article will comment on pressures that arise from such scenarios, but is in no way a commentary on actual policies adopted

by the Saudi or U.A.E central banks, nor, to the extent that these central banks are not independent of their governments, on each government's policy of the day.

"The Good" – Recession

Should the current economic trend be, in fact, a recessionary time (more on that below), such an event has short - and longer term - positive implications for the GCC, and particularly for the U.A.E.

Recessions, at least under a conventional Keynesian analysis, are thought to reflect an underlying weakness in demand for goods and services. Monetary policy, known as quantitative easing, as applied by the central bank, is an accepted means of stimulating demand.

Under a classical economic system (non-Keynesian approach), prices of goods and services adjust flexibly and quickly to competitive forces. In theory, then, adjustments to the amount of money in the system would have no effect. Though this may be true when observed in the longer term, in the short term, economists generally accept that the "price-stickiness" factor (the inflexibility of current prices) - for example the price of goods or labor - prevents an easy adjustment of prices to reflect shifts in demand or supply. Thus, economists consider the injection of more money into the economy by a central bank (quantitative easing) to be an appropriate response in the short term to an economic recession.

The premise dictates that by having more money available to chase the same number of goods that existed moments before the "new" money was created, competitive forces will raise the nominal prices for those same items, thus directly creating inflationary pressure on prices. In conventional thought, the next domino would fall as follows. Raising prices directly results in an increase in the nominal value of GDP demand. Other parties are prompted to create products and/or provide additional new services in response to the nominal increased price of such services. The economic law known as Says Law suggests that an increase in supply will itself stimulate or create its own demand. New money moves along the demand curve to meet and absorb existing supply at an increased nominal price. The observation by others of this activity then stimulates new supply, which, itself by creating more supply of goods and services, competitively reduces the cost of such goods, which itself induces the consumer to consume at a perceived beneficial price. And so the cycle repeats itself and the "normal" business cycle resumes.

So much for theory. What are the implications for Saudi Arabia and the U.A.E?

Printing money (monetary policy) and providing it cheaply to financial institutions, or investing the same money in public projects (fiscal policy), are both accepted Keynesian approaches for a central bank to use to manage a recession.

Witness the announcement of new development projects in the U.A.E during the latter half of 2016, as well as the finalization of existing investment and tourism projects. The U.A.E has taken the West's investment inertia of the last three years as an opportunity to test Keynes' hypothesis, which is simply that the government of the day should stimulate and raise the demand curve through fiscal policy/public investment. The number of infrastructure projects adopted, as well as the long-term vision implicit in those projects, suggests UAE's confidence that once "normal" economic activity across the globe resumes, it will be well-placed to service logistics by sea and air, to promote tourism, to stimulate investment through real estate, and possibly to fulfill the financial requirements of its own citizens and the broader region as a whole, ultimately making a positive return for itself and investors.

Low interest rates (and resultant minimal and negative real interest rates) have enabled the U.A.E to mobilize local and international investors to fund this infrastructural spend. The fact that the West does not anticipate real interest rates to rise for a significant period enables the cost of finance related to this investment to be minimal, especially when compared to the expected revenues and related growth pertaining to the development projects already underway.

A risk for the U.A.E, common to all entities that have raised finance, is the possibility that projects may not be completed or that that they may be deferred, causing a crisis in investor confidence. It is, however, highly probable that the U.A.E has learned from its 2008 restructuring experiences. It is expected that the Emirates will not make any policy decision related to government projects that could shake investor confidence. Furthermore, the investment in infrastructural projects, consistent with the vision articulated before 2005, reassures investors that the path is not only dynamic, but also forward-moving.

Similarly, the K.S.A economic reform plan, Saudi Arabia Vision 2030, outlines a long-term economic roadmap intended to end the kingdom's reliance on oil. It targets greater private investment in non-extractive industries, including infrastructure and transportation. In addition, Vision 2030 envisages a partial privatization of the state-owned oil giant, Aramco.

On one hand, the centerpiece of Vision 2030 is a five-year plan known as the National Transformation Plan (NTP), intended to restructure the kingdom's entire economy. A core component of the NTP is that 40 percent of projects during the five-year period will be funded by the private sector, with the aim of reducing financial pressure on the state.

The construction and transportation sectors have traditionally been among the largest recipients of investment in the kingdom. Investment in these sectors is now expected to further increase between now and 2030, and to do so rapidly. A corresponding increase is expected in the number of development projects under way as the NTP is implemented.

A significant element of the Vision 2030 roadmap is the construction of a 30-mile bridge across the Red Sea, linking Saudi Arabia with Egypt. The bridge is intended to provide a significant boost to trade and commerce by linking two of the region's biggest economies and providing a platform for transporting millions of dollars worth of cargo.

The bridge showcases the scale and scope of the NTP's ambitions for the wholesale transformation of the kingdom's infrastructure, in perfect accordance with Keynesian policy.

Reality, however, has interfered. Officials in Riyadh just recently announced the cancellation of many projects. The exact number is disputed. Numerous accounts of unpaid workers and delays in government projects suggest that a fundamental shift in government policy related to both prioritization and the funding of priorities has taken place. Investment will take place, but exactly when now depends on a new vision.

This was to be expected. The oil-price shock to government revenues has cascaded down to the provinces and will continue to cause competitive destruction and fragmentation of long-standing "understood" ways of doing business until the outflow of precious forex is reduced to a level with which the K.S.A is comfortable.

In a certain sense, the kingdom is experiencing in 2016 forces similar to those experienced by the West in 1973, when OPEC

flexed its muscles – a shifting of prices, business contracts, delay of investment, crisis of investor confidence, and significant worker dismissals. In fact, worker dismissals form the silver lining in the recessionary environment. Obviously, the pain and suffering caused in these instances to the workers and their dependent families is not insignificant.

But “price-stickiness” itself, as embedded in the wage structure across Saudi Arabia and the U.A.E, makes the necessity of resetting the price of labor wholly dependent upon the release of workers. (The alternative is the retention of workers under non-competitive priced labor contracts.)

Both Saudi Arabia and the U.A.E are intent on developing economies that compete in a global market. Until now, both countries have been comfortable paying a premium to secure the use of talent. But the time may have come when examining the cushy hardship allowances and tax-free packages paid to executive talent means taking a hard look at what the world stage is now paying for the same talent, and what talent is available on that stage.

This itself has a positive knock-on impact. Both countries have citizens generously employed by the state. When considering the packages for their own citizens, it becomes necessary to compare them to those offered to the expat. By reducing the cost of the expat, it then reduces the cost of meeting expectations of the citizen. Austerity may mean one thing to the West, but it is not an option that Saudi Arabia and the UAE are willing to adopt with regard to their own citizens, especially since demonstrating charity and concern for their well-being is so culturally intrinsic to the state and its relation to the citizens in both countries.

Tim Harford, in his book *The Undercover Economist*, outlines his playbook for a central bank to address a recessionary environment:

1. Try to avoid being in debt so that when you need to raise debt from lenders, you look like a good bet. Identify some big public infrastructural projects with reasonable benefits, conduct all your due diligence, and keep them on the shelf to dust off and press into action.

2. Use monetary policy as a first line of defense. (Cutting interest rates is relatively simple.)

3. If recession is looking “long and deep”, implement projects identified in Step 1.

4. Ensure that investors suffer no crisis in confidence in the ability of the borrower to repay. Consider taxation policy. Reduction of taxes indirectly stimulates demand.

The U.A.E has followed this advice to the letter, even very recently implementing the Financial Restructuring and Bankruptcy Law that will enable distressed corporates to engage with financial institutions and work it out. This is to be welcomed as it brings flexibility to both parties and reduces the scorched earth, “elephant-in-the-room” question common to most economies with regard to NPLs at present. (Should the bank write this off or can it be worked out?) Furthermore, the implementation of VAT is only expected from 2018, and, in all probability, will be delayed if the authorities in the GCC identify that the immediate disruption to their economies costs more than the short-term tax revenue to be raised.

In summary, Saudi Arabia and the U.A.E could conceivably benefit from a ‘reset’ caused by a recession if they:

- Focus on the reduction in the nominal prices of revenues gained from delivery of services to the commercial sector and private citizens (as recessionary forces absent inflation would create a deflationary pressure on the cost of such services to stimulate demand), or modify taxation, or possibly both.
- Take advantage of the large global investment pool that is anxious to invest in productive opportunities while the global gilt market makes holding cash or investing cash in the West unpalatable. This means accessing credit on favorable terms, thereby reducing the financing cost of such investments in real terms.
- Restructure or overhaul the worker contract system to enable more flexibility to be utilized by the employer to reset employee costs (with the consent of the employee).
- Consider providing a real rate of return, enticing more foreign investment from investors and institutions flush with quantitative easing funds received from their own central banks. Central banks benefit when a little inflation enters the system, primarily because inflation tends to have a reducing effect on the real value of debt. And it is acknowledged that the global overhang of debt and leverage still needs to be dealt with.
- Use innovative financing such as sukuks to attract foreign investors to public infrastructural projects, recognizing that adding more debt in a recessionary environment is what Keynes advised as the necessary fiscal policy needed to stimulate demand. With the cost of the finance at historic lows, this may be an opportunity to ‘build on the cheap’.

“The Bad” – Deflation

All things considered, there is a general consensus that the global recession of 2008 was not a “typical” recession. It showed weak demand, slack capacity, and all that in the face of low-interest rates. The U.S. invested significant funds in “shovel-ready” projects with seemingly little to no continuing impact on demand. The West is worried that European countries continue to flirt with “deflation”, and though K.S.A and the U.A.E have strong forex reserves, both countries’ central banks must be just as concerned about the looming specter of deflation.

Deflation is a phenomenon whereby weak demand, driven by slow or stagnant economic growth, creates downward pressure on prices. One indicator of a deflationary environment is the declining cost of credit, or low interest rates. Since central banks tend to set the benchmark by which financial institutions peg their own cost of credit to the consumer, central banks are often unwilling participants in the “inflation debate”.

The temptation for every central bank is not only to rein in price inflation in the hope that this reduces the cost of finance sufficiently to trigger growth, but also to hope that this policy reduces the cost of finance incurred by the State when taking on debt to fund new investments. Inflation can beneficially reduce the real value of future contracted payments, which can be a boon to a highly leveraged government.

Unfortunately, European governments have not only encouraged central banks to reduce rates to historic lows, flooded the market with quantitative easing (which, with low rates attached, hardly makes the new cash injections attractive to the lenders of finance), but also, at the same time, engaged in austerity programs to rid government expenditures of “waste”. It is only natural not to wish to incur waste in times of hardship, even though economic theory indicates that causing a crisis in confidence in current times only accelerates the impulse of consumers to withhold spending their available cash, thereby causing even more of a decline in demand. Keynes would advise to take on debt, not reduce government consumption at this time.

History has shown that deflationary periods can be incredibly difficult to cure, such as the great world deflation of 1929-32, when prices, production, and employment levels fell by hitherto unprecedented amounts. The same scenario could be true of central

banks in Europe today, where a tangled mess of fiscal and monetary policies have not stimulated inflation. Real interest rates are at historic lows and are dangerously close to negative real rates of return.

Hesitancy to go "all out" is why the Eurozone is now a textbook example for economists of central banks flirting with deflation. In January 2015, The Economist **published** an article entitled "Why Deflation is Bad" of which the following is an excerpt:

"… Prices in the euro zone are falling. Figures released on January 7th showed that consumer prices in the year to December fell by 0.2%, marking the return of deflation for the first time since 2009. Weak demand, driven by austerity, debt and a lack of economic growth is dragging down prices. The falling oil price is making things cheaper, too. One might think falling prices would be something to celebrate. But concerns about deflation traps and downward spirals abound. The European Central Bank may launch a programme of quantitative easing this month to fend off the threat."

What is the Deflationary Trap?

In simple terms, the interest rate reflects the price of financing investment today relative to financing the same investment tomorrow. When interest rates are high, savings are worth more tomorrow, and vice-versa. The return earned in money terms based on the interest rate specific to a loan is called the "nominal" interest rate. But inflation also matters. Subtracting expected inflation from the nominal rate produces the real interest rate, which identifies the expected return after inflation from the lenders.

Low inflation reduces the real rate of return. Central banks prefer not to permit the nominal interest rate to fall below zero because that would mean savers gain no return for lending out their cash, in which case they might prefer switching out of cash into investment in real assets such as infrastructure or real estate. This fact establishes a floor on the real interest rate, too. If inflation is low and real rates cannot fall far enough to boost demand and perk up prices, demand will weaken still further. This is the dreaded deflation trap. The central bank in a sense runs out of an ability to "manage" the economy through monetary policy. You can print the cash, but others still don't want it. If that happens, what to do?

Deflationary traps cause other more significant problems as well. Lower-than-expected inflation increases the real burden of debts. Deflation also increases price rigidity in the labor market. Workers are resistant to wage cuts in cash terms, but inflation lets firms cut real wages by freezing pay in nominal terms. Deflation, in contrast, makes this problem worse.

The solution is simply to reverse falling prices by making them rise, thus stimulating demand by creating inflation sufficient to create a real rate of return for investors.

An antidote for deflation is the step taken by Mark Carney. Quantitative easing (as has been shown above) is expected to stimulate demand and create price inflation. But that comes with the price of devaluation of the currency. The British pound has lost value relative to other currencies in the recent weeks as the markets continue to react to Brexit and this monetary policy.

Both Saudi Arabia and the U.A.E are restricted in terms of using quantitative easing as a means to ward off deflation. Their currencies are pegged to the U.S. dollar, which has been strengthening of late. The dollar may strengthen even further, should the Federal Reserve implement the rise in interest rate it has long threatened to do (but which it has held off doing while the global economy recovered from 2008).

To the degree that most of the imports to Saudi Arabia and the U.A.E are dollar-denominated, the central banks avoid the impact on local prices stemming from a change in price of a good imported from the U.S. If the cost of a pound of walnuts in Sacramento increases by USD 1, the GCC states will experience the same increase in price, expressed in their own currency. The problem for both countries occurs when the dollar appreciates in value against other currencies due to a Fed rate hike. A double impact is felt in Saudi Arabia and the UAE. The increased nominal price of an American import, as well as the increased dollar value relative to other currencies, makes general food items sourced in California, for example, now much more expensive relative to food sourced from France. In an extended deflationary period, the temptation to reduce imports from stronger currency locales, and instead buy local, becomes much more of a necessity than a passing whim.

But the real longer term problem in a deflationary environment is that it is experienced in the labor market. Greece, Italy, and Spain are excellent examples of economies where the young cannot find a job at any price. The prospect of such a deflationary environment developing in Saudi Arabia would be cause for worry in all countries across the MENA region.

The kingdom already has a time-bomb ticking in terms of the number of new entrants into the labor market. In September 2016, the Brookings Institute **reported**: "Saudi Arabia's youth unemployment is now the biggest socio-economic challenge" **with** "two-thirds of the Saudi population, of 30.8 million, under the age of 30. A published paper by the Woodrow Wilson International Center for Scholars in 2011, suggests that thirty-seven percent of all Saudis are 14 years old or younger! Saudi Arabia needs to create at least 3 million new jobs by 2020".

It is arguable whether youth unemployment, housing shortages, or food crises precipitated the most unrest, giving rise to the Arab Spring in Egypt and the Maghreb. What is not arguable is that should the central banks in the region be hampered by a sustained deflationary period, the resulting sustained unemployment will incubate a public mood that can manifest as discontent, radicalization, and, at worse, regime change.

The economic solution of stimulating demand by creating real rates of interest, abandoning the currency peg (devaluing the currency), walking away from foreign debt (restructuring at deep discounts), and resetting disbursements to citizens would, although possible and definitely a means at Riyadh's disposal, not be palatable to the K.S.A central bank. Economically, it may have worked in the past for countries like Brazil, but culturally it is not a path that would be welcomed in the MENA region, let alone in Saudi Arabia.

Oil: The Banana Peel beneath the Central Bankers' Feet

Sudden and significant changes in the price of oil are examples of what economists term "exogenous shocks" that alter the prevailing demand and supply model, resetting prices and generally setting Schumpeter's creative destruction paradigm in motion.

Harford asserts that oil shocks have historically set off multiple recessions in the West. It is notable that the U.S. recession of 2001 and the world recession of 2008-9 were preceded by substantial oil price shocks.

Though a recession may provide a welcome period of reassessment of investment priority, government sources of revenue, and labor pricing, the reality is still that both Saudi Arabia and the UAE, to the degree that oil dominates the sources of government

revenues, are “petro-states”. A period of deflationary economics would be detrimental to both economies.

Continued pressure on commodity prices, especially oil, causes a significant shock to government revenues, which then cascade into a reduced demand for government’s own services because of an inability to pay for such services at the current time.

One only has to look at what has happened to Russia since the dual impact of the restriction of credit (caused by sanctions) and the reduction in government revenues. CNBC **reported:**

“While the United States and Europe continue to eke out a steady economic recovery, very little is going right for Russia. Gross domestic product in Russia cratered from USD 2.23 trillion in 2013 to USD 1.33 trillion last year — a staggering 40-percent drop, according to figures from the World Bank. To put that in perspective, U.S. GDP shrank at the onset of the Great Recession from USD 14.719 trillion in 2008 to USD 14.419 trillion in 2009 — a decline of 2 percent. Russian economic output is expected to contract by another 1.8 percent in 2016, while the poverty rate is seen rising from 13.4 percent to 14.2 percent over that period, the World Bank says. Russia has been crushed by Western sanctions and the global plunge in oil prices.”

The recent rapprochement, evidenced by the willingness of Russia, Saudi Arabia, and Iran to discuss a means to stabilize the price of oil, suggests that economic practicalities are forcing political realignment. Certainly for all members of OPEC, including the UAE, a stable price horizon would take pressure off of forex requirements and improve the ability to use monetary policy as an economic tool.

The message is clear. Central bankers find it hard to manage either a recession or a deflationary environment. When a volatile, exogenous element is added to the fiscal and monetary policy mix (for example the timing and quantum of oil revenues), then management can become well-nigh impossible. Stability, as in all things, is desirable, even if that means one has to look at new alliances and relationships to achieve this objective.

“The Ugly” – Stagflation

Having established that inflation is a desirable “good” for central bankers, the challenge for central banks is to determine how much inflation is enough. If the central bank wishes to stimulate demand through quantitative easing (monetary policy) or investment (fiscal policy), the risk is that price inflation gains, yet no demand change is created. Now the result is high inflation with muted demand, an extremely negative situation.

Under such circumstances, the central bank has to move from a Keynesian frame of mind toward that of a classical economist. Now the issue is actually not a failure in demand, but one of supply. An oil shock can change the supply characteristics so that the central bank must do a 180 degree turn. It must implement austerity; raise taxes (as government revenues will be reduced for some time to come and if people still want the same level of services as before, they will have to pay for them); and raise real rates on finance until the inflationary impulse is reduced so that little to no inflation is observed. Savers gain, but lenders pay for the privilege.

Over time, supply will recover to a stage where it stimulates demand again, and then prices will resume the merry inflationary dance as before. Till then, the economy will be less active than it was before the reset occurred.

With regard to both Saudi Arabia and the UAE, stagflation is not anticipated to manifest itself. Policy makers are keenly observing local investment patterns, the cost of imports, and the anticipated pipeline of exports.

Stagflation becomes an ugly prospect for the MENA region in general if China is unable to avoid the deflationary trap and shifts toward a more classical than Keynesian view of what needs to be done to stimulate the economy. That, coupled with a NIRP policy adoption by the Federal Reserve (which would push gilts into negative territory, punish savers and dis-incentivize investment), and the move by the Eurozone toward an extended decade of deflation à la Japan, would all have significant negative impacts on the demand for oil and related commodities for KSA and the UAE. Finding foreign finance would become trickier, as the finance cost inflates to accommodate inflation yet must still preserve a real rate of return. In such a scenario, the state may be forced to defer projects and consider austerity.

Thus, the degree to which Saudi Arabia and the UAE have built other non-oil reliant sectors that can generate economic activity becomes critically important. The UAE has invested significantly in logistics, tourism, and hospitality. These industries provide more of a share to GDP for the UAE than for Saudi Arabia and provide a working model for the Saudis.

Lastly, and truly irrespective of the current state of economic cycle for both countries, the ongoing creation of an environment stimulating entrepreneurial private enterprise, that can absorb new entrants into the labor market from their own citizenry, hired at competitive prices that encourage economic activity, is a sine qua non for both. This challenge remains a high priority if continued social stability, accompanied by economic sustainability, it to be ensured.

About the Author:

Grant T. Huxham is a Dubai-based senior advisor of Gulf State Analytics (**@GulfStateAnalyt**), a Washington, DC-based geopolitical risk consulting firm.

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