How Arab States Are Learning to Stop Worrying and Love Debt

Michael Gordon
National Security Fellow
Wilson Center

The Arab World's ongoing security predicaments and restrained economic growth have produced a different set of challenges for the governments across the region. In an attempt to continue financing their projects, these governments have circumnavigated their sovereign wealth funds and government subsidy programs, and have turned to the issuance of bonds. This may ameliorate the financial concerns of the region, but it can also worsen the financial climate if economic growth stagnates.

Viewpoints
No. 123

February 2018

Wilson Center

~ ~ ~ ~ ~ ~ ~ ~ ~

Great shifts in regional security and geopolitics in the Arab world have overshadowed the quieter but no less monumental shifts in the region's financial markets. The sustained softness in global oil prices and regional conflicts have restrained economic growth, and governments across the region have struggled to pay their exorbitant bills. Faced with either draining their sovereign wealth funds or cutting too deep into government subsidy programs, cash-starved governments launched bond issuance programs without precedence in size or scope for the region, amounting to tens of billions of dollars of foreign-currency denominated debt that is transforming the financing landscape.

Before 2014, neither Kuwait, Oman, nor Saudi Arabia had ever issued an international bond.[i] By 2017, roughly a third of Saudi government debt was in foreign currency.[ii] Saudi Arabia led all emerging markets in new foreign-currency denominated debt in 2017, according to the Institute of International Finance,[iii] and the *Financial Times* last October called this the "Goldilocks" moment for bond issues in the Middle East.

Government bonds in the Gulf Cooperation Council (GCC)—whether in local or foreign currency—were rarely offered prior to the oil price crash that began at the end of 2014 because capitals were usually flush with hydrocarbon revenues. The precipitous fall in oil prices changed that as the oil-exporting states of the GCC had few financing options. In 2013, when the price of Brent topped $109/barrel, oil revenue accounted for an eye-popping 72 percent of Kuwait's GDP, a proportion that fell to 56 percent in 2015 when prices fell to $52/barrel for the year. Although Kuwait is more dependent on oil revenues to fund government expenditures than the other GCC states, hydrocarbons' impact on fiscal resilience is telling. According to IMF calculations,[iv] exports of hydrocarbons make up at least half of state revenues in the GCC.

In 2017, GCC countries raised more than $50 billion in international bond issues and *sukuk* (*sharia*-compliant financing instruments with bond-like characteristics), topping the previous year's record of $37 billion, according to Middle East Economic Survey.[v] Last September, Saudi Arabia raised $12.5 billion from its second US dollar bond offering of the year, and just one month later the government of Abu Dhabi raised $10 billion in bond sales, an issue that pushed the MENA region to record bond sales with still two months left in the year. Riyadh's colossal $17.5 billion issue in October 2016 remains to date the largest bond sale by an emerging economy.

Almost as important as the sheer size of the debt issues themselves have been the competitive yields these oil exporters could obtain, despite suffering from expanding budget deficits and low economic growth. Saudi Arabia's September 2017 bond issue, for example, consisted of 5-year, 10-year, and remarkably, 30-year tranches, the latter priced at only 180 basis points (1.8 percentage points) over US Treasuries. Such competitive pricing is noteworthy for countries new to large international debt offerings and under fiscal stress. Abu Dhabi's October issue was priced evenmore competitively, likely because of its more diversified economy and revenue streams. For oil exporters unaccustomed to sovereign debt issues, especially those in the multiples of billions of dollars, this trend has been nothing short of extraordinary. The oversubscription by investors of these long-dated maturities is a bold statement of confidence in these markets.

But Can They Afford It?

Kuwait, Qatar, Saudi Arabia, and the UAE will have few problems servicing the debt they have already issued, and they could continue to add to their debt stock with little fear of the clichéd day of reckoning. Arguably, even lower-rated Bahrain and Oman could continue debt financing via international bond offerings, although with a creep-up in interest rates new issues could become less economical. Saudi Arabia's external debt-to-exports ratio (the amount of foreign-currency debt relative to the kingdom's level of exports) shot up from a mere 24 percent in 2013 to an estimated 67 percent in 2017, and the IMF forecasts this to rise to more than 75 percent in 2018. This sudden and sharp rise in debt to exports can be worrisome, but the Saudis have a fairly conservative history of financing, and the global environment for debt remains accommodating. Although policymakers in the Gulf should not bank on the recent rise in oil prices to spark an economic turnaround, the improved export revenues will strengthen the countries' ability to service their debt.

But what of those GCC countries with fewer blessings of hydrocarbon wealth or thinner reserves, such as Bahrain and Oman? Or Iraq, flush with oil, but depleted from years of conflict? Or Egypt (still in the throes of economic transition) and Jordan (long dependent on foreign sources of support)? This is where the analysis proves a bit tricky. Bahrain's debt-to-GDP ratio reached 82 percent in 2016, a stunning increase of nearly 20 percentage points in one year, and Oman saw its government debt to GDP almost triple in size in three years to hit nearly 40 percent in 2017. Investors could look at Bahrain's situation and begin looking for exit strategies, but the economy is small enough that if a bailout were needed, the island kingdom's richer neighbors could step in with cash as they have in the past to bolster stability.

It is hard to be optimistic about Iraq's economy. The country's success in driving back ISIS has put a shiny veneer on things, but the economy has made little progress on diversifying away from its overreliance on erratic oil revenues. The country's hugely successful sovereign bond issue in August 2017 marks a turning point in how international investors and financiers look at the country's prospects. The $1 billion bond was seven times oversubscribed, and although the bond carried a coupon rate of 6.752 percent—a much higher rate than the richer Gulf States are paying—Baghdad is still paying less than similar Ukrainian bonds.[vi] Eight months earlier the United States had guaranteed a $1 billion, five-year sovereign bond on international markets coupon rate of just over 2 percent. Despite the much higher coupon rate of the unsecured August issue, Iraq has proved that it can jump into the markets without US backing and find international investors eager for higher yields.

Egypt remains in the throes of economic challenges with inflation at more than 25 percent (though declining), but it has managed to enter the international debt markets with relative success, raising billions in multiple foreign-currency denominated issues this year to cover its financing needs. Egypt's debt burdens have rarely been light, and the economic decline since the revolution has forced Cairo to double down on borrowing, with total government debt (domestic and foreign) rising to more than 90 percent of GDP in 2016. Data from the Central Bank of Egypt show that Egypt's foreign debt jumped from $48 billion in 2015 to $67 billion by the end of 2016, accounting for 38 percent of Egypt's total government debt, compared with a mere 14 percent in 2015.[vii]

Egypt's success in easily finding buyers of its sovereign debt is notable and a sign that debt buyers are relatively confident in the government's ability to make its payments. What is less certain is what is driving the confidence. Economic growth will remain underwhelming at least through 2019 and high foreign debt payments loom. Egypt's debt servicing ratio—the ratio of the interest and principal payments on external debt to the country's exports of goods and services—climbed from a mere 6 percent before the revolution in 2010 to 19 percent in 2016, according to the World Bank, a ratio that undoubtedly climbed through 2017. The worry in Egypt's case is that, unlike Bahrain, it is too big to save. No debt crisis appears imminent, but Egypt's external financing situation is poor. Investors should be wary of counting on a regional savior for a bailout if fiscal strains become crushing.

Lastly, Jordan's economy has been buffeted by regional conflict, which has shrunk its exports, and persistently low oil prices, which have caused some traditional aid donors in the Gulf to pull back on financial support. As a result, Jordan's government debt to GDP has been on a steady upward trajectory for years, peaking at around 96 percent of GDP in 2017. The IMF forecasts this ratio to fall over the coming years, but what could be troublesome for Jordan is that while overall debt to GDP is set to decline, the percentage of foreign debt is increasing as a share of GDP. Foreign debt jumped from 31 percent of GDP in 2014 to 41 percent in 2017, a ratio likely to climb further in the coming years. For a resource-poor country long dependent foreign aid and debt financing, Jordan could find itself in a precarious debt-servicing scenario if economic growth does not pick up and its export revenue continues to stagnant.

The Advantages of Debt

History is littered with economies pulled down by the weight of debt, and markets have proved especially unkind to those countries with high levels of foreign-currency debt. With prudent management, GCC countries in particular will be able to manage the sharp rise in debt. For this debt experiment to pay real dividends, however, regimes must continue with their economic diversification plans and ensure broader income streams outside of hydrocarbon exports. Absent that, higher debt burdens will weigh ever more heavily on countries already struggling to manage socioeconomic stability, especially Egypt and Jordan.

Risks abound, but for those countries that successfully manage their new-found status on emerging debt markets, they can reap the long-term benefits of deeper financial markets and foundations to expand the financing options for their corporates. Evidence suggests that sovereign securities act as benchmarks that promote vibrant corporate bond markets by allowing corporates and investors to more effectively price bonds, assess risks, and improve liquidity.[viii] The lack of a sovereign yield curve had been a factor holding back corporate bond issuance in the region, and, not surprisingly, corporate bond issues took off in 2017. Global oil prices began to creep up at the beginning of 2018 and hit $70 per barrel in January, the first time since 2014. These (likely ephemerally) higher prices will make debt servicing easier for the oil exporters. Only the very foolish make bets on the direction of oil prices, but at least oil-exporting capitals can take some comfort in this trend, though it may be short-lived. At the very least, fiscal necessity has bred innovation in the region's financial markets, especially in the Gulf, and years of revenue shortfalls might now prove the unexpected catalyst for growth in their financial and corporate sectors.

The author is an employee of the United States Government, which is funding his fellowship at the Wilson Center. All statements of fact, opinion, or analysis in this work are those of the author and do not reflect an official position or views of the Government or of the Wilson Center.

~ ~ ~ ~ ~ ~ ~ ~ ~

[i] "GCC Debt Smashes All Records," Middle East Economic Survey, 24 November 2017.
[ii] "Saudi Arabia 2017 Article IV Consultation," IMF Country Report No. 17/316, International Monetary Fund, October 2017.
[iii] "Global Debt Monitor: Hidden Vulnerabilities," Institute of International Finance, 4 January, 2018.
[iv] https://www.imf.org/external/np/pp/eng/2016/102616.pdf
[v] "GCC Debt Smashes All Records," Middle East Economic Survey, 24 November 2017.
[vi] https://www.bloomberg.com/gadfly/articles/2017-08-03/iraq-s-new-bond-is-swamped-with-orders-greed-beats-fear
[vii] https://dailynewsegypt.com/2017/04/06/621081/
[viii] Robert Dittmar and Kathy Yuan, "Do Sovereign Bonds Benefit Corporate Bonds in Emerging Markets," *The Review of Financial Studies*, September 2008.

Recent MEP Publications

Viewpoints

An America Journalist Looks Back: Sadat, Begin, and the Palestinians, The Gamble That Helped Spawn a 40-Year Peace
Viewpoints No. 122 (December 2017) by John Martin

The Kingdom's Capital: An IPO and an Ambitious Prince
Viewpoints No. 121 (November 2017) by Michael Gordon

Is the U.S.-Saudi Security Alliance in Trouble?
Viewpoints No. 120 (October 2017) by David Ottaway

GCC Stock Markets: Sliding Toward Relevance?
Viewpoints No. 119 (October 2017) by Michael Gordon

Iraq's Victory in Kirkuk a Harbinger of More Conflict
Viewpoints No. 118 (October 2017) by Marina Ottaway

The Economics of Financial Market Growth in the Middle East
Viewpoints No. 117 (October 2017) by Michael Gordon

The War on ISIS: U.S. Success without a Payoff
Viewpoints No. 116 (October 2017) by Marina Ottaway

Occasional Paper Series

The Shifting Drivers of the AKP's EU Policy
(Spring 2017) by Moira Goff-Taylor

American Exceptionalism in Syria: The Faith and Heresy
(Winter 2016) by Rami Ruhayem

From Tribe to Nation: Iraqi Kurdistan on the Cusp of Statehood
(Fall 2016) by Amberin Zamman

Learning from Sykes-Picot (Fall 2015) by Marina Ottaway

ISIS: Many Faces, Different Battles (Winter 2015) by Marina Ottaway

Iraq Ten Years Later: A Different Country in a Different Region
(Spring 2013) by Marina Ottaway

Economic Lessons from Iraq for Countries of the Arab Spring (Spring 2012) by Joseph Sassoon

Post-Occupation Iraq: The Brittleness of Political Institutions
(Spring 2012) by Adeed Dawisha

Edited by Reda Baig
Woodrow Wilson International Center for Scholars