BREXIT AND THE MENA REGION

Nadim Kabbara, head of research at FFA Private Bank, looks at the potential impact of British exit from the EU on regional markets

The outcome from the recent British referendum on EU membership took markets by surprise. Going into the vote, markets were pricing in a low probability of a 'Brexit', and the British pound and global risky assets were trading higher days leading into the vote, responding positively albeit nervously to the latest polls which favoured the remain camp, albeit by a small margin.

Understandably this shock outcome coupled with unfavourable investor positioning and ensuing uncertainty did not play well on investor risk appetite, and risky assets were sold heavily in favour for safe-haven ones. While this outcome will certainly have an effect on an already fragile global economy, markets have come to understand that this will likely be a drawn-out process that will have greater political and economic ramifications predominately for the UK and the EU. Fears of global recession and financial contagion were possibly overblown, while global central banks particularly the Bank of England took the courageous and immediate step to watch developments closely and provide support as needed helping to shore confidence.

For the Mena region, we would expect to see the effects from Brexit to be largely limited to indirect transmission channels, largely from price developments in oil and the US dollar on account of investor sentiment, particularly for oil-exporting GCC nations. While we have seen the undesirable effects the stronger USD has had on the commodity complex over the past years, the oil market is now on a better footing with improved demand/supply balance recently in contrast to prior supply excesses, which should help support prices. I would expect the stronger USD to have impacted non-oil trade balances for USD-pegged Mena nations and placed pressure on those with floating rate regimes and heavy USD-denominated external debt. Having said that, the US Federal Reserve will likely err on the side of caution before raising rates, which should help calm USD strength fears, as markets are pricing in a move closer to 2018. This could help regional banks that have seen tighter liquidity but hurt profitability in those with excesses held at near-zero rates.

> “THE EFFECTS FROM BREXIT WILL BE LARGELY LIMITED TO INDIRECT TRANSMISSION CHANNELS”

More direct transmission channels including trade are rather low given GCC countries' limited trade links to the UK and the EU, therefore likely weaker growth prospects in the UK and EU will not be as material as seen elsewhere, in the CEE for instance. The most affected GCC nation is likely to be Qatar, still at low-to-single-digits exposure to UK as percentage of trade. But Qatar, like other GCC sovereign wealth funds, has also invested a sizeable share in global real estate and corporates which include the UK, in contrast to Saudi Arabia, which is more focused on US treasuries. Mena oil-exporting countries largely from GCC do not generally depend on international community having run sizeable current account balances in the past, and financial linkeages with the UK and EU are limited in terms of interbank markets and GBP and EUR foreign-denominated assets.

Mena countries that are importing oil largely from the Levant and North Africa have similar limited exposure to trade with UK, but larger significance with the EU, Morocco being one. Where Dubai may benefit vis-a-vis its GCC peers in terms of diversification from oil, a stronger USD, weaker pound/euro environment may hurt its retail, hospitality, tourism, and real estate sectors given the weaker purchasing power of UK/EU nationals which represent material share. Recent history could validate this judging by the effect the weaker Russian rouble has had on Dubai.

A possible silver lining from Brexit – should the UK actually exit the EU several years from now – could drive stronger bilateral agreements, particularly given the UK's historical ties to the region. UK goods, services, and investment would also be more attractive given a weaker GBP/USD, and weaker FX may help rein in imported prices. ■