

Hard pegging and a vicious circle

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The recent debate over the potential revaluation of the UAE dirham against the US dollar has generated more heat than light.

Soaring oil export revenues have helped the UAE to enjoy a current account surplus of nearly 30 per cent of its gross domestic product (GDP). Similar examples are abound in other Gulf states too.

However, despite the UAE's robust external balance, the country's central bank has not provided any indication about the possibility of a much-needed revaluation. In the wake of higher material inflation (including import inflation) pressure has build up to revalue the dirham, which has been pegged to the dollar since the UAE's independence in 1971.

Even a layman can tell that something is not going right. The dirham's purchasing power has fallen sharply over the past couple of years despite the UAE's strong economic growth. Is the undervalued dirham to blame for the loss in purchasing power? The broad answer is "yes". The prolonged hard peg has taken the monetary policy out of the hands of the government and central bank and put it on autopilot.

Pegging implies that the UAE has to adopt America's monetary policy, which may not fit to domestic conditions always -specially during a high-inflation regime. Thus the recent decision to lower the UAE's interest rate by 15 basis points following the US Federal Reserve's move to cut its benchmark rate by 50 basis points to 4.75 per cent was wrong.

In fact, nominal interest rates in the UAE should go up. One consequence of the central bank's persistent indifference towards controlling inflation is the bizarre result that the real interest rate has fallen to negative. This is very hard to digest for a fast-growing economy which is currently expanding at an annual average rate of eight per cent on a real basis. The negative real interest rate has helped businesses to borrow money recklessly.

Domestic credit is growing at an average rate of 30 per cent, while the pace of broad money (M2) growth has jumped to an average 20 per cent. To me, the current inflation problem at its best is an application of Milton Friedman's famous adage that "inflation is always and everywhere a monetary phen-omenon", and its corollary that monetary policy should concentrate on the one thing it can do well - control inflation. Can the UAE Central Bank fight inflation?

Inflation

Import inflation has intensified in recent years due to a weakening dollar. When the dollar drops,

imports cost more. A revaluation would help to diminish the impact of global commodity price inflation because commodities are priced in dollars so that a revaluation lowers their domestic prices in dirhams. However, a revaluation presumably is not on the policy agenda of the UAE Central Bank. The bank rationalises the peg on the basis of the planned GCC currency union in 2010.

However, Kuwait's recent unilateral decision to unpeg its dinar-dollar peg to an undisclosed basket of currencies has raised suspicion about the GCC's commitment to meet the deadline of 2010 to implement the monetary union.

Further, Oman's announcement that it will not join the union in 2010 came as a blow to the adherents of the single currency. I am not saying that the planned currency union is not a viable option for the UAE or the Gulf as a whole. But the inability to contain inflation will surely delay the process of forming a monetary union.

While higher oil prices have put upward pressure on the real exchange rate between the dirham and dollar, rising inflation cannot be contained unless nominal exchange rate is allowed to rise. The idea that abandoning the dollar peg will generate exchange rate volatility that may harm the competitiveness of the non-oil sector is not supported by the data.

Non-oil industries were squeezed at the same time when the dollar strengthened and the price of crude was sliding in the late 1990s. The magnitude of volatility will largely depend on the nature of exchange rate flexibility. A fully floating exchange rate may lead to too much volatility, but a trade-weighted currency may seem more practical and beneficial for the UAE and other Gulf states.

A flexible exchange rate will provide room for the Central Bank to manoeuvre monetary policy, especially during times of high inflation. Further, compared to the existing hard peg, a bit more flexibility in dirham could help oil exporters to adjust to fluctuations in oil prices. Evidence from other countries has shown that a more flexible currency allows economies to manage oil shocks better.

In the wake of growing market speculation about domestic currency revaluation, pressure is mounting in the UAE and across much of the Gulf region to raise the undervalued currency. A recent Reuters poll indicates that the UAE is most likely to revalue its currency, while Saudi Arabia was least likely.

The bitter truth is that while the UAE's exports do better from an undervalued dirham, most residents are getting poorer due to falling purchasing power. As such, inflation cannot be beaten without any intervening change in the monetary policy. Neglect of proper anti-inflationary measures will only intensify the inflationary pressure further and may pose a threat to regional economic stability.

The debate should not be limited to the issue of a hard peg versus revaluation of the domestic currency. The central issue in conquering inflation is whether the Gulf countries have a chance to undertake broader long-term measures by setting up institutions and mechanisms that will efficiently guide their monetary authorities in fighting inflation.

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