

Unravelling the myths of the GCC dollar peg

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Despite the global financial chaos, the US dollar has come through the turmoil surprisingly well.

A resilient dollar may be what GCC central banks are praying for after being pressured by analysts and market participants for possible currency revaluations in the first half of 2008.

Much has been discussed on this issue of late, and despite the negative consequences arising from the dollar pegs, Gulf central banks (except Kuwait) remained firmly committed to the fixed exchange rate regime.

From time to time the proponents (in particular the GCC central banks) have provided several compelling justifications in favour of the existing dollar peg. The goal of this column is to revisit the three most proposed explanations for the GCC dollar pegs. First, proponents argue that fluctuations by the domestic currency will result in destabilising governments' oil export revenues measured in local currencies.

Since oil is priced in US dollars and oil contributes significantly to the country's gross domestic product, it may seem a good idea to fix the domestic currency against the US dollar. Nevertheless, oil prices fluctuate wildly within a day and, due to the dollar peg, a nominal exchange rate cannot adjust to insulate the real economy from external shocks. In the end, the real economy is left vulnerable to inflation/deflation depending on the nature of the trade shocks.

Second, the proponents argue that a revaluation would reduce the local currency value of dollar investments abroad. But this is misleading since these are US dollar assets and they will not lose value in dollar terms if they remain in dollars. Besides, upon maturity, these assets can be converted into new US dollar securities. Hence, there is no capital loss due to revaluation.

It is true that revaluation reduces the value of foreign assets expressed in local currency. Then again, these assets are worth less domestically because of high and rising inflation. Revaluation would take some pressure off domestic inflation, which would in turn increase the real value of foreign assets in local currency. Furthermore, revaluation would make it cheaper to buy alternative foreign securities denominated in euros or yen. Therefore, the net position may or may not be a capital gain or loss depending on the degree of revaluation vis-a-vis the reduction in domestic inflation.

Third, proponents argue that the dollar peg is a good idea until the adoption of a common currency which is planned to take place in 2010. However, this need not be the case. History shows that several European countries did not have a de-facto pegged exchange rate prior to joining the euro in 1999. In fact, some had moved away from the German mark peg following the European Exchange Rate Mechanism (ERM) crisis in 1992-93 and allowed limited or full flexibility to their exchange rates before adopting a common currency. The proponents' explanation is thus more political than economic.

Summing up, although GCC currencies are administratively fixed to the US dollar, they are fully market driven against other currencies such as the euro or yen. With over 70 per cent of GCC trade with Europe and Asia, the region is in dire need of exchange rate reforms. Sadly, GCC central banks failed to show the necessary will and foresight to move forward. So far, at any rate.

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