

## Qatar's currency in need of reform

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Exchange rates act as a leading indicator of the performance of any economy. Roughly, a stronger (i.e. appreciating) national currency can be seen as an indication of better economic performance, while a weaker (i.e. depreciating) national currency tends to portray weakening economic activity.

Generally, we focus our attention on the movement between a national currency and any major international currency such as the US dollar. For example, the movement between the UAE dirham and US dollar has been constant for two decades. This relationship is known as the bilateral exchange rate.

Although it serves many important purposes, it would be unwise to draw conclusions about general economic performance solely based on the movement of bilateral exchange rates. For example, it is incorrect to say that both the UAE and US economies have performed identically since the bilateral exchange rate between the two economies has been constant. Likewise, although the UAE dirham has become weaker against the Japanese yen over the past few years, we cannot claim that the Japanese economy has performed better than the UAE's economy.

In order to draw a meaningful conclusion of the performance of an economy we need a measure called "effective exchange rate", which is nothing but the weighted average of bilateral exchange rates. The effective exchange rate (EER) distils the information contained in bilateral exchange rates into a single series.

Generally, only the most important trading partners' currencies are included in the construction of an EER, while the weight of each trading partner's currency is determined on the basis of either export or import trade shares, or both. In practice, EER is an exchange rate index which shows appreciation (index above 100) or depreciation (index below 100) of the national currency against a basket of trading partners' currencies for a certain period relative to the base period.

Thus, an EER index can be thought of like a stock market index where an increase in the index value shows strengthening of the economy, while a decrease in the index value indicates economic weakness.

Two types of EER are available. One is nominal EER, which simply shows the movement of national currencies against a set of trading partners' currencies. The other is real EER, which is adjusted for inflation and provides analysis of global competitiveness.

The goal of this column is to analyse the developments of nominal and real EER indexes for Qatar over the past several years. Like other GCC economies, Qatar adopted a de-facto fixed US dollar peg system, which came under increasing scrutiny following the US dollar's persistent decline against

major international currencies. High and rising inflation in Qatar has caused the dollar peg system to become increasingly unstable.

Against this backdrop, it is useful to analyse the movements in effective exchange rate indices, which can provide us with a litmus test of the existing dollar peg system in Qatar.

Before we get ahead of ourselves, it is useful to note that these indices are constructed using the eight most important trading partner currencies of Qatar, namely Australia, euro zone, Japan, India, Korea, Switzerland, the UK and the US. Further, these indices use import weights with the intension of preserving the purchasing power of the Qatari riyal.

The solid line in Fig. 1 plots the nominal effective exchange rate of the Qatari riyal from the first quarter of 2002 to the second quarter of 2008. As can be seen, the nominal EER index of the Qatari riyal has been declining for most of that period. Why is the nominal EER index falling? This is simply because since the start of 2002 the US dollar has been depreciating against major vehicle currencies (e. g. euro, yen, and British pound); thus due to the fixed exchange rate between the Qatari riyal and US dollar, the riyal is also depreciating against these vehicle currencies.

In fact, from the start of 2002 until the first half of 2008, the Qatari riyal has depreciated by about 29 per cent in nominal terms against a basket of seven most important trading partners' currencies (see above).

Meanwhile, the nominal EER index of the Qatari riyal increased in 2005 because the US dollar appreciated against major vehicle currencies during most of that year.

Ideally, in a stable economic environment both nominal and real exchange rates should move together.

This was the case in 2002-03 when both nominal and real EER indices of the Qatari riyal were falling in tandem, however, the real EER index (dashed line in Fig. 1) has been moving in the opposite direction to that of nominal EER index since the start of 2004.

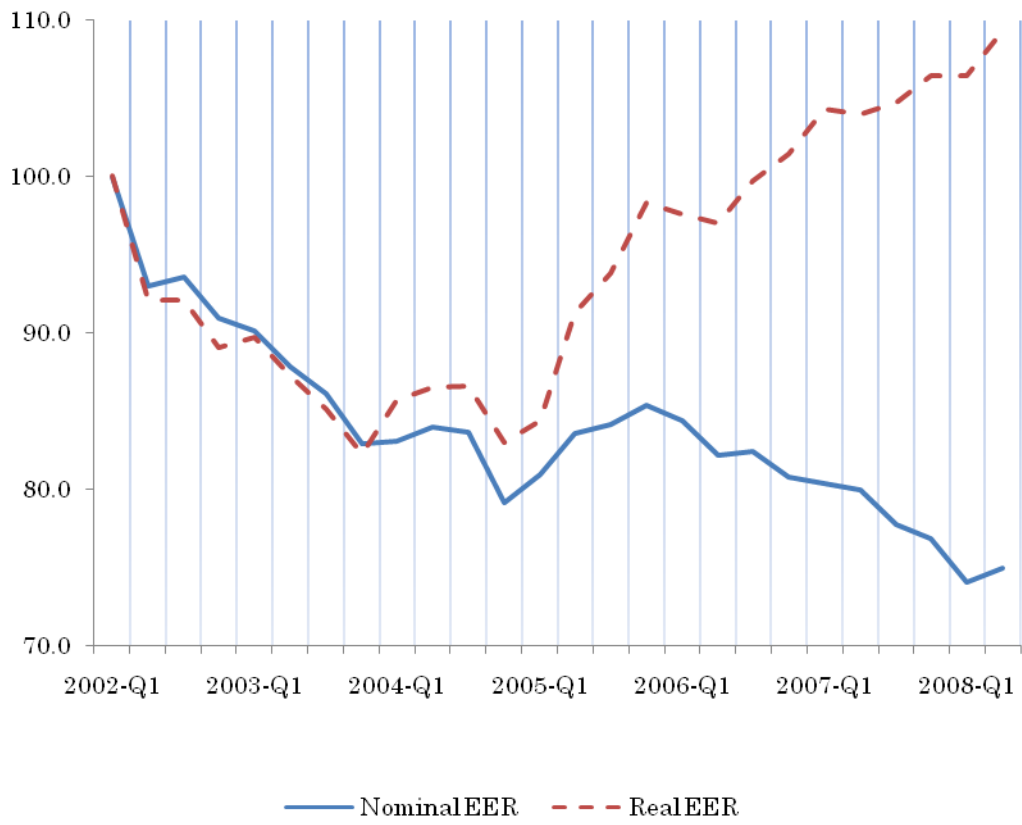
The reason why the real EER index fell in 2002-03 is because of falling inflation in Qatar relative to her trading partners' inflation. For example, in 2002-03 the annual average inflation rate in Qatar was about 1.56 per cent, while it was about 2.18 per cent in the trading partners' countries.

Likewise, the real EER index has been rising since the start of 2004 mainly because inflation in Qatar has been increasing at a faster rate than her trading partners' inflation. For example, during 2004 to second quarter 2008, the annual average inflation rate in Qatar was 11.44 per cent compared to annual average inflation of 2.92 per cent in the trading partners' countries.

Based on this evidence, we can see that the existing exchange rate system in Qatar is unsustainable and thus immediate exchange rate reform is needed to align the riyal's nominal and real exchange rates. For the last five years the Qatari economy has been enjoying resilient growth and a robust current account surplus, and therefore the nominal exchange rate must rise (appreciate) to insulate the real economy from shocks such as inflation.

The real appreciation of the riyal will undoubtedly hurt exports of the non-hydrocarbon sector and will also slow the process of economic diversification. Additionally, real appreciation is affecting the non-tradable sector such as real estate by making construction materials more costly.

**Fig 1: Nominal and real EER in Qatar:  
2002Q1 to 2008Q2**



- *The author is a research economist at Qatar Central Bank. Views are author's own.*