



Research Bulletin

December 2007

Gulf One Investment Bank B.S.C. (c) is a Bahrain registered bank whose vision is to be the leading knowledge-based infrastructure investment bank in the MENA (Middle East and North Africa) region. Its mission is to mobilise local and global capital to accelerate the execution of infrastructure projects via innovative custom made financial solutions.

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The currency peg debacle: the GCC at a crossroads

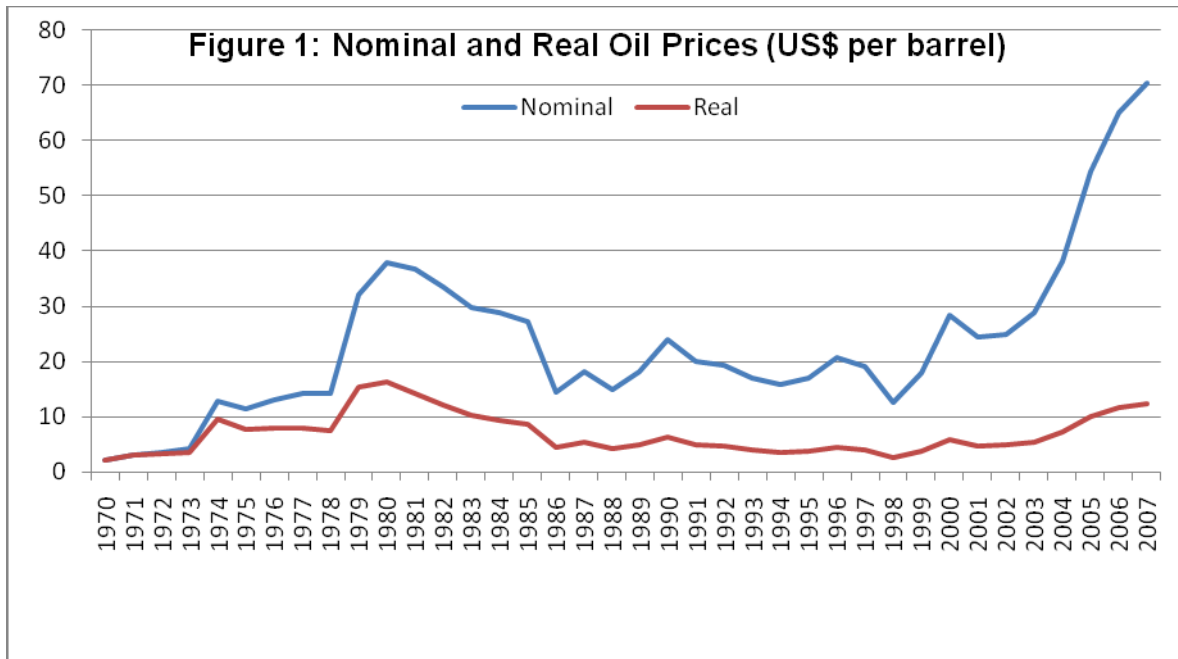
Overview

The global economy in 2007 has witnessed a number of dramatic events which have unfolded simultaneously. The recent oil price surge, sparked by geopolitical uncertainties, accelerating oil demand from fast growing emerging economies, and limited oil supply capacity, has added upward pressure on world price indices. Many other commodities, including precious metals, have all set record highs during 2007. The depreciation of the dollar has amplified the oil price surge in dollar terms. The weakening of the dollar, combined with financial turbulence linked to the subprime mortgage market in the United States, may have induced investors to diversify away from dollar-denominated financial assets.

The direct effect of the recent oil price rise on headline inflation in the United States is estimated to be around ½ percentage point only by the end of the year. The impact in other advanced economies will likely be smaller because reliance on private transportation is lower, and prices have risen less in other currencies.

The weakening dollar is projected to be a trend, not a cycle, implying that future declines in the dollar would continue so long as the U.S. current account deficit remains too large for too long.

For the GCC countries (Saudi Arabia, the UAE, Kuwait, Qatar, Oman, and Bahrain), these events have presented them with both opportunities and challenges. Opportunities in the sense that the high oil prices have enabled these countries to improve their balance of payments and fiscal positions. At \$350 billion, the GCC current account surplus is almost comparable to China. In spite of these impressive statistics, the current oil price in real terms (deflated by global inflation) is nowhere near the levels achieved in the late 1970s (see Figure 1). This suggests that the income terms of trade for the oil exporting countries, especially the GCC, though positive, are well below their levels in the previous oil 'boom' periods.

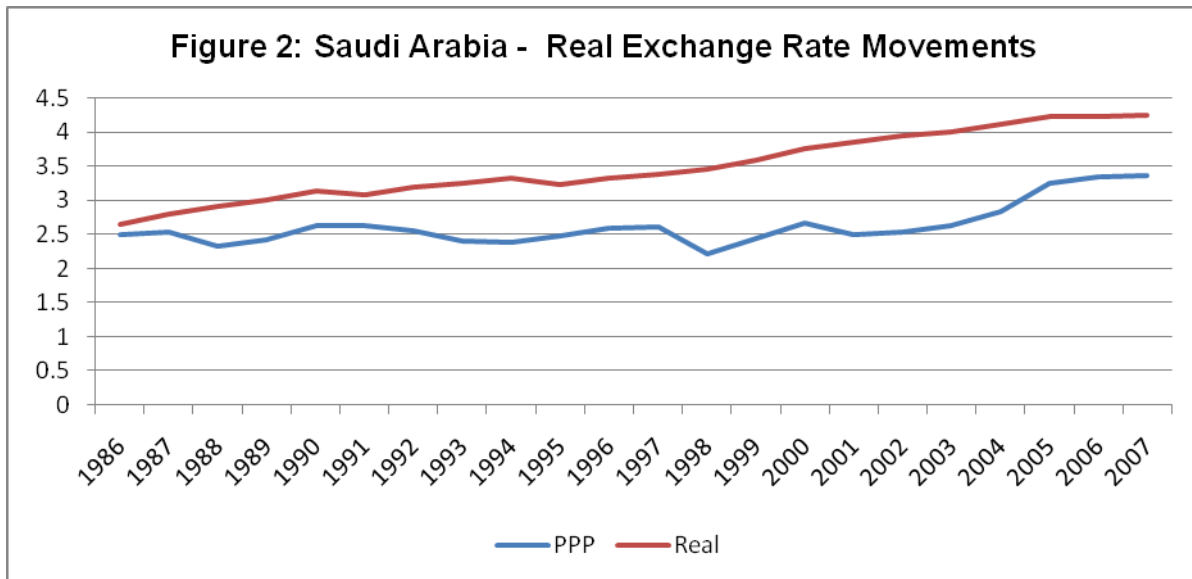


Source: OPEC and SAMA

It should be noted also that the current global economic situations impose real and potential challenges to the GCC countries for a number of reasons. First, with the exception of Kuwait, all GCC countries' currencies are pegged to the US dollars for a long period of time, and the continuous decline in the value of the dollar tends to erode the purchasing power of these currencies. Kuwait is the only GCC country that switched back from a dollar peg in May 2007 to a basket of currencies which it followed in the past, but other members of the GCC have continued to stick to their dollar pegs, in spite of the US currency slumping to record lows.

Secondly, the deteriorating dollar – coupled with steep oil prices – has fuelled global inflation, which is imported into GCC countries through demand for foreign goods, particularly food products. Thus, as the dollar devalues against a basket of currencies, such as the Euro, Sterling and Yen, the rise in GCC inflation forces GCC governments to seek higher yields in order to protect the purchasing power of their oil revenues. Estimates by Morgan Stanley show that a 10% decline in the value of the dollar vis-à-vis other major currencies leads to a 5% reduction in the purchasing power of oil producing countries.

This can be illustrated by the continuous depreciation in the exchange rate for Saudi Arabia in terms of both real exchange rate (official exchange rate adjusted for inflation differentials between Saudi Arabia and the US) and purchasing power parity (PPP) exchange rate, which takes into account both tradable and non-tradable goods in the exchange rate basket. As can be seen from Figure 2, both real and PPP exchange rates have exhibited an upward trend over the years, signifying that the purchasing power of the Saudi riyal has deteriorated considerably.



Source: IMF, World Economic Outlook 2007 Database

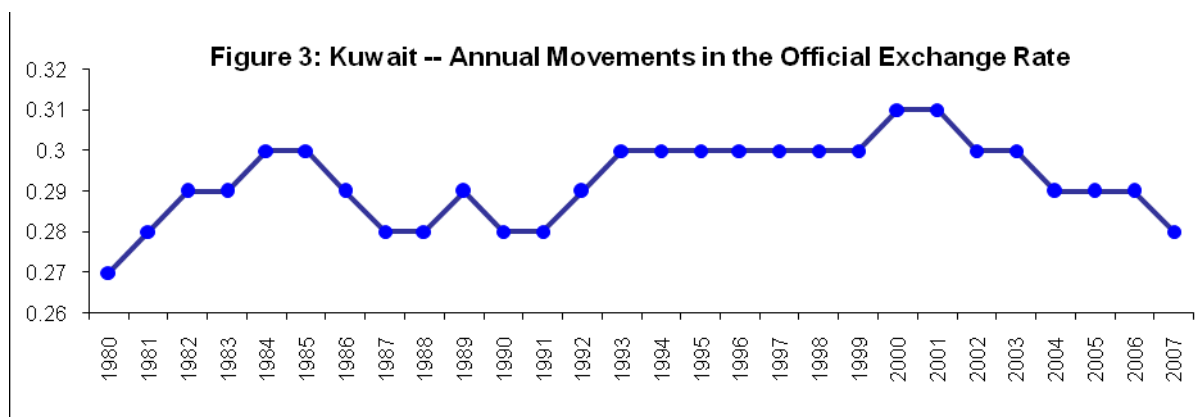
The continuous decline in the value of the dollar has also led to heightened speculation that the five other GCC countries (Bahrain, Oman, Qatar, Saudi Arabia and United Arab Emirate – UAE) were preparing to abandon their currencies' pegs against the greenback. Indeed, the speculation was intensified in September 2007, when some of the GCC countries ignored the 50 basis points interest rate cut by the US Federal Reserve to prop up its sluggish economy. In Saudi Arabia, the decision not to alter interest rates by the Saudi Arabia Monetary Agency (SAMA), aimed at containing inflation, triggered speculation of a revaluation in the Saudi riyal. The Saudi monetary authorities had to intervene aggressively in the forward foreign exchange market to defend the riyal's peg. In the second interest rate cut in the US (November 2007) by 25 basis points, however, SAMA mimicked such move by reducing the reverse repo. Other GCC countries equally followed suit.

This shows the dilemma facing the GCC countries, given the divergence in the economic cycles of the GCC and the US. Whilst the US economy is facing 'slugflation' (slow growth and high inflation), the GCC economies are experiencing strong growth and high inflation. Clearly, different sets of policy instruments are needed to tackle these twin problems in both regions. Whilst the US needs to cut interest rate to stimulate economic growth, the GCC need to raise interest rate to curb inflation. But the GCC currency peg regime leaves them with little or no flexibility in using monetary policy to curb inflation!

As the fall in the value of the dollar shows no sign of abating, the key questions are: for how much longer should the other GCC countries wait before they follow the footsteps of Kuwait to abandon their dollar pegs? What lessons could the other GCC countries learn from the experience of Kuwait? What are the consequences of sticking to the dollar peg? The answers to these and other related questions would shed light on policy options for the GCC countries as they grapple to address key development challenges facing the region.

The Kuwaiti Experience

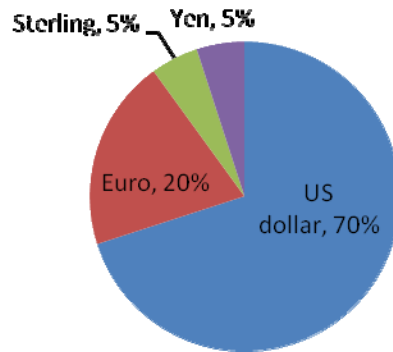
The recent delinking of the Kuwaiti dinar from the US dollar did not come as a surprise to many observers and students of exchange rate policy. The May 2007 abandoning of the dinar-dollar parity was not the first time in Kuwait's history. The first case occurred at the start of the New Millennium when the dinar was de-pegged from the dollar and then devalued by 3.3% (see Figure 3).



Source: IMF World Economic Outlook 2007 Database

However, the circumstances that warranted the recent change in the exchange rate regime were different from those that prevailed in 2000. That is why the latter unpeg was followed by a revaluation of the dinar whilst the former was followed by a devaluation. In addition, the current exchange rate policy involves linking the dinar to a basket of currencies, consisting of the US dollar, EU euro, British pound sterling, and Japanese yen. The basket is heavily weighted in favour of the dollar (see Figure 4). However, this could gradually change according to trade and economic patterns with international economies. This is particularly important because although the US dollar currently accounts for 70 percent of the currency basket, the US only accounted for 7 percent and 15 percent of Kuwait's exports and imports, respectively, in 2006. The bulk of Kuwait's exports (over 42 percent) last year were destined to Asia while over one-third of its imports originated from Europe.

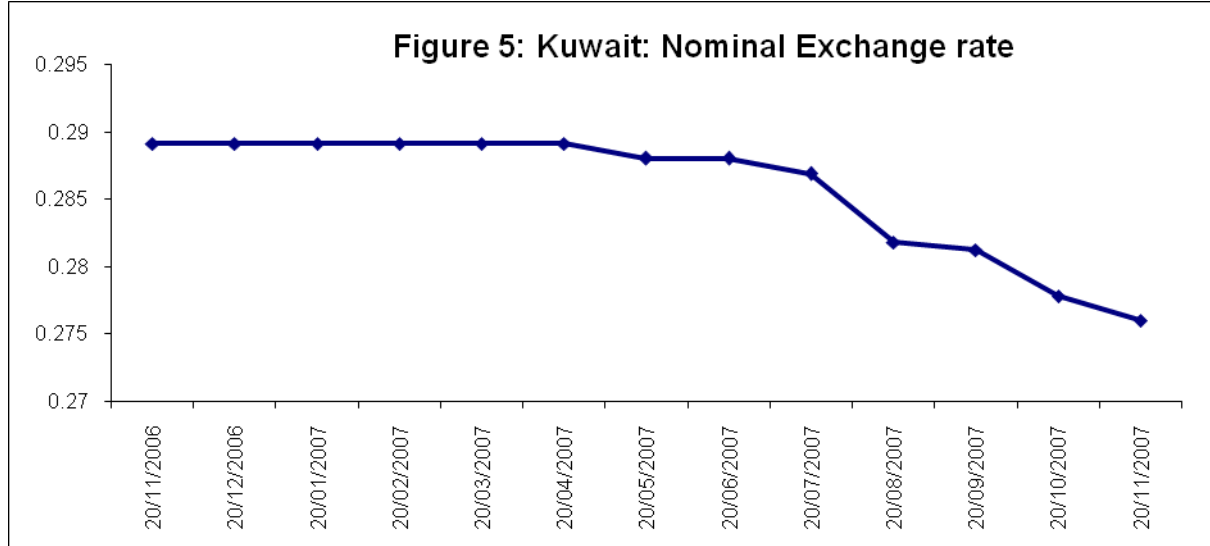
Figure 4: Currency basket for Kuwait dinar



Source: Khaleej Times Online.

Since ditching the dollar peg, the Kuwaiti dinar has appreciated by 4.5% against the dollar and is gaining momentum daily. As can be seen from the monthly exchange rate movements (see Figure 5), the Kuwaiti dinar appreciated from nearly 0.288 to US\$ in May 2007 to 0.275 in November 2007. This represents a 12% appreciation of the dinar over the past 6 years.

Figure 5: Kuwait: Nominal Exchange rate

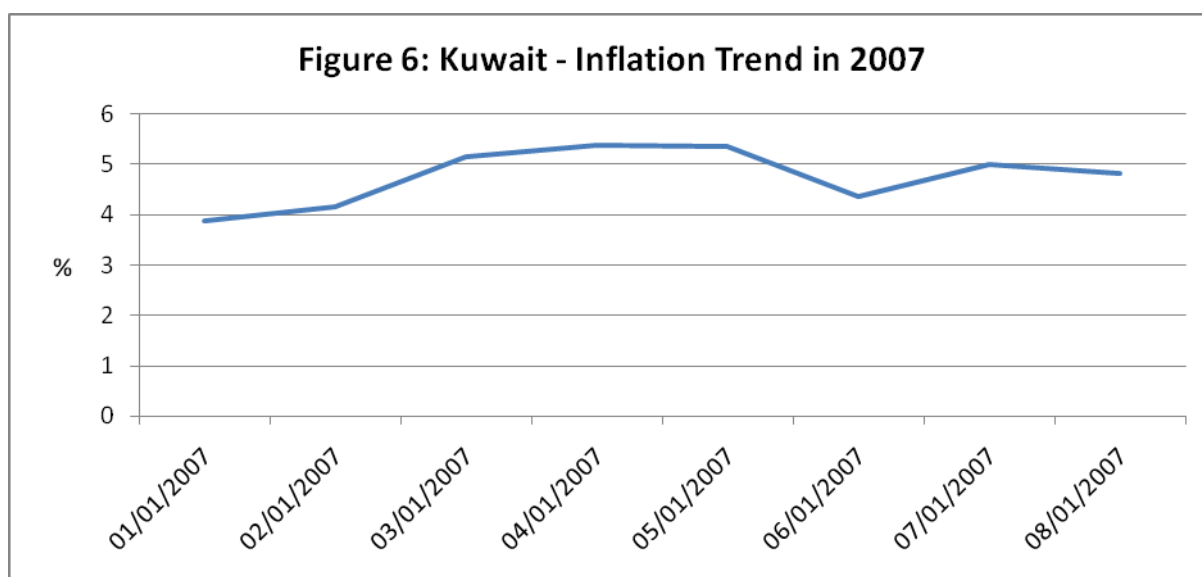


Source: Reuters' Database

Impact of the Kuwaiti Dinar Revaluation

It is too early to gauge the impact of the Kuwaiti currency unpegging and its subsequent revaluation on all key economic fundamentals in the economy due to the short duration of the new exchange rate regime and also due to the fact that most economic variables, such

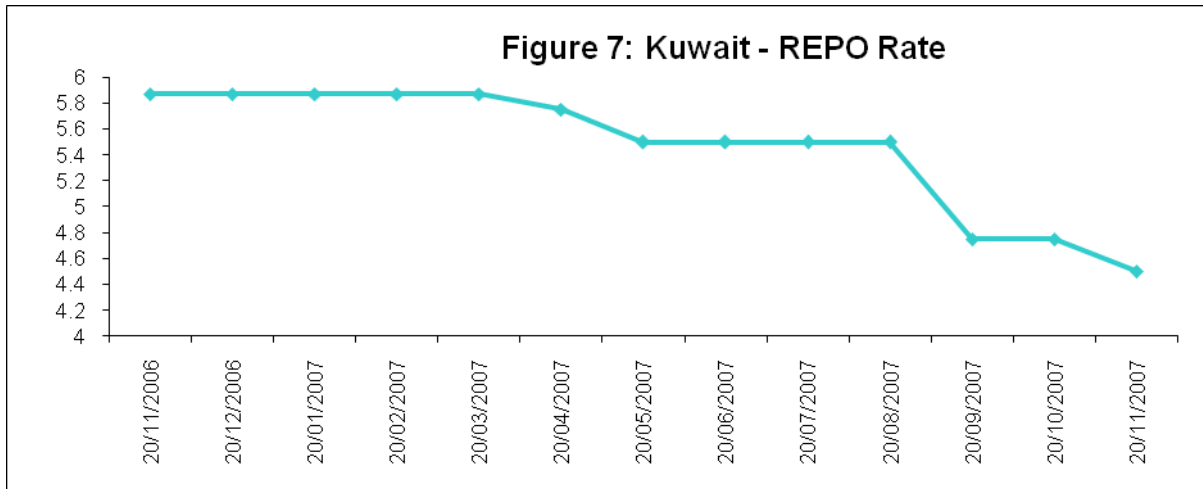
as exports, imports, unemployment, and fiscal position are reported on a quarterly basis. Other variables, such as the GDP, are even reported on a longer term basis, usually one year. Nonetheless, available data on inflation, which triggered the Kuwaiti authorities to abandon the dollar peg, is available on a monthly basis. From the monthly inflation figures, it can be discerned that the switch from the dollar peg to a basket of currencies has led to gradual decline in inflation. For instance, inflation declined from over 5% in May, prior to the unpegging/revaluation, to 4.8% in August. It is likely that inflation in Kuwait will continue its declining trend, and a number of research agencies, including the IMF, have projected 2.7% inflation at the end of 2007 and 2.6% in 2008, the lowest in the GCC.



Source: Reuters' Database

Decomposition of inflation in Kuwait shows that much of the inflationary pressures is on account of housing costs, which currently account for nearly 30% of total price/cost basket, followed by transport and communications (16%), and food (10%). All three categories of consumer spending have exhibited declining trends since the May 2007 revaluation of the dinar. For instance, inflation on account of transport and communications declined from nearly 10% in July 2007 to around 8% in August 2007. Similarly, food price inflation fell from 5.6% in May 2007 to 2.1% in July of this year, thanks to the dollar delinking of the dinar, which gave the monetary authorities autonomy and flexibility to use monetary policy to rein in inflation.

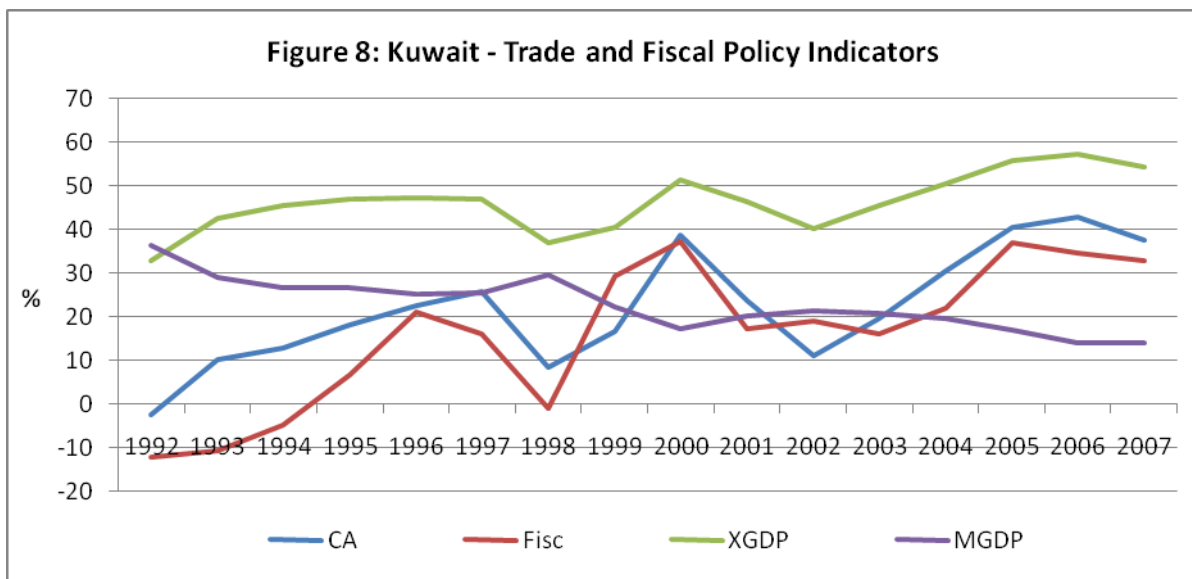
It is worth noting here that interest rates in Kuwait, since May 2007, have been revised downwards rather than upwards (see the trend in the REPO rate in Figure 7).



Source: Reuters' Database

Two interest rate episodes are noticeable from Figure 7. First, three months after the dinar unpegging, the monetary authorities decided to keep the repurchase rate unchanged (June – August). Since then, two interest rate cuts were effected, bringing down the repo rate to around 4.4% in November 2007, down from 5.2% in August 2007. Having succeeded in containing inflation to a 'comfortable' level, there was the need to use interest rate policy to stimulate growth in the economy.

Annual data on GDP growth and other key economic indicators suggest that the economy is moving in the right direction. Kuwait's GDP growth rate, fiscal balance and current account position were projected to improve in 2007 owing to both high oil prices and low inflation. Nonetheless, our analysis suggests that, on current trends, Kuwait would continue to record fiscal and current account surpluses but at a decreasing rate (see Figure 8).

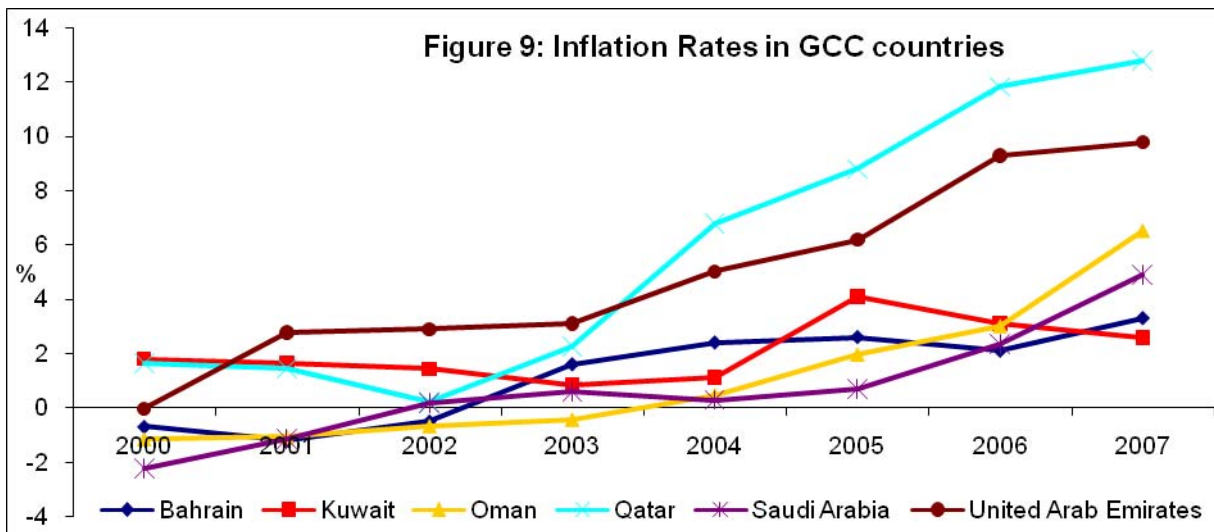


Source: IMF World Economic Outlook 2007 Database

Although the de-pegging of the dinar was an inevitable and desirable process under the current circumstances, it remains unclear whether or not future adjustments to the exchange rate may be beneficial without a strong diversified economy. According to the theoretical and empirical literature, changes in the exchange rate (devaluation or revaluation) are expected to be effective only when the Marshall Lerner condition holds. This condition requires that the sum of the price elasticity of demand for imports and the price elasticity of export supply is greater than or equal to unity. Estimated regression equations for Kuwait's import demand and export supply functions for the period 1980-2007 yielded an import price elasticity of 0.22 and an export price elasticity of 0.69 (combined price elasticity of 0.91, less than unity). Given that the Marshall Lerner condition is not met, it suggests that exchange rate changes are unlikely to alter trade patterns considerably. This outcome is unsurprising since Kuwait, like other GCC countries, is largely dependent on oil exports whose prices, determined by the international oil market, are invariant with exchange rate movements. Also, the economic structure is less diversified to boost non-oil exports which are often more sensitive to price changes than oil exports. Clearly, the lesson from this analysis is that Kuwait and other GCC countries should use the oil proceeds to diversify the non-oil sectors of their economies.

Lessons for other GCC Countries

As a step towards achieving the GCC currency union in 2010, the Gulf economies agreed long ago to fix all their currencies to the dollar. However, both the continued decline in the value of the dollar and increasing inflation led Kuwait to take a different direction and shift to a basket of currencies. Kuwait's success story of taming inflation creates a conundrum situation for other GCC countries. The high and rising inflation in these countries, due largely to imported inflation, is a big source of concern. As can be seen from the figure below, with the exception of Kuwait, all the GCC countries are experiencing a positive and increasing trend in inflation rates.



Source: International Institute for Financial Statistics (IIF) Database

According to the IMF, annual consumer prices in the GCC region are expected to rise to 10.8%, up from 7.5% in 2006, and are projected to rise by 9.2% in 2008. These inflation figures are all based on official data and so they do not accurately reflect inflationary gaps (measured as the difference between money supply growth and GDP growth). For instance, inflation in Saudi Arabia in November 2007 stood at 4.9% but the inflationary gap, as defined above, for 2007 is over 15%. The high inflationary pressures in the region are causing havoc across the board. Three of the GCC countries – Qatar, UAE, and Oman – are experiencing negative real interest rates of 7%, 5%, and 1% respectively (see Table 1) with attendant consequences.

Standard principles of monetary economics would suggest that the current inflation rates in the region should really lead to a tightening of monetary policy. But with their currency tied to the dollar, the GCC countries have had to follow the US Federal Reserve's lead and cut interest rate (instead of raising it) to maintain the parity. This is spurring monetary and credit growth. For instance, Saudi broad money growth has averaged a twelve-month rate of 18.1% so far this year, compared with 14.4% last year. In the UAE, the equivalent numbers are 29.2% (2007) and 25.1% (2006). This massive monetary growth is fuelling asset prices as well as driving up prices of goods and services, and eroding real wages!

The monetary and political authorities in the GCC countries are aware of this conundrum. The UAE authorities have recently commented on the desirability of a change in foreign exchange regime. Similarly, Saudi Arabia was also examining the desirability of a revaluation of the Saudi riyal. But de-pegging from the dollar will not be easy for the GCC countries for various reasons as discussed later in this piece.

Already, Oman had decided to stick to the dollar peg, but Saudi Arabia (the biggest GCC economy) and UAE are still keeping their options close to their chests on whether to unpeg or to have a one-off revaluation or to maintain the status quo. Each of these options has its

advantages and disadvantages. Maintaining the status core means that these GCC countries would see the value of their dollar-dominated assets being eroded by the continuous weakening of the dollar whilst at the same time they would be helpless in curbing inflation (since they have little power over monetary policy), which would further undermine economic growth and development. Speculative tendencies about the Saudi Riyal and the UAE Dirham, unless they are nipped in the bud, are likely to destabilize both the foreign exchange and capital markets, as the disparity between the needs of the economy and the needs of the peg will continue to increase.

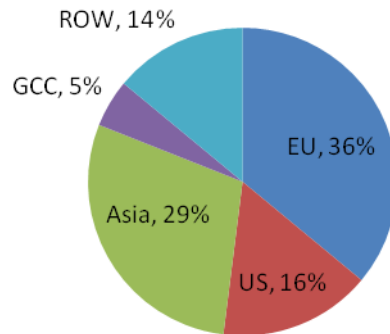
A one-off revaluation of the GCC currencies is not a good idea as it will fail to address the medium-term to long-term problems associated with the dollar peg system. Maintaining the status quo may even appear to be a better option than a one-off revaluation of currencies, from both economic and political angles. On the political front, the dollar de-pegging by the two largest GCC countries (Saudi Arabia and UAE) would not be viewed favourably by the US as it would have a destabilizing effect on the US economy, with adverse global consequences. Indeed, Western central banks fear that a GCC unpeg would increase commercial and financial demand for floating non-dollar currencies, such as the euro and sterling, which in current market conditions would send them sharply higher. Marvin King, Governor of the Bank of England recently expressed his concerns about speculations that GCC states such as Saudi Arabia and the UAE might de-peg their currencies, and indicated his preference for Asian currency appreciation to an early de-pegging from the GCC (Financial Times, 12 November 2007).

On the economic front, it is argued that the GCC countries currently depend heavily on oil exports, which account for 80% of government revenues. Given that oil is still and will continue to be priced in dollars (judging by the 3rd OPEC Summit in Riyadh, 17-18 November 2007), unpegging the GCC currencies from the US dollars would erode oil revenues. There would also be huge foreign exchange transaction losses for the region's banks and sovereign investment agencies. Similarly, dollar-denominated investments of the GCC states would suffer as a result of unpegging!

The unpegging option

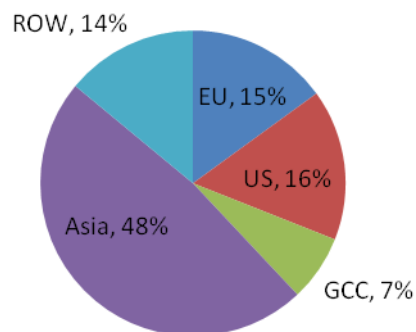
In spite of the economic and political motivations for maintaining the status quo, there are ample grounds for a shift to a new exchange rate regime, namely a managed float linking the GCC currencies to a basket of foreign currencies with limited band of movements. This becomes imperative in view of the paradigm shift in the trade and investment patterns of the GCC, especially with the strong current privatization and diversification activities. For example, in 2006, only 16% of Saudi imports originated from the North America, predominantly the US, while 36% came from the EU (see Figure 10). In the case of Saudi exports, 48% of it went to Asia, with Europe and North America accounting for 16% and 15% respectively (see Figure 11).

Figure 10: Saudi Arabia - Sources of Imports, 2006



Source: Economist Intelligent Unit, 2007.

Figure 11: Saudi Arabia - Destination of Exports, 2006



Source: Economist Intelligent Unit, 2007.

Clearly, a de-pegging policy should be based on a basket of currencies using trade-weighted indices to determine the share of each currency in the basket. On current trade patterns, a hypothetical basket of currencies for the Saudi riyal should consist of the following currencies: Euro (30%), Sterling (10%), US dollar (20%), Yen (10%), Yuan (10%), other GCC countries (20%). Such a basket of currencies should be dynamic in the sense that it should reflect the changing nature of trade patterns. The inclusion of other GCC currencies in the basket would provide a basis for Exchange Rate Mechanism between the GCC countries as they move towards a single currency.

It is worth emphasizing that the dollar decline has undervalued GCC currencies by a considerable margin. The extent of the undervaluation, in nominal terms, ranges from 25% to 30% over the past five years. This means that simply abandoning the fixed peg without revaluation of the currencies would only insulate the GCC currencies against further dollar deterioration but it would not correct for the past decline in the value of the dollar and the GCC currencies. Therefore, unpegging should be accompanied by a substantial revaluation of the GCC currencies to address the current undervaluation of the currencies.

Implications for Business

Whatever options the GCC governments eventually decide to pursue will have significant implications for business. Under a 'do nothing' approach, i.e. the current dispensation of sticking to the peg, business entities with substantial holdings of dollar-denominated assets would be adversely affected, particularly when the bulk of their transactions is carried out in other currencies.

The best option to mitigate the risks against exchange rate exposure is to have a diversified portfolio using a basket of currencies. There is no easy allocation criterion, but the simplest option is to allocate portfolios based on the proportion of key transactions or activity areas. For instance, if 40% of all transactions are in euro, 40% involve local currencies and 20% is conducted in dollar, then a capital allocation rule of 40:40:20 involving euro, local currency and dollar, respectively, should be adopted. Within the local currency area, such as the GCC, the decision to hold reserves in specific currencies should again be guided by transactions based rule in order to avoid heavily transactions costs.

In the case of investment in infrastructure, however, adhering to the dollar peg would erode the profitability of such projects on two grounds. First, the high imported inflation on account of equipment and machinery sourced outside the US would increase project finance costs. Secondly, incomes collected in local currencies from infrastructure projects, e.g. tariffs on utilities (water, electricity, telecommunications) and toll charges on transport infrastructure, will be grossly understated under a dollar peg system. One way of mitigating against the exchange rate risks is to raise infrastructure charges to compensate for the currency undervaluation but such a move may be unpopular and unappealing to regulatory agencies due to its social and political repercussions. A policy of domestic price hike for infrastructure services is likely to lead to a vicious cycle of inflationary pressures as workers demand wage increases to compensate for the erosion of their nominal wages. Eventually, such a policy would, after all, defeat the economic development objective for undertaking infrastructure projects in the first place.

A second option for safeguarding against the exchange rate risks is to simulate the extent of the erosion of net revenues and build it upfront into the current and future investment deals. Yet another option would be to devise an appropriate instrument or mechanism of diversifying portfolio investments such that returns on non dollar-denominated assets could offset low or negative 'real' returns from dollar-pegged activities.

In sum, many of the problems highlighted above could be avoided if GCC countries could move away from the fixed peg system. After all, when the GCC countries decided to align their currencies to the dollar, the economic cycles were completely different (low oil prices, strong US economy, strong dollar, low inflation). Given that currently the GCC countries are witnessing high inflationary situation that threatens their relatively buoyant economic growth, it is high time they moved away from the dollar peg system to a 'crawling' (within a band) peg exchange rate mechanism linked to a basket of currencies.

Table 1: Key Economic Indicators for the GCC Countries

	Years	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	UAE
Real GDP Growth Rate (%)	1990	7.3	-26.2	8.4	-14.6	8.3	23.6
	2000	5.2	4.7	5.5	10.9	4.9	12.4
	2006	7.6	5	5.9	10.3	4.3	9.4
	2007	6.8	5.2	6.53	8.31	4.1	7.7
Inflation Rate (%)	1990	-0.9	15.8	10	3	2.1	0.6
	2000	-0.7	1.6	-1.2	1.7	-1.1	1.4
	2006	2.9	2.8	3.2	11.8	2.2	9.3
	2007	5.2	2.6	6.5	12.8	4.9	9.8
Broad Money Growth Rate (%)	1990	-11.6		10	28.9	4.2	-8.2
	2000	10.22	6.32	6.02	10.68	4.46	15.32
	2006	14.89	21.66	24.60	37.94	20.41	23.20
CA Position (%GDP)	1990	1.5	20.3	9.4	-8.9	-3.6	22.1
	2000	10.6	38.9	15.5	23.2	7.6	17.3
	2006	12.8	43	8.4	31	27.4	22
	2007	17.2	37.8	4.1	33.8	22.2	22.6
Fiscal Position (%GDP)	1990	32.0	38.8	47.0	45.6	36.2	
	2000	34.9	74.9	44.1	38.6	36.5	44.5
	2006	32.31	63.75	50.22	38.57	50.10	50.49
	2007	30.1	64.1	47.9	38.8	47.4	46.6
Foreign Exchange Reserves (US\$ billion)	1990	1.23486	1.95168	1.67242	0.631076	11.6677	4.58387
	2000	1.569149	7.08235	2.37985	1.15799	19.5855	13.5227
	2006	2.8051	12.566	5.01	5.3827	27.52	27.61
	2007	3.5	24.74241	7.655082	6.45924	28.896	41.415
Interest Rate 2007	Nominal	5.5	4.5	5.74	5.55	5.25	4.5
	Real	0.3	1.9	-0.76	-7.25	0.85	-5.3

Source: Various sources, including IMF, IIF, and monetary agencies of national countries.

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