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Thought Leadership

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Gulf currencies: Change needed and likely

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I. Overview

A revaluation of the GCC currencies is needed now and the region should begin preparations to shift their currencies away from a peg to the dollar to managing their currencies against a basket of currencies with which the Gulf trades.

This shift in currency policy is needed not only to reflect the present vulnerable state of the dollar, but more importantly to help position the region's economy for both the cyclical and structural shifts that it is undergoing.

This Report looks at this issue in detail. We think of the Gulf in terms of the three D's: diversification, demographics and the dollar.

The Gulf needs to diversify its economy away from energy to the non-hydrocarbon sector. Dubai has already done this. Whilst it will be hard for other countries to replicate that shift, they need to increase the size of their non-hydrocarbon sectors. A shift away from energy may help reduce the cyclical swings the region has previously experienced. More particularly, a shift from capital-intensive energy to more labour-intensive sectors such as tourism and wider services would create jobs for the region's large young population - its demographic opportunity.

This naturally has implications for dollar policy. In our view there is a strong case for the Gulf to move away from a dollar peg - but it makes more sense for this to occur gradually, in stages.

The decision to peg their currencies to the dollar achieved credibility by tying the region's monetary policy to that of the US Fed, and also achieved certainty in the minds of the general public. There is, however, a cyclical challenge. As the UK found to its cost when it was tied to Germany and the Deutsche Mark in Europe's Exchange Rate Mechanism in the early 90s, once there is a disconnect between the policies needed at the centre of the system (at that time higher interest rates in Germany) and those needed elsewhere (at that time lower rates in the UK) then problems develop. A similar episode, albeit different in scale, is now being seen in the Gulf. Whilst the US is cutting interest rates in response to a slowing economy, the Gulf needs a tighter monetary policy to curb inflation. And, even though the Gulf is deepening and developing its capital markets, it does not yet have sophisticated enough

capital markets to sterlise or neutralise the local build up of liquidity - which of course continues as the region booms and oil prices stay high.

Given that the main export of the region is priced in dollars, there is a strong case to be made for sticking with a dollar peg until the economies have become diversified - or certainly more diversified - away from energy. But if that is the case then there will certainly be the need for a large revaluation, we calculate of the order of 20% versus the dollar, and this needs to take place now!

The aim should be to achieve more flexibility in currency policy. It is not only the level versus the dollar that is important.

This flexibility could be achieved by moving to a currency basket. This basket should include the major currencies of the countries with which the Gulf trades. The components of the basket can be kept secret, although the reality is the constituent parts can be calculated by the market (for instance we estimate that Kuwait's basket has a 70% dollar weighting).

Such a basket would still have a huge dollar weighting, both now and in the future, but importantly it allows the scope for the constituents of the basket to change over time, to reflect the inevitable growing importance of the Chinese yuan, Korean won and other currencies in trade. As the Middle East and the Gulf retain still close ties with the US and Europe both the dollar and euro will have important weights in a basket, but over time these, and other weights, will change.

Already, we are witnessing passive currency diversification in parts of the world. That is, countries are not actively selling the dollar from their reserves, instead they are putting less of their net new reserves into dollars; hence passive diversification.

The Gulf too, may decide gradualism is the most appropriate way to proceed, mirroring their desire to diversify their economies. Greater flexibility is an important aim, and given the present build-up of liquidity and rising inflation expectations, a large 20% revaluation now, followed by a move to manage their currencies against a trade weighted basket makes most sense. This needs to occur alongside a move to further deepen domestic capital markets. A currency shift is needed and appears likely, but many options are possible - as we highlight in the table. Even though our recommendation is for a sizeable and credible revaluation now, it would be understandable if the policy makers decide to opt for a smaller revaluation. They could even replicate what China did a few years ago and opt for a small revaluation and adoption of a basket albeit one dominated by the dollar. The important point is to see this as part of a gradual process towards further currency change.

The economic case for currency reform is strong. But, it is the region's rulers that will make the final decision. Although Kuwait has moved independently we expect the rest of the Gulf to move together. If the authorities decide not to proceed with any change now, this should be seen as merely delaying the inevitable.

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Table 1: Currency Options

High Probability Currency System	PROS	CONS
No change: Remain pegged to dollar at present rate	1. Provides stability anchor for policy. 2. Well understood.	1. Leaves the economy at the mercy of USD interest rates 2. Exchange rate not able to adjust to meet local needs of the economy 3. Not best for a region that wants to diversify its economy
Sizeable revaluation (20%)	1. Clearly understood and helps reduce imported inflation. 2. Credible-too small a move might encourage further inflows. Reduction of inflows will drive local interest rates higher and will help tackle inflation 3. Could be seen as first step in the process of currency reform. 4. 20% is based on our analysis and takes account of shifts in global markets. These shifts include the fall in the value of the dollar and also the appetite of Global Central Banks to diversify their reserves.	1. Still leaves economy tied to future dollar and US interest rates 2. Revaluation needs to be large enough to be seen as not being repeated soon; else it will encourage inflows adding to liquidity issues. 3. Value of region's overseas assets in local currency terms (unadjusted for inflation) falls. 4. Could prompt uncertainty in oil market and could increase oil price budget rates for oil producing countries.
Smaller revaluation and simultaneous adoption of a basket, albeit dominated by the dollar	1. Adds flexibility, will drive rates higher and will help reduce imported inflation 2. Politically easier to accept	1. GCC currencies will remain significantly out of line with other currencies in the world. 2. Needs to be explained well for general public to support. 3. Requires more sophistication than present set up.
Manage against a basket of currencies	1. Sends clear message that the region is positioning itself in a changing global economy. 2. Pegging to a basket provides a stability anchor for policy. 3. Ability to adjust the basket allows for greater flexibility in exchange rate management. 4. This policy is being used effectively in some other open economies and could become even more widely accepted if China and India become more proactive in this approach.	1. Needs to be explained well for general public to support. 2. Requires more sophistication than present set-up.
Medium Probability Currency System	**PROS**	**CONS**
Managed float	1. Allows central bank to set interest rates according to the local environment. 2. Ability to smooth currency moves can minimise impact on non-hydrocarbon sector of swings in oil and gas.	1. Complicated to manage. 2. Region's currency will be subject to greater volatility as global growth and energy prices shift, and will be caught between fluctuations in major currencies against the dollar.
Free float	1. Currency acts as the shock absorber. 2. Central bank can use interest rates more independently.	1. Can lead to greater volatility in currency, which, given the region's stage of development, may deter inward investment and certainly trigger greater volatility in flows into and out of the region.
Low Probability Currency System	**PROS**	**CONS**
Peg to oil prices	1. An effective policy for a country heavily dependent on one major commodity export	1. Would work against economic diversification as the non-hydrocarbon sector would bear the brunt of currency adjustment. 2. Reduces sharply effectiveness of monetary policy.

II. Structural Factors

The prevalent exchange rate policy in the Gulf Cooperation Council (GCC) countries has been to peg local currencies to the US dollar. UAE was officially pegged to the IMF's Special Drawing Rights (SDR) from 1980 to February 2002, but in practice it was tracking the dollar at a fixed parity. The official move to a USD peg came in 2002. Saudi Arabia pegged its currency to the USD in 1986. Qatar had its currency pegged to the SDR between 1975 and 2001, introducing a USD peg in 2001. Kuwait has always been more adventurous with its currency regimes, introducing a USD peg as part of the transition to the common currency target in 2003, only to scrap it in 2007. Oman pegged its currency to the USD in 1986 and Bahrain in 2001. The main rationale for the peg was the fact that the regional economies were, in effect, heavily 'dollarised' given the high dependence on oil production.

A lot of the discussion on currency reform is driven by cyclical considerations, in particular rising inflation. But instead of looking at purely cyclical factors there are a number of other reasons that need to be addressed.

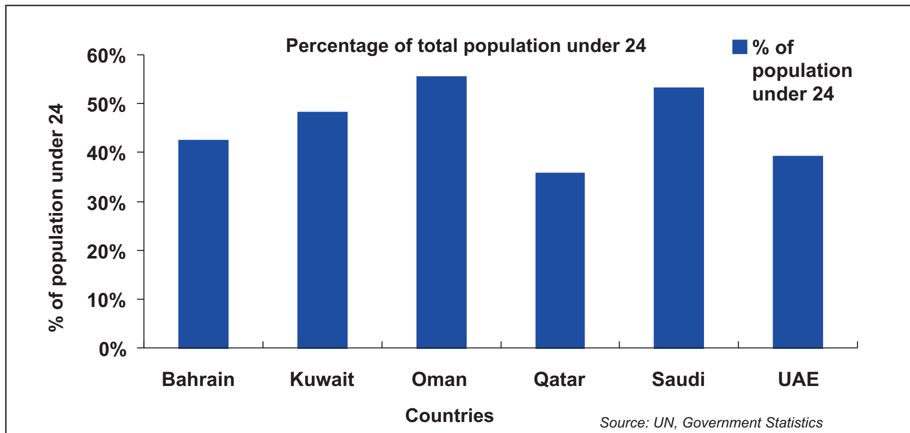
(a) Demographics

Population growth from 2005-2010 is expected to average 3.5% a year for the region. Growth is expected both in terms of the national and non-national population. On the national front, the GCC has a very young population. The percentage of total population under the age of 24 ranges from 37.5% in Qatar to 55.3%[1] in Oman. In addition to its young population, the region experiences significant migration trends.

While a young population offers a promising future for a country, it could also weigh heavily on the economic fundamentals of a nation. Essentially, governments must provide jobs to sustain this population and prevent the strain of unemployment on the government in the future.

The other characteristic is migration. While the GCC has a very young population, the population is small. The GCC must hence rely on importing labour from other countries. For example, in Kuwait, UAE and Qatar over 60% of the population are expatriates. Bahrain, Saudi Arabia and Oman have a much smaller yet significantly large expatriate population, 40%, 33%, and 26% respectively. The expatriate populations are growing. For example, in Dubai, the population within a year (2005-2006) increased from 1.13mn to 1.422mn, an increase of 292,000 people. The plans are to grow Abu Dhabi, the UAE's capital, to 3.1mn people by 2030, from 930,000 now. In a country like the UAE, only 20% of the population are UAE nationals. Thus, the reliance on foreign workers is rising in importance.

Chart 1



Source: UN, Government Statistics

(b) Diversification

Demographics and diversification are interlinked. One of the main reasons behind the inflow of people to the GCC, and in particular to the UAE and Qatar, is the rapid diversification of the economies. However, because of the expansion of the population, and also because of the high proportion of young people, diversification needs to continue, and also spread to the entire region. Job creation is essential. There is a need to invest in more labour intensive industries, and in this respect the importance of the service sector cannot be underestimated.

Dubai was the first to embark on an aggressive strategy of diversification into service sectors such as logistics, transportation, ports, tourism, financial services, health, education and media. The result is that the oil industry now accounts for a mere 5% of the economy, even at current oil prices. Back in 1988 oil contributed about 28.3%.[2]

Much of the rest of the region is trying to emulate a similar diversification path. Abu Dhabi, for instance, is reported to be investing USD 270bn in the economy in the coming 5-6 years, at least two-thirds of which are in areas aimed at diversifying the economy. The diversification will include high profile projects like a Formula One street racetrack and the Louvre and Guggenheim museums.

The diversification process has led to a boom in infrastructure projects. The GCC looks set to invest in projects worth over USD 1trn[3] with the focus on expanding both infrastructure and improving the hydrocarbon sector. The Middle East Economic Digest (MEED) points out that infrastructure projects were responsible for increased capital expenditure in Kuwait, Qatar, and Saudi Arabia. MEED states that the total size of projects from July 2006 to July 2007 rose from USD 1.0trn to USD 1.5trn, accounting for 209% of 2006 GCC GDP. In the two largest economies, Saudi Arabia and the UAE, for instance, infrastructure is a priority. Saudi Arabia has undertaken a regional development project to build six economic cities throughout the kingdom. These cities will include an industrial zone, a port, a logistic service centre, a power and water plant and a residential area. The project seeks to create half a million jobs and will require close to USD27bn in investments. These cities will be developed in response to the infrastructure, housing and employment needs of the growing population. In the UAE, infrastructure and industrial projects are picking up steam. Projects in the hydrocarbons, power and non-

oil industries are planned in both Dubai and Abu Dhabi, valued at USD 25bn and USD 35bn, respectively. The table below provides an overview of the infrastructure projects throughout the GCC.

Table 2: Projects (planned or under way) continue to soar

USD bn	27 Jul 07	28 Jul 06	% change
Bahrain	32.4	29.6	9.6
Kuwait	250.9	212.3	18.2
Oman	45.3	37.5	20.6
Qatar	138	117.3	17.6
Saudi	364.3	269	35.4
UAE	660.8	352.9	87.3
GCC total	**1491.6**	**1018.6**	**46.4**

Source: MEED Projects

(c) Debt

High oil prices have resulted in windfall gains, and these have led to the GCC's minimal accumulation of debt. Saudi Arabia was able to reduce its government debt from 81% of GDP in 2003 to 29% in 2006. The two countries with the highest external debt are Qatar and UAE (40% of GDP), which are also the countries leading the way in diversifying their economies. Both countries, however, have very low total government debt (less than 10% of GDP). Saudi Arabia has the highest total government debt at 28% of GDP. The amount of debt that these countries have accumulated is of little or no concern to the welfare of the economy. The levels of foreign debt can have implications on the currency. Heavily indebted currencies can face greater foreign exchange volatility, as greater levels of debt can be interpreted by the markets as a higher accumulation of inherent risks. This increased volatility can be undesirable, especially if a country needs to plan its debt repayments with some degree of certainty. A country with a higher level of foreign liabilities would therefore have a bigger incentive to peg its currency to the currency denomination of its liabilities.

(d) Investment & Oil income

The same concept applies to investment and income flows. Despite diversification, income from the hydrocarbon sector is still important, and it is denominated in USD's. Any fluctuation of the exchange rate between GCC currencies and the USD will lead to a fluctuation in oil incomes, when expressed in local currency. In other words, a revaluation of GCC currencies against the USD would imply a drop in oil incomes when expressed in local currency, other things being equal. This also applies to the returns on foreign investment. The table below summarises the net foreign asset position of GCC states. The majority of GCC foreign assets are held in USD's.

Table 3: Net Foreign Assets in the GCC (2006)

Country	$ billion	% of GDP
Bahrain	16	120
Kuwait	400	300
Oman	8	25
Qatar	50	115
Saudi	400	130
UAE	210	160
Total	**1064**	**178**

Source: IIF Estimates

(e) Implications of these structural issues for currency policy

Demographic trends together with diversification suggest that GCC economies are now becoming larger, and more complex. They will therefore become harder to manage. This is already happening.

There are two issues with the current pegged exchange rate regimes. First, there is the issue of valuation. A pegged exchange rate does not allow the currency to freely fluctuate and reflect the state of economic fundamentals. Second, there is the issue of flexibility. Because of the peg, the currency cannot move in order to absorb shocks. As a result, the economy itself becomes the shock absorber. At the moment, higher oil prices are not reflected in the exchange rate. The currencies have not absorbed this shock. Instead, higher oil prices and ample liquidity in the region are reflected in higher inflation, including asset price inflation. In the case of the GCC, the real economies are absorbing all the shocks. Furthermore, the lack of flexibility that comes with a peg also affects monetary policy in general. In the presence of free capital mobility and a currency peg, monetary authorities have to follow the policies of the currency they are pegged to.

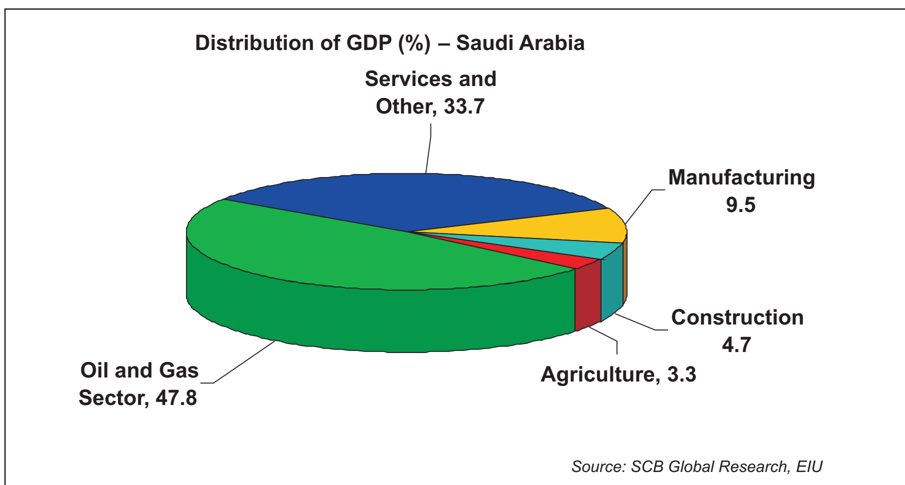
In the GCC, the presence of USD pegs implies that the authorities have in effect forgone monetary policy as a tool to manage their economies. The cost of such a sacrifice might have been negligible in the 1980's and 1990's, when the economies were both smaller and simpler. But as the economies grow both in size and complexity, the need for reform will become more evident. Furthermore, the low level of foreign debt and foreign liabilities make it easier for the authorities to scrap the pegs and introduce a more flexible FX regime without becoming increasingly worried about their foreign debt obligations. It is also worth remembering that pegging to the currency in which oil is priced passes on the full volatility of the oil price changes to the real economy.

The argument that stronger GCC currencies would reduce the value of foreign investments can lead to misleading conclusions. Authorities should be mostly concerned with the macroeconomic stability of their countries in order to ensure sustainable economic development. Boosting foreign investment returns by keeping their currencies weak can lead to higher inflation. Ironically, this rise of inflation and of course the weakening currency will erode the value of foreign investments and in a more troubling way. Inflation does not discriminate between rich and poor, and it is effectively a regressive tax, so not only will the real value of foreign investments drop, but the general public will also be made worse off. Mohammad Mazraati [4]of OPEC estimated that from 1970 to 2004 nominal oil revenues for OPEC countries were about USD 5trn. Because of the weakening USD and rising inflation, Mazraati

estimated that 73% of the oil revenue, or USD 3.7trn was lost. This suggests that the idea that weaker currencies will increase revenues for GCC markets is merely an illusion. Yes, if the GCC revalue this will reduce the local currency value of USD investments and USD proceeds, but these proceeds are worth less domestically because of inflation, and internationally because of the weak dollar.

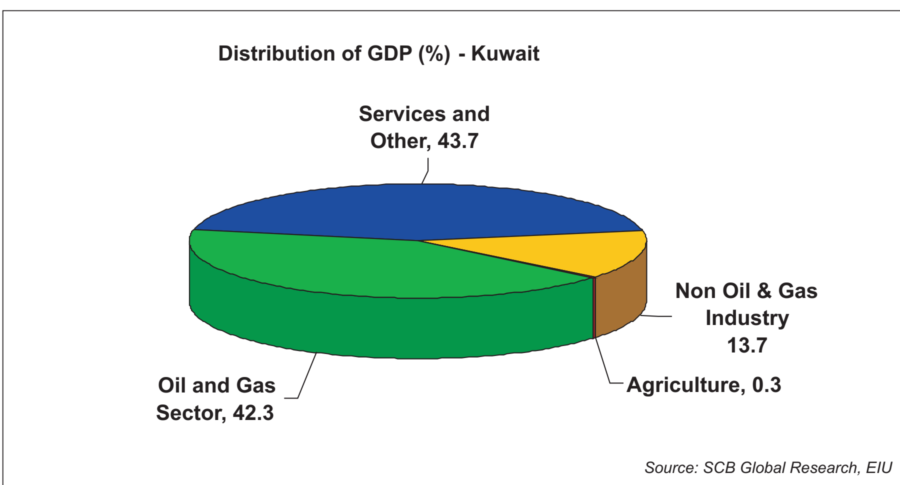
Singapore is a good example of an open economy which has introduced some flexibility in its FX regime. Like the GCC region, it has very strong net foreign assets and fiscal positions. Singapore manages FX policy comfortably, albeit by targeting an undisclosed but still reasonably transparent trade-weighted exchange rate band. Indeed, those that have challenged the Monetary Authority of Singapore's ability to control the exchange rate have often come out second best. The same applies to China, which currently enjoys FX reserves of around USD 1.4trn, the majority of which is held in USD's. This did not stop China from scrapping the USD peg in 2005 to introduce a more flexible exchange rate regime.

Chart 2



Source: SCB Global Research, EIU

Chart 3



Source: SCB Global Research, EIU

Chart 4

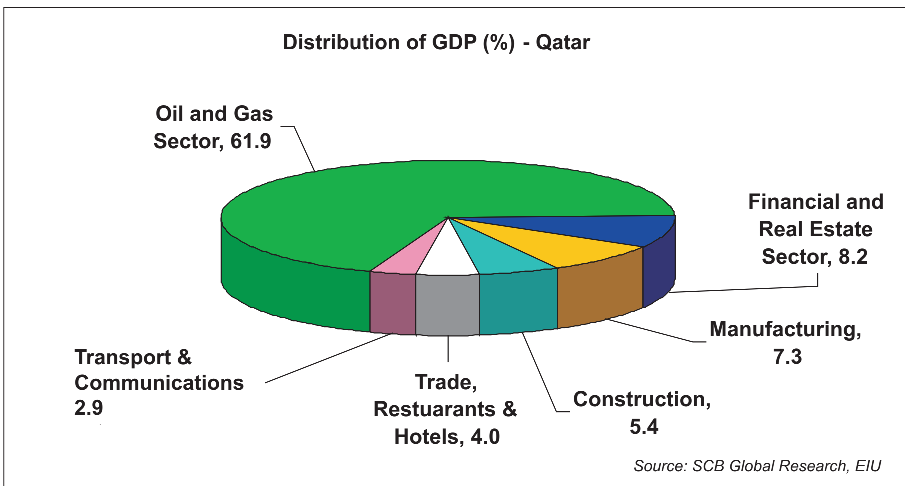


Chart 5

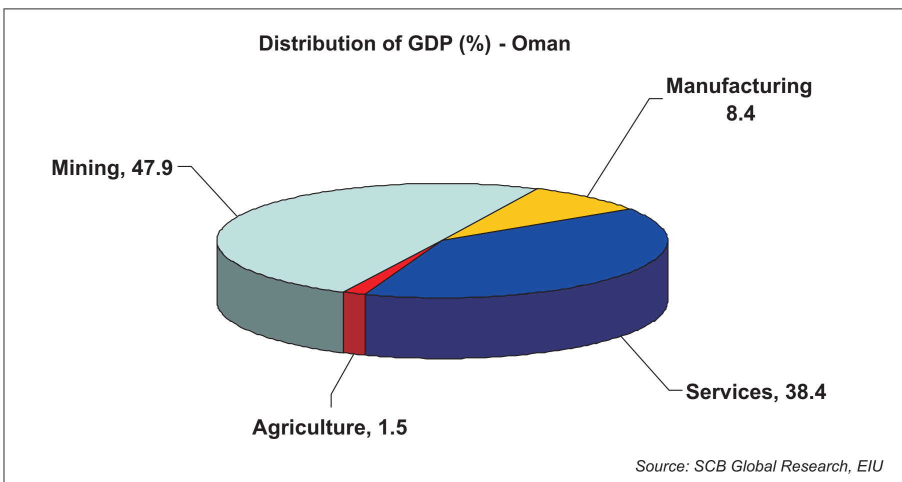
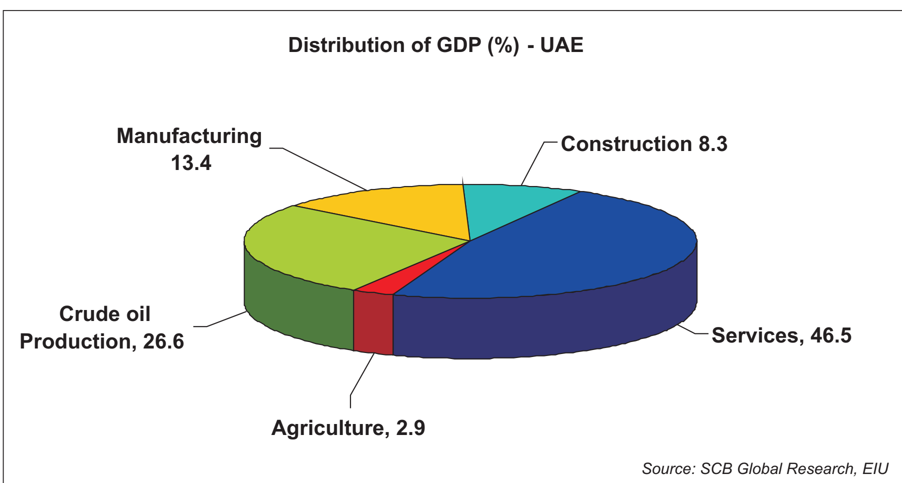


Chart 6



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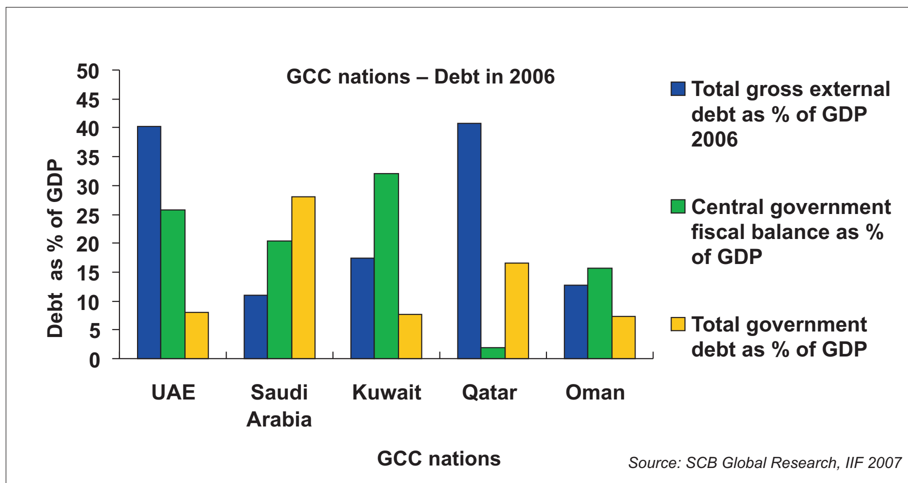


III. Cyclical Factors: Inflation Outlook

Inflation in the GCC is rising, and it is becoming a concern. As recently as 2003, inflation throughout the GCC was less than 3%. In the case of Kuwait, Oman, and Saudi Arabia, inflation was one percent or less. Qatar and the UAE were dealing with inflation in the 2-3% range. However, by 2004, inflation shot up to 5% in the UAE and 6.8% in Qatar. For 2007 we expect inflation to reach 11.5% in Qatar and 9% in the UAE. In Saudi and Oman, inflation levels for 2007 are expected at 3% and 4%, respectively. One should note that 2002 marked the beginning of the rise in oil prices. Surpluses throughout the GCC were mounting by that point, with investment in the local economy surging.

Milton Friedman described inflation as a situation where too much money chases after too few goods. This applies to the GCC. Capacity constraints in the housing market in the UAE and Qatar have been receiving a lot of attention. These constraints fit the "too few goods" side of Friedman's definition. However, the "too much money" side of the story does not receive the attention it deserves. The three main drivers of inflation in the GCC are the excess liquidity, food prices and housing costs. Excess liquidity is the dominant theme throughout the GCC. Food prices are more important when it comes to Kuwait, Oman and Saudi. In their case, a stronger currency would help, given that food is mainly imported. Inflation in Qatar and the UAE is also driven by housing costs.

Too much money: the problem of excess Liquidity

The GCC is awash with liquidity. Because of the USD pegs, interest rates in the region are kept low, which limits the ability of the authorities to drain liquidity out of the system. The absence of a mature bond market is another limitation, as the authorities cannot use open market operations and issue bonds in order to reduce liquidity.

It is important to make a distinction between market rates and policy rates. With the Fed cutting interest rates, GCC Central Banks have been reducing rates as well. However, GCC central banks have tried to limit the extent of official rate cuts. Take for example the UAE. Even though there is no official benchmark rate, the Certificate of Deposit (CD) rates act as the policy rates for the Central Bank. The 1-year CD rate in the UAE was at 4.80% on September 17th 2007, just before the Fed started cutting interest rates. Since then, the Fed has cut by 75 basis points (bps). However, the 1-year CD rate in the UAE was only lowered by 40bps. In other words, because of the concerns of inflation the reduction in the de facto policy rate in the UAE was less than the reduction in the Fed target rate. In the past, banks in the GCC could deposit their excess liquidity with the central banks. This was an effective way of dealing with liquidity. However, things are now different and there are practical limitations to what can be deposited with central banks. As a result liquidity in the GCC remains ample

This is due to the following reason. Even though policy rates were kept higher, market interest rates are much lower. In the UAE for example, the 1-year swap rate is around 3.05%, even though the one year CD rate, is at 4.40%. This suggests that in practice, monetary conditions are much looser than official rates suggest. The main reason why swap rates are so low is the speculation on the currency. The markets have detected that the USD peg and the interest rate policy in the US are not suiting the GCC region very well. With speculation rising, the purchases of GCC currencies have risen

dramatically. The higher holdings of GCC currencies are putting significant downward pressure on local interest rates, causing further increases in the money supply.

Table 4

Broad Money (Annual Percent Change)					
	1998-2002 average	2003	2004	2005	2006
Bahrain	10.1	6.4	4.1	22	14.9
Kuwait	4.9	7.8	12.1	12.3	21.7
Oman	6.3	2.6	4.3	20.9	24.9
Qatar	12.3	4.8	20.8	42.9	39.6
Saudi Arabia	7.6	6.9	18.8	11.6	19.3
UAE	12.4	16.1	23.2	33.8	23.2

Source: IMF Regional Economic Outlook Middle East and Central Asia, October 2007

Weakening currencies and the price of food

The GCC as a whole is a net importer of food; due to its arid climate, agriculture is limited. Furthermore, for all the GCC states, food accounts for a large portion of CPI; Qatar 19%, Saudi Arabia 25%, UAE 14%, and Kuwait 36%. The fact that food is mainly imported suggests that the weakness of GCC currencies on a trade weighted basis is inflationary.

The effects of higher food prices are not limited to the GCC. In the last year, prices of corn, soybeans and wheat have risen remarkably due to disturbances in weather patterns and the demand for bio fuels. The IMF estimates that the contribution of food inflation on overall inflation for January to April 2007 is more than 50%[5] for the Middle East as a whole. In terms of the GCC, Saudi Arabia, Oman, and Kuwait, the countries whose baskets are most heavily weighted towards food, are dealing with the most significant increases in food prices. From 2004 to 2007, food prices in Saudi Arabia have increased by 3-6% y/y.[6]

As for Kuwait, food inflation started to take its toll on the country in 2004 and persisted up to and including 2007[7], increasing at a rate of 2%, 3%, 8.5%, and 5.6% respectively. Both countries were affected by the rise in world basic food prices. Even Saudi Arabia's capability to produce its own wheat has been falling. Both countries have become increasingly reliant on other countries for food commodities.

Information is not available on the origin of food imports to Saudi Arabia or Kuwait. However, it is important to note the main import partners for these two countries. For Saudi, its largest import partner is the European Union; 30% of all imports are from the EU, followed by Asia at 22%. Looking at the most basic food commodity, cereals, both countries import a large amount from the EU. As for Kuwait, the same holds true; the EU is the country's largest import partner, 25% of all imports, followed by Asia.

The same problem applies to Oman. Like its GCC neighbours, food is a weighty component of Oman's CPI, 30%, and it is a net food importer. Oman saw an 11% increase in the cost of food in 2007. While the EU may not be Oman's largest trading partner, it is the second largest trading partner after

the Middle East with almost 20% of all imports. It is evident that Oman cannot rely on its neighbours for basics such as cereals and will have to import from the EU. Thus, the pegged currency for Oman is causing a serious spike in inflation.

For Qatar and the UAE, food CPI tells a similar story. Food comprises less than 20% of the CPI basket. However, like Kuwait and Saudi Arabia, they too felt the repercussions of the food inflation. In Qatar, y/y food inflation rose 3% in 2004 and 2005, but by 2006 the y/y change in food prices grew as high as 7%. For the UAE, food prices rose dramatically between 2004 and 2006, 4-7%. Even though food price inflation is rising in both the UAE and Qatar, it is not the main driver of overall inflation. Inflation in both Qatar and the UAE is the highest in the region, and this is mainly because of the sharp increases in housing costs.

Chart 8

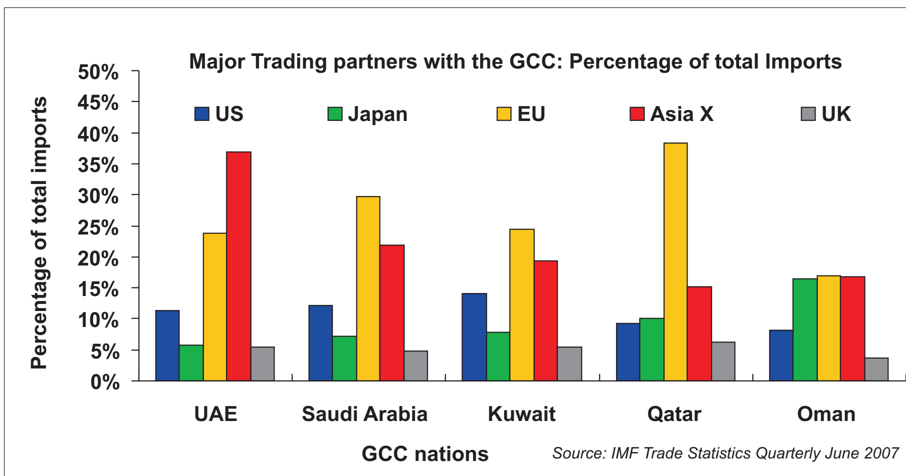


Chart 9

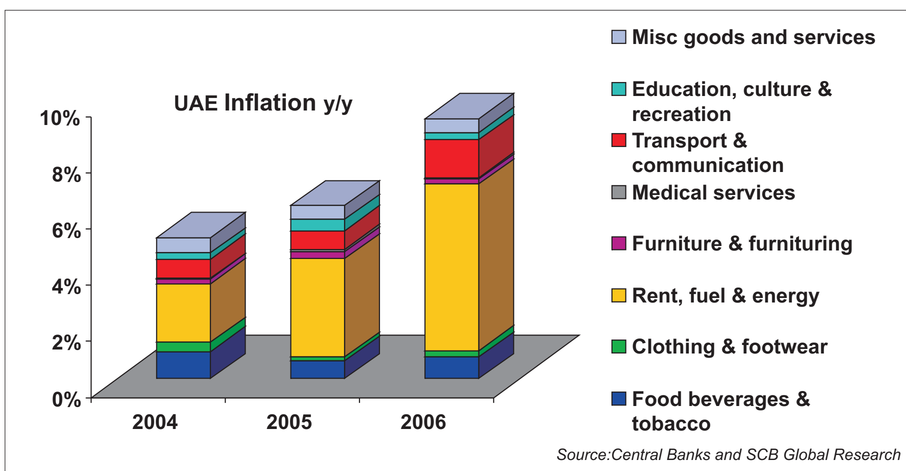
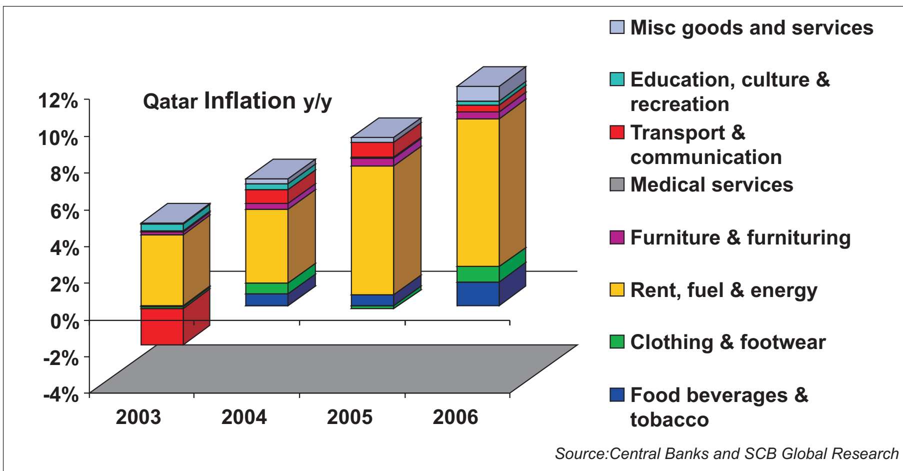
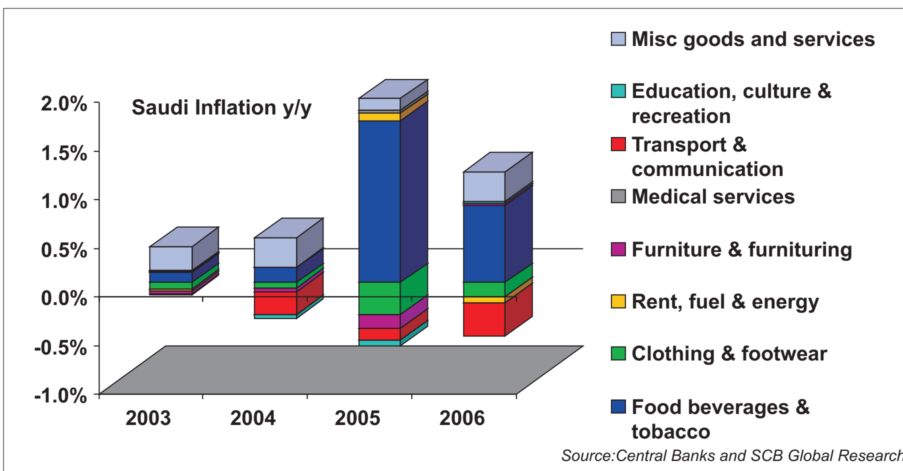


Chart 10



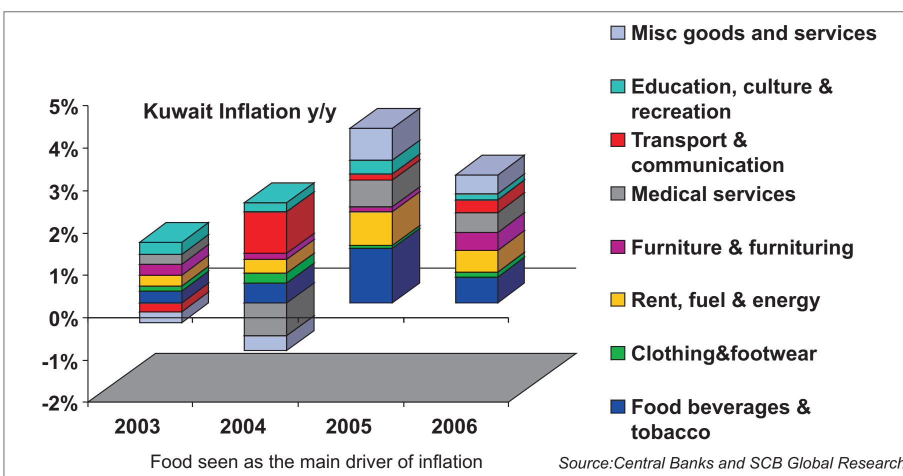
Source:Central Banks and SCB Global Research

Chart 11



Source:Central Banks and SCB Global Research

Chart 12



Food seen as the main driver of inflation

Source:Central Banks and SCB Global Research

Domestic sources of inflation: The Cost of Housing

The housing component of CPI brings a whole different theme to light. For Qatar and the UAE, one may argue that growth rates of 8-9% in both countries may themselves be the cause of the inflationary pressures. However, it is not the fast growth rates that are inflationary per se, but rather the capacity constraints that limit further growth. With oil prices at record highs and budget surpluses mounting, money supply is growing faster than GDP. Both countries are responding to the capacity constraints by investing in more capital and labour. For example, both countries recognize that they lack the population necessary to fully contribute to the labour markets. Thus, they have relied on importing both blue and white collar labour. Both countries have increased their investment in capital. However, building infrastructure takes time.

The need to import labour feeds the acceleration of the housing market. To accommodate all the new labour coming into the markets, the governments of Qatar and the UAE must build, and are building more residential units. However, supply is not keeping up with the increases in demand. In the UAE, in particular, our own studies suggest that rent increases have contributed 7.3% or over 50% to overall inflation in 2006.

With such rapid growth and need for new residential space, it is of no surprise that the main reason behind the housing crunch is simply a lack of supply for such high demand. The government has taken steps to curb the effects of housing on inflation by implementing rent inflation caps on lease renewals.

Implications on currency policy

When it comes to currencies, the focus is usually on the nominal exchange rate, which is simply the price of one currency in terms of another. However, when it comes to the impact of the currency on the economy, the concept of the real exchange rate is far more important. The real exchange rate is the exchange rate, adjusted for the different inflation levels between countries. Inflation therefore has a direct impact on the currency. For example, if a country in the GCC was facing higher inflation numbers than its trading partners, that would imply that the non oil exports of that country (also including the exports of services and tourism) are becoming more expensive. This implies a loss of competitiveness; it has the same effect as an appreciation of the currency. The real exchange rate is the nominal exchange rate adjusted for inflation. It can appreciate when inflation is rising, even if the nominal exchange rate is stable. In the case of the GCC, the real exchange rates have been fluctuating through changes in inflation

We have already discussed that there are two issues with the current pegs, valuation and flexibility. The inflationary pressures in Qatar and the UAE are related to capacity constraints. A mere revaluation of the currency would have a negligible impact on domestic inflation but would reduce imported inflation. It is also important to note that even though inflation in Qatar and the UAE is mainly driven by domestic and not imported factors, a significant revaluation could still help curb the excessive money supply growth the region is experiencing. An increase in the purchases of local currencies is putting downward pressures on interest rates and a significant revaluation of the currencies could lead to a reduction of such positions and a drainage of some of the excess liquidity. This should drive market rates higher, towards and even above the policy rates, which will allow the central banks to regain some control of monetary policy in the region.

It is concerning to see that wage pressures in the region are already picking up. In Saudi Arabia, the Shura Council has recommended increasing wages as a response to the rising inflation. Likewise in the UAE, companies have already announced their willingness to increase wages. This will likely enhance inflationary pressures. Inflation is rising at the moment, but it is also a longer term concern that needs to be addressed by monetary policy. The rigidity of the current regime, and also the fact that GCC currencies are pegged to a depreciating currency like the USD, makes it difficult for authorities to achieve price stability.

IV. The concept of fair value

There is a creeping consensus in the markets that GCC currencies, indiscriminately, are undervalued, and that a revaluation should take place. In order to reach such a conclusion, one has to have an idea where the fair value of a currency is. A number of different approaches exist in academic literature for calculating the equilibrium exchange rate, ranging from the traditional purchasing power parity (PPP) theory to more recent approaches such as the Internal-External Balance (IEB) approach also known as the macroeconomic balance approach. It is interesting to highlight that for some GCC currencies the findings of PPP are exactly the opposite from what the Internal External Balance approach (IEB) suggests. Take for example the AED. PPP would suggest that the AED is overvalued whereas the IEB approach would tend to suggest that it is actually undervalued. This difference in findings is cause for concern and it raises questions on the appropriateness of valuation models for the GCC in general. The idea of currency reform in the region should be therefore taken in the broader context of regaining some control over monetary policy, and not simply on fair value estimations.

Purchasing Power Parity (PPP): The PPP approach is based on the law of one price, which dictates that the same good in different countries should have the same price when expressed in a common currency. According to PPP, the exchange rate moves in order to equate prices across countries. In other words, the fair value of the exchange rate is the rate that would ensure the same price for the same good globally and hence result in no arbitrage opportunities. The IMF provides PPP estimates for GCC currencies. Higher inflation has the same impact as a currency appreciation, since in both cases a country loses international competitiveness. Because of this loss of international competitiveness, PPP estimates would suggest that the AED is about 20% overvalued.

The Internal External Balance Approach (IEB): According to this approach, the fair value of the exchange rate is the one that prevails when the economy is both in internal and external balance. The economy is said to be in internal balance when it is operating at the natural rate of unemployment and at external balance when there is a sustainable flow of capital. The general approach of the IEB approach is to estimate the optimal current account that is likely to emerge when the economy is in internal and external balance, and then compare it with the prevailing current account. If they are different, then it is assumed that the exchange rate would move to bring the prevailing current account to its optimal level. The resulting adjustment in the exchange rate is an indication of the degree of over- or undervaluation of the exchange rate.

When it comes to the GCC in general, the current account balances are determined by oil prices. WTI oil prices are currently much higher than their long term averages. The 20-year average of WTI oil is at USD28.60 per barrel. This oil price boom and the positive Terms of Trade shock that came with it, led to a rise of the current account surplus. Using the IEB approach of exchange rate valuation would suggest that currencies like the AED are extremely undervalued.

The IEB method will become more important as the region continues to diversify. The current account surpluses are putting pressure on the

economies. Given the importance of oil, these models will tend to overestimate the extent of the overvaluation of GCC currencies, but are nevertheless giving some interesting insights and highlight the need for reform. The extent of the undervaluation might be overestimated, but the idea that the current account surpluses suggest some degree of undervaluation cannot be ignored. The Saudi Arabia case is very interesting, as both the PPP and IEB models suggest an undervaluation.

Behavioural Effective Exchange Rate Approach (BEER): This is a more direct approach, and it is becoming increasingly popular in Academia. The Behavioural Equilibrium Exchange Rate approach involves the direct econometric estimation of the behaviour of the exchange rate. Unlike other approaches, the Behavioural Equilibrium Exchange Rate approach ignores any concepts of internal and external balance. Instead, the Behavioural Equilibrium Exchange Rate approach provides estimates of the exchange rate equilibrium under the current economic conditions, not the economic conditions that would prevail in an ideal world. This is a relatively modern approach that is increasingly gaining popularity. The Standard Chartered fair value models on the Turkish Lira, Japanese Yen, South African Rand and Australian Dollar are based on this approach.

Data constraints and the current peg to the USD make the use of Behavioural Exchange Rates impossible. Also, the long history of the peg makes the use of Behavioural Models impossible. For example, the USD-AED pair cannot be used in any analysis because it is constant. One could argue that the trade weighted AED could be used in econometric analysis because it fluctuates. This is not entirely true. The AED pairs fluctuate, but they are not liquid. The fluctuation for example in AED-EUR is identical to the fluctuation of EUR-USD. The AED simply mirrors the USD, and it is hence completely meaningless to directly model econometrically GCC currencies using the BEER approach.

Implications for the GCC

Out of the three methods Behavioural models cannot be used and the PPP and IEB approaches give conflicting messages. It is therefore difficult to justify the need to reform on valuation issues alone. However, despite their different findings, both PPP and IEB model findings are affected by the same issues, even though these issues give rise to different conclusions in the cases of some currencies like the AED.

These issues are related to liquidity, inability to control monetary policy, and the rising inflation. In the presence of the pegs the currency is not the shock absorber, the real economy is. According to PPP, because of the rising inflation, some of the currencies have become overvalued. But in the case of IEB, the same currency (ie AED) is undervalued because of the massive surpluses. Both the rising inflation and the accumulation of surpluses, however, are the result of the lack of flexibility and the fact that the economy is acting as the shock absorber. Valuation concerns aside, both approaches point to the need for greater currency flexibility that would provide the authorities with the necessary tools to deal with liquidity and the surpluses and at the same time reduce inflation.

V. Different Regimes

The currency regime should be seen in the broader context of monetary policy, and this chapter looks at different arrangements the GCC could adopt. There is a range of choices. To begin with, the authorities can chose not to change the current FX regimes, and continue with the USD pegs. When it comes to adding flexibility, the authorities can chose from targeting a currency basket, pegging to the price of oil, introducing a managed float with inflation targeting, and finally a free float.

Peg to the USD

The advantage of a USD peg is that it can provide a stable anchor for policy. This was important in the past, but it is no longer a priority given how well positioned the region is from a financial perspective. With the currency pegged to the USD, the exchange rate cannot act as a shock absorber. The result is that the real economy is absorbing the shocks. The last shock, with oil prices rising, has been a positive one. The real exchange rate has responded, but it has done so though increases in the price level, rather than through a nominal appreciation.

Peg to a basket of currencies

This is a tempting option as it gives scope for central banks to use the currency to manage inflation via a manipulation of the exchange rate. If the economy is extremely open then this policy can be used quite effectively - as in the Singapore case where the trade-weighted exchange rate is targeted. However, where domestic inflationary pressures are significant, then it has the significant weakness of still not being able to fully control interest rates, but it will give more control than the current USD pegs. Authorities do not need to fully disclose what the baskets are. This will give them the flexibility to change rates and the currency at different times.

Kuwait's smooth transition to targeting a KWD nominal effective exchange rate is encouraging. One of the key concerns within GCC policy circles will undoubtedly be the uncertainty that could be caused by any shift away from the current USD peg. Kuwait's experience can illustrate that this need not cause much fanfare and that a little opaqueness about the regime can go a long way to help address the problem of inflation.

However, there is an inherent contradiction between policy objectives in the region that is highlighted by Kuwait's decision to determine its weights by looking at both import weights and the relative importance of different countries in Kuwait's foreign investment portfolio. If the sole target was to control inflation, then an import-weighted basket would make sense as it is this that would best counteract imported inflation pressures.

The inclusion of the investment position highlights a regional, as well as a global, issue. The objective of the holdings of overseas assets has been to secure the financial future of the region in the event that oil prices fall sharply. As long as the USD peg exists, then there exists an understandable desire to hold US assets as this eradicates the currency risks. This tendency has then been reinforced by the fact that the size of asset holdings means that liquidity is a key issue and again this is best located in the US's developed and deep financial markets.

But once you move away from the USD peg, the first reason for the holding of US assets disappears. Meanwhile, it has become increasingly clear that higher returns can be achieved by investing outside of the US.

Peg to oil prices

The idea of pegging a currency to a country's major export price has been popularised by Jeffrey Frankel. The basic argument is that economic crises have generally been caused by a situation where a currency has been pegged to an appreciating USD while export earnings have been hit by a slump in the price of the country's key commodity. While the region is clearly experiencing the reverse situation at the moment (high oil prices and a weakening USD), that does not mean the above situation cannot happen. Pegging the currency to oil prices would protect the oil sector, but leave the non-hydrocarbon sector to bear the brunt of currency fluctuations. While most companies are used to managing currency fluctuations to some degree, the idea of having to live with currency volatility at the level of oil prices would inhibit planning for the future and would deter companies from setting up operations that had any significant local cost involved.

Meanwhile, the idea of pegging the currency to a commodity price is largely defensive in nature. Indeed, in his 2003 paper, Frankel focused on countries with a weaker financial position and deliberately ignored those who are net creditors. The rationale for such an omission was probably that 1) such countries are less at risk even if oil prices slump significantly and 2) the need for a credible anchor for monetary expectations was lesser as the lack of a widespread and meaningful election process means that the incentive to artificially inflate the economy for political reasons is just not present.

Free float

Authorities can choose to allow the currency to freely float against other currencies. There are only very few countries that practice this on an absolute basis. Even countries such as the US, UK, Europe and Australia acknowledge that, at times, intervention can be warranted. However, it is used so infrequently that it sends a wake up call to financial market participants that currencies may have become dramatically misaligned. Because of this, the success of such action in turning sentiment is usually fairly good for these countries, especially if they coordinate their action which indicates that they are all willing to put policies in place that will solve this misalignment.

Of course, the positive thing about this is the fact that it gives a central bank total freedom to set interest rates in line with local conditions, while taking into account the current level of the exchange rate. The main concern with this approach for the Gulf region is that it may well result in excessive currency strength, leading to the Dutch disease - whereby the non-hydrocarbon sector becomes extremely uncompetitive. Not only does this get in the way of one of the region's key policy drives - diversification in order to create jobs for the young population - but it also means that currency weakness would not be an effective tool to expand the economy at times of low oil prices as the non-hydrocarbon sector would be too small to offset weakness in the hydrocarbon sector.

Managed float

One can easily state that there are only very few currencies in the world that are free floating in the true sense. Most currencies in the world do see some

type of official intervention. This leads us to the outcome of the managed float, which is effectively a blended approach of the free-float and the pegging to a basket of currencies. This allows the central bank to try to determine the best overall monetary settings (both interest rates and the level of the currency) for current economic conditions. This system also allows for the recycling of petrodollars on a selective basis in order to manage the currency outcomes. Of course, the main issue with such a system is that it is complex to manage, especially when data availability is a major issue. The authorities can also introduce inflation targeting as well, by announcing their inflation targets and then managing their monetary policy to achieve the official inflation targets. The authorities can also intervene occasionally in the markets to smoothe out currency volatility.

VI. Monetary Union

Table 5

Convergence Criteria for the GCC based on the Maastricht Criteria						
	2003			2007 IMF est.		
	Inflation	Central Government Fiscal Balance as % of GDP	Total Government debt as % of GDP	Inflation	Central Government Fiscal Balance as % of GDP	Total Government debt as % of GDP
Bahrain	1.7	1.8	36.9	3.2	5.0	24.0
Kuwait	1.0	17.4	23.0	5.2	35.8	6.5
Oman	0.2	4.7	16.3	3.7	11.1	6.0
Qatar	2.3	6.4	41.6	11.5	12.2	12.1
SaudiArabia	0.6	1.2	82.0	3.3	18.2	20.1
UAE	3.2	2.6	6.6	9.3	29.4	10.6

Source: ECB, SCB Global Research

Any recommendations should be put in the context of the GCC common currency. The GCC central bank governors have hinted that the target of moving onto a common currency by 2010 will be difficult to achieve. Nevertheless, the aim to move to a common currency at a later stage remains.

The concept of convergence deserves more attention. The GCC seeks to achieve economic integration among its member states through the harmonization of economic and fiscal policies. The unified management of economic policy is directed towards establishing a single currency within the group. Article 22 of the GCC economic Agreement (1981) states that "member states shall seek to coordinate their financial, monetary and banking policies, and enhance cooperation between monetary agencies and central banks, including the endeavor to establish a unified currency in order to further their desired economic integration."

To achieve convergence in order to move to Monetary Union, the GCC can learn from the European Union. Prior to adopting the euro, the EU outlined a series of criteria that were required prior to admittance. Likewise, the EU has recommended to the GCC to adhere to the same guidelines. The ECB[8] addressed the convergence criteria for the GCC and explained some of the regions shortcomings and strengths in the formation of a monetary union.
Members of the European Monetary Union were required to adhere to the Treaty of Maastricht. The treaty lists the following criteria for the European states: 1) inflation of no more than 1.5% above the average rate of the three member states with the lowest inflation 2) a national budget deficit close to or below 3% of gross national product and 3) public debt not exceeding 60% of gross national product. Likewise, the GCC is required to follow the same items.

The problem with the GCC is that inflation numbers have begun to diverge in the last three years. The average inflation rate among GCC countries in 2003 was 1.5%. In 2007 we expect it to be 6.3%. This is a clear sign that the current FX and monetary policy framework is not helping to bring the regional economies closer together.

There is also a disparity among the GCC countries in terms of GDP growth and GDP per capita. The likes of Qatar and the UAE are recording robust GDP growth and per capita numbers while Saudi Arabia and Oman are lagging and are among the poorer nations in the region. Bahrain and Kuwait

have grown at steady rates, and are among the wealthier nations in the region with high per capita GDP.

GCC currencies and interest rates have of course been stable against each other. The similarity in economic structure, policies, and accumulation of significant foreign exchange reserves has underpinned the credibility of the authorities to maintain the peg and deter speculation. However, one can easily argue that interest and exchange rates might be stable, but they are not at their optimal level. And even though interest rates and the bilateral currency rates between GCC currencies are stable and converging, the real economies are now diverging hence the problems on both the fiscal and the structural front. It is far more important for the region to achieve macroeconomic stability, and economic convergence to sustainable levels first. Convergence of interest rates and exchange rates can then follow.

Implications for currency policy
Advocates of the USD peg would argue that the USD pegs were necessary for the transitory period between now and the common currency in 2010 in order to achieve convergence. One could also argue that countries in the Eurozone had to be pegged for at least two years under the Exchange Rate Mechanism II regime before becoming part of the Euro. Convergence, however, in the Eurozone was not only expected to take place through the exchange rate, but also through other different economic criteria that were part of the Maastricht Criteria. The case in support of the USD pegs in the GCC however is completely different than the case for the pegs in the Eurozone.

First, European currencies were not pegged to the USD, but first to the Deutsche Mark (DM) and then to the Euro (EUR). Both the DM and the EUR were floating against the USD. The idea was for currency stability within the common currency area, and not with a currency outside the area. Similarly in the GCC, and consistent with the concept of multilateralism which is so important for the GCC currencies, the currencies of the region can be at a later stage pegged to each other, but not necessarily to a currency outside the region.

Second, with great uncertainty surrounding the date of the GCC common currency, keeping the USD pegs just for the purpose of transiting to the common currency is pointless. It is far more important to ensure macroeconomic stability. The currency together with monetary policy can be viewed as a tool to achieve this economic convergence.

Third, the presence of the USD pegs has not helped regional economies converge. The problem is that if there is any sort of convergence under the current exchange rate regimes, it is more likely to result in the inflation numbers of the rest of the GCC rising further, converging to those of Qatar and the UAE rather than the other way round.

VII. The recommendation

The present USD pegs served the region well in the past. But what worked well in the past, is not necessarily the right solution now. The current pegs are now failing to deliver price stability, policy flexibility, and even currency stability when one looks at exchange rate of GCC countries against other currencies than the USD.

This section argues that a managed float and an inflation target should be the ultimate goal. Norway is a very good example of a resource rich country that has adopted a float and an inflation target with great success. However, we acknowledge that the authorities cannot follow such a solution yet. For a managed float to be successful several conditions need to be satisfied. Policy response needs to be gradual, with the authorities adding more flexibility at a pace that GCC countries can cope with.

(a) Step 1: Now: 20% revaluation or moderate revaluation with immediate introduction of currency basket dominated by USD

A first point of action can be a significant, 20% revaluation of GCC currencies, with the USD peg staying and a later introduction of a currency basket dominated by the USD. Alternatively, the GCC can proceed with moderate revaluation (5%-10%) with a simultaneous introduction of the currency basket.

As discussed, it is not so clear that all GCC currencies are undervalued. Nevertheless, a revaluation can lead to an increase in local interest rates. We have discussed in the section on inflation that because of the increased purchases of GCC currencies, local interest rates have fallen, leading to a sharp acceleration in money supply growth. The revaluation needs to be significant in order to be seen as a one off, and deter renewed capital inflows. A small revaluation would not achieve that, as it can be seen as too small to have an impact, leading to expectations for more. A significant revaluation would end speculative buying, driving market interest rates higher.

A 20% revaluation may sound too aggressive at first. But it needs to be put in context. GCC currencies need to catch up with other currencies in the world which have been appreciating against the USD for some time. Since January 2002, the New Zealand dollar (NZD) has appreciated by 83%, with the Australian dollar (AUD) appreciating by 77%. In terms of oil producing countries, the Canadian dollar and the Norwegian krona both appreciated by 67%. The euro (EUR) appreciated by 65%, the underperforming Japanese yen (JPY) appreciated by 20% and even the Chinese yuan (CNY) appreciated by 11%. When put in this context, a 20% revaluation of GCC currencies Vs the USD, as aggressive as it may sound at first, will merely help GCC currencies catch up with other currencies in the world.

A moderate revaluation between 5%-10% is also an option. In order to be effective however, it would have to be followed by an immediate introduction of a currency basket. The basket can still be dominated by the USD, however it would give the authorities more flexibility to fine tune and make necessary changes in the future. If a moderate revaluation is not followed with an introduction of a currency basket, then the GCC would have to follow up with more revaluations in the near future. This will encourage speculation for another one-off move at a later stage, which can lead to the same problems

of ample liquidity the region is facing now. The move needs to be large enough so that it is perceived as being adequate, or it should be followed by the introduction of a currency basket that would introduce two way risks and provide the authorities with more flexibility.

(b) Step 2: Over next 18 months: Introduction of currency basket heavily dominated by USD

To gain more flexibility, the GCC can also revalue and scrap the pegs in favour of a currency basket. The introduction of such a basket can take place either at the time of revaluation, or soon after (within 18 months). The components of the basket do not need to be disclosed to the markets. In fact, the basket can be dominated by the USD. By calling it a basket and not a USD peg there will be an option to fine tune the currency, to offset future USD trends. This is exactly what China did in 2005, when the USD peg was scrapped in favour of a currency basket. However, in practice, China is targeting the currency against the USD, with an appreciation bias of around 7.5% per year, according to our forecasts. This makes it easier for the Chinese to alter the pace of appreciation when necessary and respond to the prevailing economic conditions.

If GCC authorities opt to proceed with only a moderate revaluation (for example 5%), then it will be very important to introduce the currency basket at the same time. This will add some element of uncertainty in the markets, and will be perceived as a positive step that would add some degree of flexibility. Introducing a basket will also put an end to the one way bet mentality, and should introduce two way risks. This will be very important for the future, as it will make it significantly easier for the authorities to fine tune the exchange rate in response to changing global and regional economic conditions.

(c) Step 3: 18 months to 5 years: continuous gradual shift in currency basket to a wider range of currencies with which the region trades

Approximately 60% of the GCC's trade is with Asia (including China and Japan), and around 20% is with the Eurozone. Despite the fact that the currencies are pegged to the USD, only 10% of GCC trade is with the US. The currency basket should evolve in such a way to reflect more accurately the trading patterns of the GCC in order to avoid losing too much competitiveness and importing inflation. Depending on the prevailing economic conditions, the authorities can always opt to introduce steady, appreciation, or depreciation biases. In order to introduce such a diverse basket for the GCC the region will need to diversify further and become less dependent on the hydrocarbon sector. Such a diverse basket will also be harder to administrate. Singapore has successfully introduced such a basket, and even though the Monetary Authorities of Singapore do not disclose the components of their basket, we estimate that the basket the authorities track replicates the trade patterns of the country.

The table below gives an indication of possible trade weighted currency baskets regions in the country could follow. We based our calculations on 5-year trade averages. In these baskets the Eurozone and Asia dominate. It is also important to note that such baskets should be dynamic, and should evolve to reflect the changing trade patterns. In the future, we would expect Asian currencies to become even more important in such baskets.

Table 6

	SAR	AED	QAR	KWD	BHD	OMR	GCC
USD	20%	10%	6%	19%	23%	8%	15%
GBP	5%	8%	6%	6%	15%	7%	5%
EUR	30%	30%	17%	23%	31%	13%	25%
JPY	22%	28%	44%	29%	15%	26%	25%
CNY	12%	14%	5%	6%	8%	26%	15%
KRW	11%	12%	22%	17%	8%	20%	15%

Source: IMF, SCB Global Research

(d) Step 4: Further option: Managed Float and inflation targeting:

Moving beyond the fear of floating, which is to a great extent the result of the long history of the USD pegs, the region would benefit from a gradual transition to a float (with the occasional intervention) accompanied by inflation targeting. There are countries that share some characteristics with the GCC which have already moved to a floating exchange rate and adopted an inflation target. The experience of Norway offers some valuable lessons for the GCC.

The common characteristic that Norway has with the GCC is crude oil. In 2006, the crude oil and natural gas industry had contributed approximately 14% towards Norway's total GDP and made up roughly 50% of the total exports. Despite the importance of oil, Norway has allowed its currency to float, and the decision has helped the economy prosper whilst keeping inflation under control. Inflation in Norway, between 2002, when the oil price boom started, and September 2007 never exceeded 5%. The average inflation for the period was at 1.5%. For the same period growth averaged 6.8%, reaching a high of 18.0% y/y in Q1 2006.

The Norwegian Central Bank, Norges Bank, adopted an inflation-targeting regime with an inflation target of 2.5%. The regime was introduced in 2001. To achieve the 2.5% inflation target[9] set by the Norwegian government, Norges Bank alternates the key bank deposit interest rate and, on occasion, intervenes in the foreign exchange market to stabilise the Norwegian krone (NOK) in order to avoid any negative impact on the export-oriented economy.

We believe that GCC countries would benefit from the introduction of a similar exchange rate regime. However, given the current elevated level of inflation, the inflation target of the UAE should be set at realistic, achievable levels and it is likely to be higher than Norway's 2.5%.Due to the recent bouts of high inflation in the UAE, a realistic target for them would be around 5%.

(e) Ongoing Reforms

For the GCC, data transparency is vital in the formation of a Monetary Union. The IMF, argues that "it will be important for the GCC as a regional organisation and for its member countries to put into place reliable and sound statistical programs that can flexibly address the requirements of currency union when they are agreed".[10] Thus, as the GCC considers currency reform,

statistical infrastructure and data transparency are vital to the success of the monetary union and for the region as whole.

The region also needs to develop deeper capital markets. GCC member states already have local currency T-bill or government bond markets, so the concept is not new. However, it is fair to say that these markets are under-developed, with limited liquidity by international standards. One of the biggest problems in cross-border foreign direct investment (FDI) is exchange rate risk. Whilst GCC's currency regimes currently mitigate this, there is a need to look towards the future. Local currency volatility and susceptibility to devaluation perceived or real, is a major impediment to FDI, with many investors having learnt this the hard way. Consequently, offshore investors, petrochemical companies, for example, often look to at least partially finance domestic capital expenditure relating to joint ventures in local currency. Moreover, this is typically for a longer tenor and often beyond that readily extended by banks.

VIII. Summary

This paper examines the key policy issues facing the Gulf - and indeed it could be said much of the Middle East. The peg to the dollar has worked well but now is the time for change. But change is never easy. There can be losers as well as winners, particularly if one outcome is an appreciation versus the dollar that may reduce the region's return, as well as the total value of' its overseas assets.

Yet, despite this, the region's policymakers need to seize the opportunity afforded to them and think global.

New trade corridors are seeing the emergence of sizeable trade flows, both within regions, and between regions. For the Middle East and the Gulf there is every likelihood of more rapid growth in trade flows with east Asia, south Asia, eastern Europe and Africa.

Furthermore, the region faces the opportunity to deepen and broaden its capital markets, to mirror the diversification of its economies and to help see rising domestic consumption.

Furthermore, a change in currency policy would provide further evidence of a shift in the global economy. It could be seen as one of a number of steps needed to achieve more balanced global growth. And a shift in the policies of the pegged and heavily managed currency areas (such as China and the Middle East) should ease upward pressure on the currently free floating currencies that have borne the brunt of the dollar's decline.

Throughout this paper we have stressed the need for credibility, stability and flexibility as well as the appropriate level for currencies. There is a strong case on economic, financial and trade grounds for a revaluation now and a gradual but continual evolution of Gulf currency policy. The world economy is changing and the Gulf's currency policy needs to change with it!

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