Gulf One
Investment Bank

Research Bulletin
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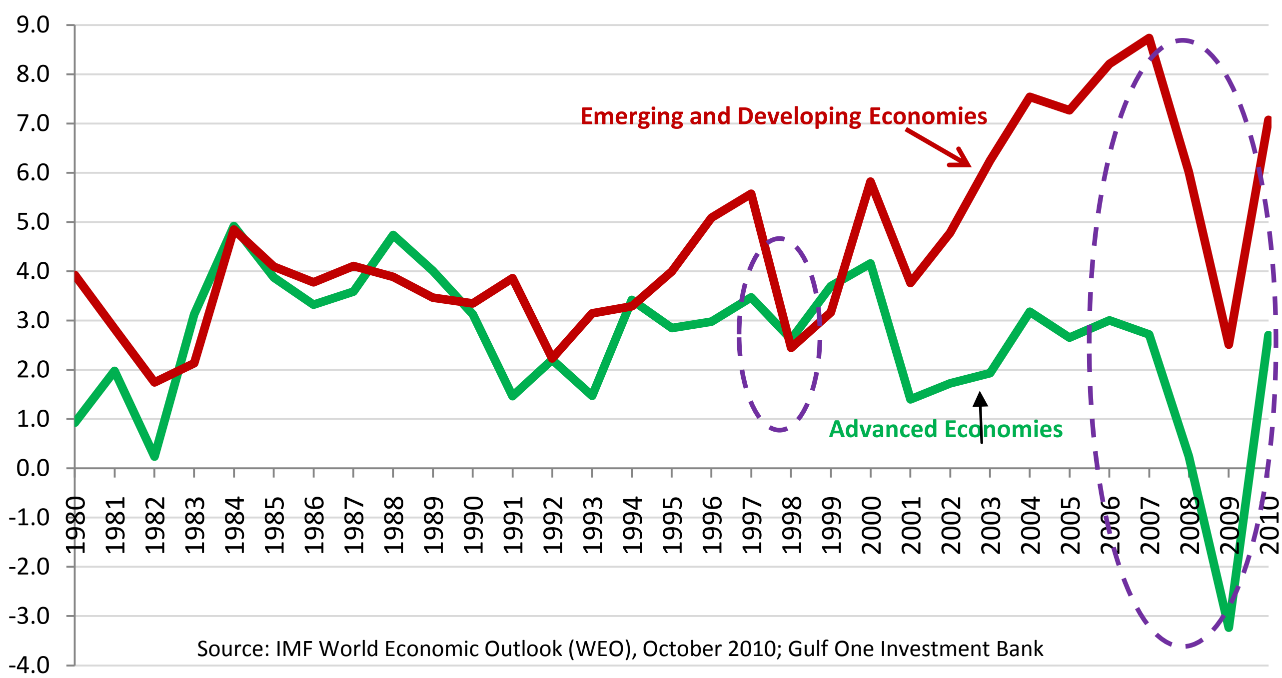
Potential Impacts of 'Currency War' on Saudi Arabia

Overview

The global economy ended the year 2010 on a stronger note than it did in the preceding year as the world's real GDP grew by around 4.8 percent in 2010 but contracted by 0.6 percent in 2009. But the global economic recovery is dichotomous and would continue to be in such a twin-track mode in the years ahead, with emerging economies accelerating in a high-speed gear and mature economies experiencing a low growth momentum (Figure 1).

Figure 1: Trends in Real GDP Growth Rate (%)



Source: IMF World Economic Outlook (WEO), October 2010; Gulf One Investment Bank

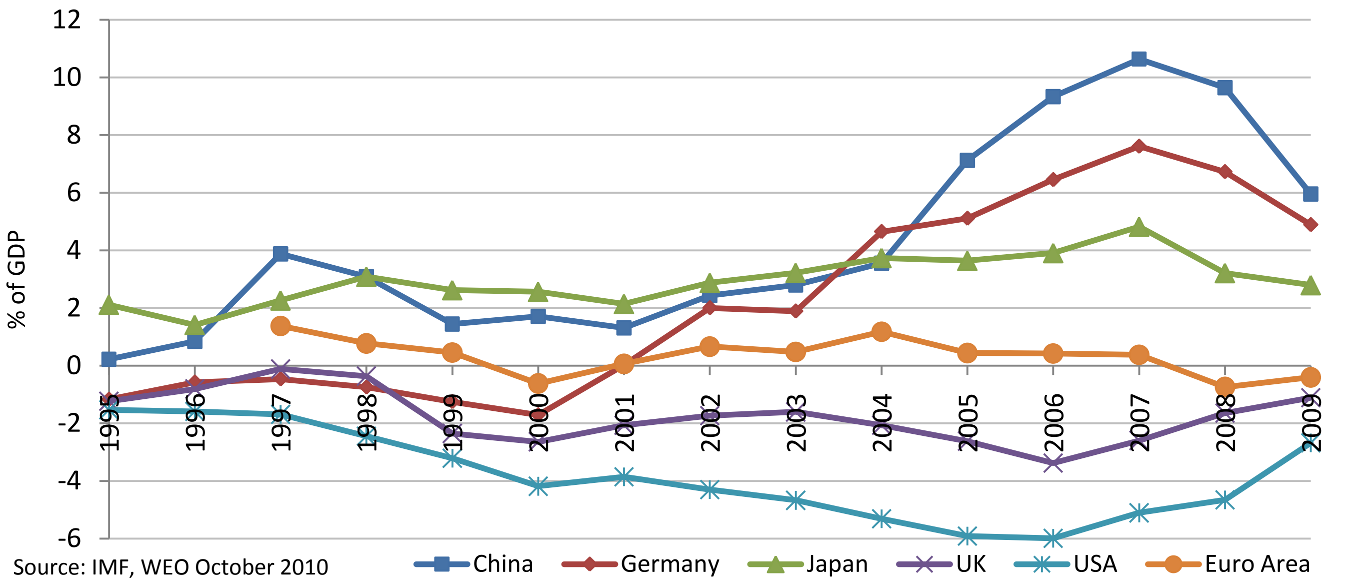
In effect, within the two growth poles, economic recovery exhibits considerable variation across individual countries. In the case of the emerging economies, growth is largely driven by the so-called BRIC (Brazil, Russia, India, and China) countries, with China in the driving seat, while recovery in the developed countries is led by Germany and Japan, as Table 1 illustrates.

Table 1: World Economic Performance and Outlook – Growth Rates of Real GDP (%)			
	2009	**2010e**	**2011f**
World output	**-0.6**	**4.8**	**4.2**
Advanced economies	**-3.2**	**2.7**	**2.2**
United States	-2.6	2.6	2.3
Euro area	-4.1	1.7	1.5
Germany	-4.7	3.3	2.0
France	-2.5	1.6	1.6
Italy	-5.0	1.0	1.0
Spain	-3.7	-0.3	0.7
Greece	-2.0	-4.0	-2.6
Ireland	-7.6	-0.3	2.3
Portugal	-2.6	1.1	-0.05
Japan	-5.2	2.8	1.5
United Kingdom	-4.9	1.7	2.0
Emerging and developing economies	**2.5**	**7.1**	**6.4**
Brazil	-0.2	7.5	4.1
Russia	-7.9	4.0	4.3
Developing Asia	6.9	9.4	8.4
China	**9.1**	**10.4**	**9.6**
India	**5.7**	**9.7**	**8.4**
Middle East	2.0	4.1	5.1
GCC	0.8	4.9	5.2
Bahrain	3.1	4.0	4.5
Kuwait	-4.8	2.3	4.4
Oman	3.6	4.7	4.7
Qatar	8.6	16.0	18.6
Saudi Arabia	0.6	3.4	4.5
UAE	-2.5	2.4	3.2

Source: IMF, WEO October 2010 & Regional Economic Outlook 2010; Gulf One Investment Bank
e = estimates; f = forecasts

The commonality between the growth drivers in both developed and emerging countries is that they have enjoyed a relatively long history of trade surpluses, while the laggards appear to be trade deficit countries. For instance, since the turn of this Millennium China, Japan, and Germany have increasingly recorded current account surpluses while the US and the UK have consistently experienced growing current account deficits (Figure 2).

Figure 2: External Balances (Current Account) in Major World Economies



It is these contrasting international trade fortunes across countries, generally referred to as 'global trade imbalances', that have been at the heart of the debate on the 'currency tension' or 'currency war' as countries search for the quickest way to speed up the pace of their economic recoveries. The recent hue and cry on both sides of the international trade divide has introduced a crack in the global coalition that was forged at the outset of the global financial and economic crisis, and this is likely to pose serious risks to the fragile global economic recovery.

As is well known, at the height of the recent global financial and economic crisis, world leaders closed ranks and acted in unison to contain the crisis and to get the global economy back on track. This led to the creation of the Group of Twenty (G20) richest countries[1] to replace the erstwhile G8 as the leading authoritative body for navigating the international economic and financial system out of turbulences. The first G20 summit took place in Washington in mid-November 2008, and since then leaders of the G20 nations have continued to meet twice yearly to discuss policy issues

[1] The G20 countries, in order of the relative size of the economies, are: USA, China, Japan, Germany, France, UK, Italy, Brazil, Canada, Russia, India, Australia, Mexico, South Korea, Turkey, Indonesia, Saudi Arabia, Argentina, and South Africa. The EU is also represented as the 20th country in the G20 summits. Collectively, the G20 countries account for 85%, 80% and 67% of world's income, trade and population respectively.

pertaining to the promotion of international financial and economic stability. So far, four additional G20 summits took place in London (April 2009), Pittsburgh (September 2009), Toronto (June 2010), and Seoul (November 2010), with the next summit scheduled to take place in Cannes (France) in 2011.

As the global economic climate began to improve, however, wrangling about the global trade imbalances and talks about global rebalancing agenda preceded the last G20 summit of 2010 held in South Korea, pitching the trade deficit countries against the trade surplus countries[2]. Such debates have sparked fears of competitive devaluation of currencies and beggar-thy-neighbour trade protectionism as countries seek to engage in a ‘race to the bottom’ to boost their export competitiveness. The most hostile exchanges on this issue so far were between the US and China, with the former accusing the latter of deliberately keeping its currency (yuan or renminbi) undervalued, and China accusing the US of indirectly devaluing the dollar by printing money, through the Federal Reserve’s Quantitative Easing (QE) policy[3], to flood the emerging countries with excess liquidity to prop up their (emerging countries) currencies.

Both sides have strong arguments and concerns, as will be discussed later in this bulletin, but it is likely that the currency tension between the world’s top two richest nations would continue and further deterioration in the value of the dollar is inevitable so long as the US struggles to find other innovative ways of boosting its export competitiveness. The exact magnitude of the overvaluation of the US dollar against the Chinese yuan is unknown, but some analysts have reckoned that the US dollar would have to be devalued by up to 40 percent to bring the US in line with China’s competitiveness[4]. Thus the US dollar, which has already lost around 11 percent against major currencies since June 2010[5], is likely to continue to fall in 2011 and beyond.

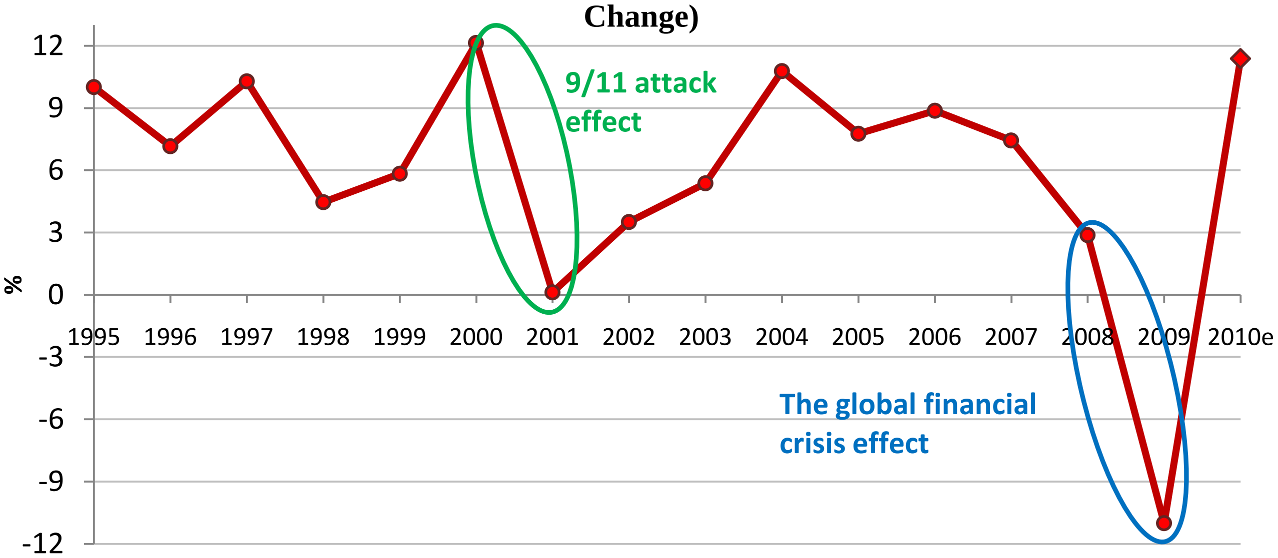
[2] To ease the tension surrounding exchange rate misalignments, the United States proposed a current account target of 4 percent of GDP for both surpluses and deficits, but such a proposal was rejected by other G20 countries.
[3] In the midst of the global financial crisis the US Federal Reserve printed nearly $2 trillion through its QE policy to stimulate the US economy. In view of the lacklustre growth performance and high unemployment, the Fed unveiled yet another QE policy in November 2010 to purchase $600 billion worth of government bonds until June 2011.
[4] Fred Bergsten of the Peterson Institute for International Economics suggested that the undervaluation of the Chinese yuan is possibly as much “25 percent on a trade-weighted basis and ... 40 percent against the dollar”. Didier Cossin also alluded to the 40 percent figure in his paper, “Big Risks, Big Responsibilities: CEO Successes and Failures” (IMD Switzerland, November 2010).
[5] Jadwa Investment Monthly Bulletin, November 2010.

Of course, the decline in the value of the dollar would boost the external competitiveness of the US and thereby help it to reduce its huge trade deficit, but there are over 80 countries in the world, including Saudi Arabia and four other GCC countries, which operate a dollar-peg exchange rate regime. What would be the effects of a continuous decline in the value of the dollar on Saudi Arabia and other GCC countries? What should countries in the region do to mitigate some of the potential adverse effects of deterioration in the purchasing power of their currencies following a weakening of the dollar? How can a full blown currency war be avoided or what can be done to mitigate the threat of eventual protectionism? Answers to these and other related questions will be discussed in this bulletin.

Genesis of the 'Currency War'

The global trade imbalances have been around for decades but the collapse in world trade during the 2008 global financial and economic crisis and the fragile global economic recovery after the crisis re-ignited the issue, with currency manipulation at the heart of the policy debate. In effect, the collapse in world trade during the crisis is unprecedented in recent history (Figure 3), so it is not surprising that, as global economic recovery began to unfold, fierce competition ensued between countries in their quest to gain increased share of the international market.

Figure 3: Growth in the Volume of World Trade (Annual Percentage Change)



Source: Thomson Reuters; Gulf One Investment Bank

In effect, such a 'rat race' to boost international competitiveness is at the centre of the current currency tensions which could escalate in 2011 unless the big players act decisively to stabilise the situation. Restoration of 'currency peace' would hinge largely on addressing the root causes of the currency war, since many analysts believe that the current currency tension is largely a "symptom of deeper maladies particularly in countries at the centre of the system. These include high unemployment and weak safety nets in the US, excessive reliance on exports in China, a history of deflation in Japan, severe competitive divergence and sovereign debt crises within the euro area, and overheating in emerging markets. Moreover, all of the large advanced countries face a major medium-term fiscal consolidation challenge" (Dadush, 2010[6]).

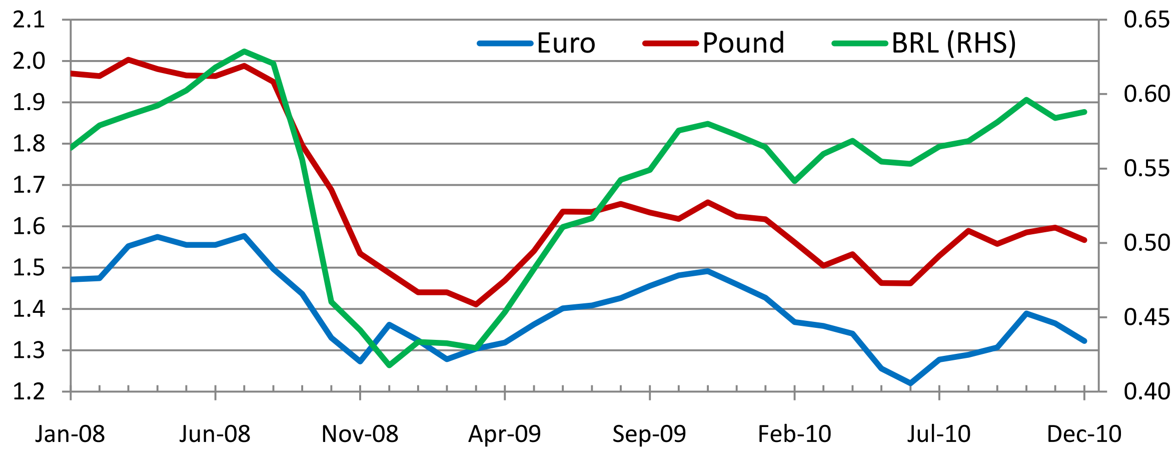
In the presence of these problems, the quickest way to gain a competitive advantage in the international market is through currency devaluation. It is therefore not surprising that in recent months many countries, including Japan, Switzerland, South Korea, Malaysia, Brazil, Chile, Columbia, Peru, Indonesia, India, Thailand, and Taiwan have all attempted to weaken their currencies to export more goods and services[7]. But the US felt that such actions have served to undermine its export-led recovery that is badly needed to boost growth and reduce the alarmingly high rate of unemployment.

The US has argued that throughout the global financial crisis, the dollar appreciated considerably due to increased demand for it as a safe haven currency, and that it is time for it to adjust downwards in line with its economic fundamentals. In effect, with the exception of Japanese yen and Chinese yuan, the dollar appreciated against major world currencies throughout the 2008-2009 global financial and economic crisis, but it has since lost grounds against these current currencies in recent months (Figures 4 and 5).

[6] Uri Dadush (2010), 'Currency Tensions: Four Lessons From History', Carnegie Endowment Online Publications, http://carnegieendowment.org/publications/index.cfm?fa=view&id=41736.

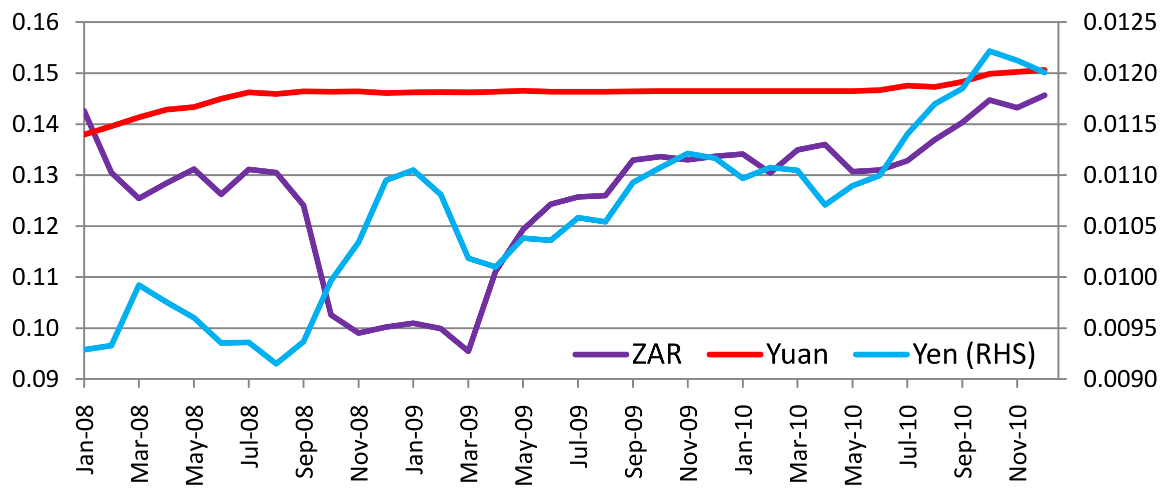
[7] For instance, in September 2010 the Bank of Japan embarked on a massive sale of yen and bought $60 billion aimed at weakening the yen's value against the dollar to enhance the competitiveness of its exporters. Similarly, between September 27 and October 11 2010, central banks in South Korea, Malaysia, Indonesia, Thailand and Taiwan collectively purchased nearly $30 billion to weaken their currencies, according to estimates by *IFR Markets*.

Figure 4: US Dollar Per Euro, Pound and Brazilian Real (BRL)



Source: Thomson Reuters; Gulf One Investment Bank

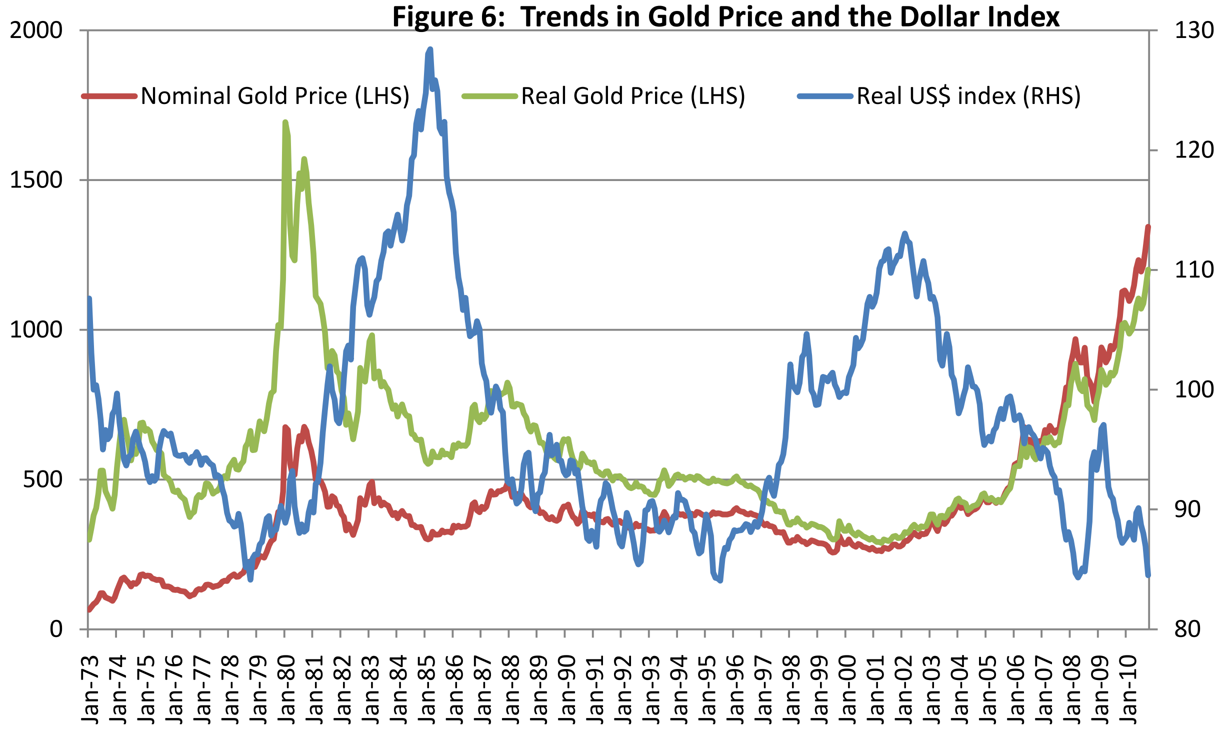
Figure 5: Dollar Per Yen, Yuan & South African Rand (ZAR)



Source: Thomson Reuters; Gulf One Investment Bank

The US dollar has also lost its lustre against precious commodities, such as gold, as an alternative investment asset class and since 2007 they exhibited strong negative correlations (Figure 6). In fact, the dollar index is today at its lowest level in nearly four decades, and it is likely to continue its declining trend in the presence of escalation of currency war.

Figure 6: Trends in Gold Price and the Dollar Index



Source: Thomson Reuters; Gulf One Investment Bank

China versus the USA

Although the currency tension is a global phenomenon, in reality it boils down to a friction between China and the US, for a number of reasons. First, the bilateral trade between China and the US has been heavily tilted in favour of China. In fact, for the past two decades or so, the US balance of trade with China has not only been in deficit but it has also widened substantially, rising from around 20 percent of the US total trade deficit in 1995 to over 40 percent in 2009, amounting to US$218 billion (Table 2). This means that the US deficit on account of trade with China rose from less than 0.5 percent of the US GDP in the 1990s to around 2 percent of GDP by end of the first decade of the New Millennium (Figure 7).

Secondly, the US believes that by pursuing a low-yuan policy China has been manipulating its currency to make its goods cheaper in international markets. Such a policy also makes imports into China more expensive, and thereby helps to make Chinese manufacturers more competitive in the domestic market. Although China has operated a dollar-pegged exchange rate for most of the past two decades (except from June 2005 to July 2008), the US believes that the yuan was pegged at a weakened level, thereby giving China undue advantage in its trading relations with the US[8].

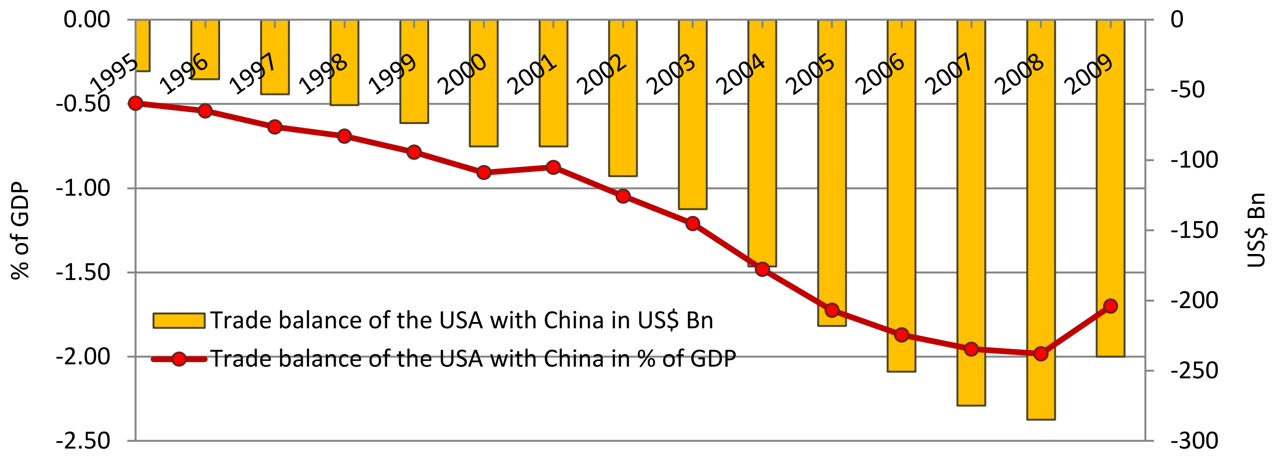
Table 2: US External Trade Position, 1995-2009

	US Balance of Trade with the World ($ Billion)	US Bilateral Trade Balance with China ($ Billion)	Share of China in US Total Trade Balance (%)
1995	-187.54	-36.77	19.61
1996	-194.72	-42.43	21.79
1997	-210.94	-53.03	25.14
1998	-264.13	-60.85	23.04
1999	-357.65	-73.54	20.56
2000	-466.01	-90.25	19.37
2001	-449.11	-90.16	20.07
2002	-509.10	-111.44	21.89
2003	-581.49	-134.84	23.19
2004	-708.88	-175.81	24.80
2005	-828.11	-218.00	26.33
2006	-882.16	-250.56	28.40
2007	-854.70	-274.88	32.16
2008	-865.83	-284.86	32.90
2009	-546.53	-239.98	43.91

Source: Thomson Reuters; Gulf One Investment Bank

[8] It should be noted that in June 2010 China allowed its yuan to appreciate by 2.5 percent against the US dollar but because the dollar has since fallen in value, the yuan has also dropped against many other currencies.

Figure 7: US Balance of Trade with China



Source: Thomson Reuters; Gulf One Investment Bank

Third, the US is using China as a lynchpin since it is fully aware that China is not the only country that is manipulating its currency, but if it can get China to strengthen its currency, then other smaller countries would follow suit.

Fourth, the US is emboldened by a recent IMF (International Monetary Fund) report which says that the US dollar is 'overvalued' and the Chinese yuan is 'undervalued' while the euro, pound sterling and Japanese yen are in line with their fundamentals[9]. Such a statement might have encouraged the US to harden its stance on the Chinese currency and to pursue other alternative policies to boost its economic competitiveness. In addition, the US has also threatened to impose trade restrictions on imports from China should the Chinese authorities fail to raise the value of their currency[10].

[9] "Global Economic Prospects and Policy Challenges", report prepared by the IMF for the Meeting of the G20 Finance Ministers and Central Bank Governors, Gyeongju, South Korea, October 21-23, 2010.
[10] On 26 September 2009 the US imposed tariffs on imports of tyres from China based on transitional safeguard measures. China took the US to the WTO, but on 13 December 2010 the WTO ruled in favour of the US. See WTO Document DS399 titled "United States — Measures Affecting Imports of Certain Passenger Vehicle and Light Truck Tyres from China" (www.wto.org).

It is for these and other reasons that many believe that the US is pursuing a dollar devaluation strategy as a key policy weapon in the global rebalancing process. They pointed to the Fed's QE policies as deliberate measures aimed to weaken the dollar and help the US economy recover through increased exports. There is some sense in this argument because since interest rates are close to zero in the US, the Fed's policies of printing large quantities of new money have led to a wave of capital inflows into the emerging economies, which have tended to push their currencies up and create inflationary pressures, thereby undermining their competitiveness.

In order to mitigate the loss of competitiveness and to minimise the collateral damage from currency war, many emerging economies have recently been introducing a number of counteracting measures to restrict inflows of capital. For instance, South Korea imposed a 14 percent tax on foreign investors' earnings from government bonds. Brazil, Indonesia and Thailand have introduced similar tax measures to prevent their currencies from appreciating. Some countries have, however, intervened directly in the foreign exchange market to stem currency appreciation. Recent examples include Japan, Switzerland, India and South Korea.

But China too has strong reasons to resist what it calls US bullying and antics concerning its exchange rate policy. Some of the notable reasons include the following: First, the Chinese strongly believe that an appreciation of the yuan in itself will not solve America's domestic and external problems since the US economic malaise (high unemployment, low domestic savings, huge debt overhang, and high unit labour costs) would require massive internal reforms to create and sustain economic competitiveness. In fact, the US runs large trade deficits with EU countries whose currency floats, so letting the yuan appreciate will put little dent to US trade deficits with China.

Second, raising the value of its currency would not prevent China from accumulating current account surpluses due to the presence of relatively low unit labour costs, foreign reserves build-up and its growing international investments. Third, the Chinese are also worried that if they raise their currency too quickly, it could bankrupt many export companies and seriously destabilise their economy.

Fourth, China is the world's biggest producer of carbon emissions, and a rising yuan could be bad news for the environment, as it will make it cheaper for China to import raw materials and energy resources to feed its growing heavy industries. Fifth, foreign consumers including those in the US could be hurt by a rising yuan as they will have to pay more for goods imported from China.

Implications of Currency War for Saudi Arabia

The escalation of the currency tension will undoubtedly lead to a further deterioration of the US dollar and could lead to 'trade war'. For Saudi Arabia and those GCC countries that operate a dollar pegged exchange rate regime, a fall in the value of the dollar will not alter their nominal exchange rates against the dollar, but it will weaken the real purchasing power of their currencies. In effect, even Kuwait, which had abandoned the dollar peg since mid-2007 and is currently using a system that links the Kuwaiti dinar to a basket of major global currencies, could be impacted because the dollar still accounts for a large proportion of its currency basket[11]. So, what are the implications of a weaker dollar for Saudi Arabia and other GCC countries with the dollar peg system? How could the adverse potential impacts be mitigated?

One of the transmission channels through which a fall in the value of the dollar could impact on the economies of the GCC countries is loss in competitiveness via appreciation of the real exchange rate, defined as the nominal exchange rate adjusted for inflation rates between GCC trading partners. Such loss in competitiveness would then lead to deterioration in the income terms of trade and would also erode the purchasing power of local currencies. We use Saudi Arabia as a case study to illustrate the consequences of currency war for the Kingdom and other GCC countries.

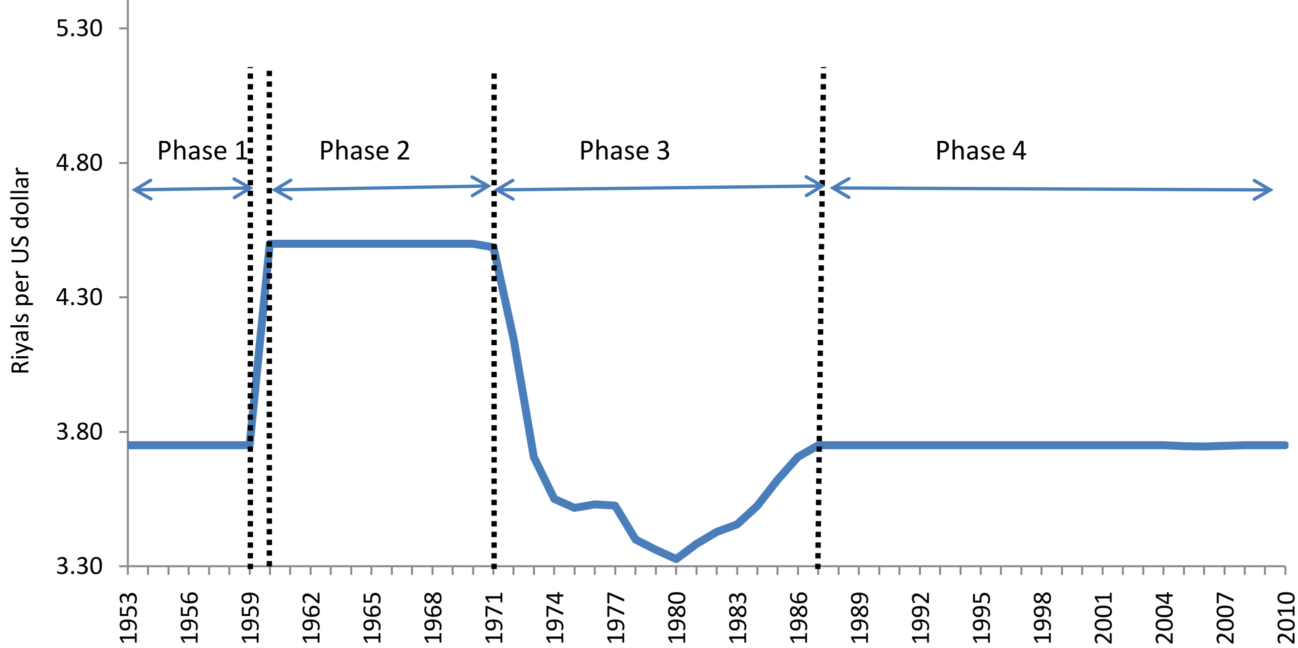
Historical Perspective

Saudi Arabia has a long history of a dollar pegged exchange rate system, as the records from the past six decades suggest. For instance, in the 1950s the Saudi riyal (SAR) was pegged to the US dollar at SAR 3.75, but in 1960 the peg was adjusted upwards (devalued) to a new rate of SAR 4.50 (Figure

[11] Although the precise weights of currencies in Kuwait's exchange rate basket are not disclosed, many analysts believe that the dollar accounts for more than 70 percent of the currency basket.

8). Between 1971 and 1986, the authorities abandoned the dollar pegged system and opted for a 'floating' exchange rate, which saw the riyal appreciate in value, hitting its strongest level of SAR 3.33 in 1980 before depreciating gradually to SAR 3.75 per dollar in 1986 when the Kingdom reverted to the dollar pegged exchange rate system, and has remained at that level for the past 26 years.

Figure 8: Saudi Arabia's Exchange Rate Regimes (1953-2010)



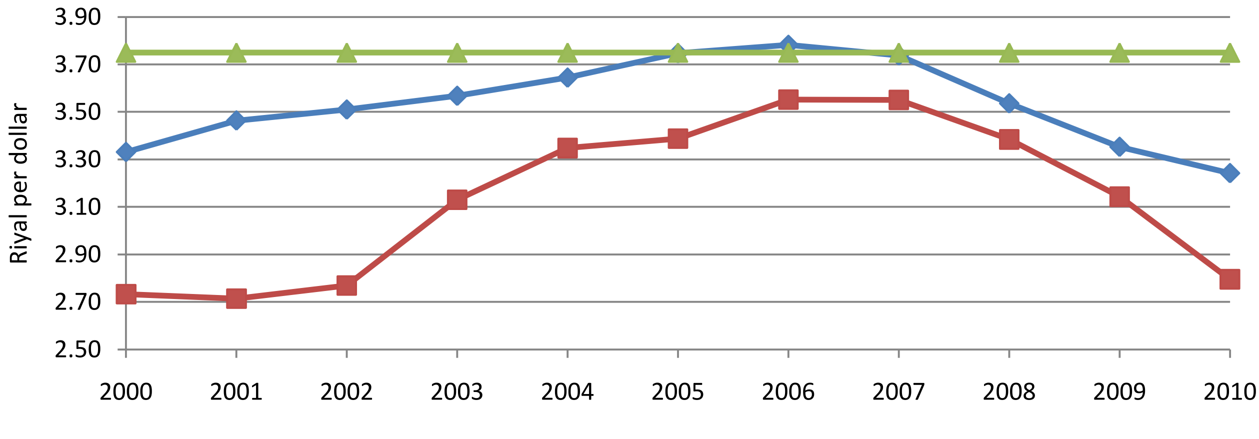
Source: Thomson Reuters; Gulf One Investment Bank

So, what are the potential consequences of currency war on the dollar and the riyal? An escalation of currency war would see the dollar plummet against major world currencies. But given the existing riyal-dollar pegged regime, a devaluation of the US dollar against other currencies would not change the nominal value of the riyal-dollar exchange rate, but it will alter the bilateral real exchange rate (BRER) between the two currencies, and also the trade-weighted real exchange rate (REER) between riyal and the currencies of major trading partners of Saudi Arabia.[12]

[12] Real exchange rate is defined as the official exchange rate weighted by trade shares of a country's trading partners, adjusted for relative inflation. So BRER is calculated by adjusting the nominal riyal-dollar exchange rate of 3.75 by the relative inflation rates between the Saudi Arabia and the US. In the case of REER, the official exchange rates between riyal and other countries' currencies are multiplied by the shares of those countries in Saudi Arabia's trade and then

For instance, during the past decade, with the exception of the period 2005-2007, the BRER and the official exchange rate of the riyal against the dollar diverged considerably. In the case of the trade-weighted real exchange rate (REER), it differed from the nominal exchange rate throughout the entire period (Figure 9).

Figure 9: Saudi Arabia's Nominal and Real Exchange Rates



Source: Gulf One Investment Bank

In both situations, the real exchange rate is lower than the official exchange rate, suggesting that the riyal has appreciated over the years, with the pace of appreciation accelerating since 2007 when the value of the US dollar deteriorated sharply against other world currencies. In fact, from 2008-2010, the appreciation of the riyal real exchange rate vis-a-vis the nominal rate was 10 percent on a bilateral basis (BRER) and 17 percent in terms of trade-weighted real exchange rate (REER)[13]. These gaps between real and nominal exchange rates are likely to widen in the presence of an escalation in currency wars.

An appreciation of the real (riyal) exchange rate would lead to a loss of competitiveness of the Kingdom in a number of ways. First, it would discourage exports and encourage imports, thereby

adjusted by the relative inflation between the Kingdom and the trading partners. Here, we used import shares rather than total trade to abstract from the influence of oil exports which are largely determined by developments in the international oil markets rather than those in the foreign exchange market.

[13] Calculated from the BRER and REER data presented in Figure 9.

leading to the worsening of the external trade position of the country[14]. Second, since the bulk of Saudi Arabia's imports come from the European Union and Asia, the devaluation of the dollar could make imports from such non-dollar currency areas more expensive, and can fuel domestic inflation in the Kingdom, as witnessed in 2007 and 2008 when inflation reached a peak of 11.5 percent in July 2008. Third, real appreciation of the riyal could lead to a deterioration in the income terms of trade by eroding the domestic value of foreign exchange earnings since the same incomes earned abroad could purchase less when adjusted for domestic inflation. We estimate the impacts of real exchange rate appreciation in Saudi Arabia using three currency war scenarios.

Three Scenarios on the Impact of Currency War on Saudi Arabia

To evaluate the potential impacts of currency war on Saudi Arabia we first developed three scenarios on the nature and extent of US dollar devaluation and then estimated the hypothetical income losses associated with potential loss of competitiveness due to real exchange appreciation. We employed a simple methodological approach by comparing the benchmark values of key indicators without the currency war with the estimated values in the presence of currency war. In each scenario, the benchmark values are the 2011 forecasts for the relevant indicators while the estimated values of the corresponding indicators take into account the various assumptions built in each of the three scenarios.

Scenario 1 or 'base scenario' is based on the assumption that the current trend of real appreciation of the riyal continues. This is our 'base scenario'. Prior to the 2007 when the deterioration in the value of the US intensified, the BRER and REER grew by 12 percent and 30 percent respectively, implying a slowing down of the pace of real exchange rate appreciation, but from 2007-2010, the BRER declined by 13 percent while the REER declined by 21 percent. The decline in both BRER and REER is consistent with acceleration in the pace of real appreciation of the currency. We assume that escalation of the currency war would reinforce the post-crisis trends in both BRER and REER.

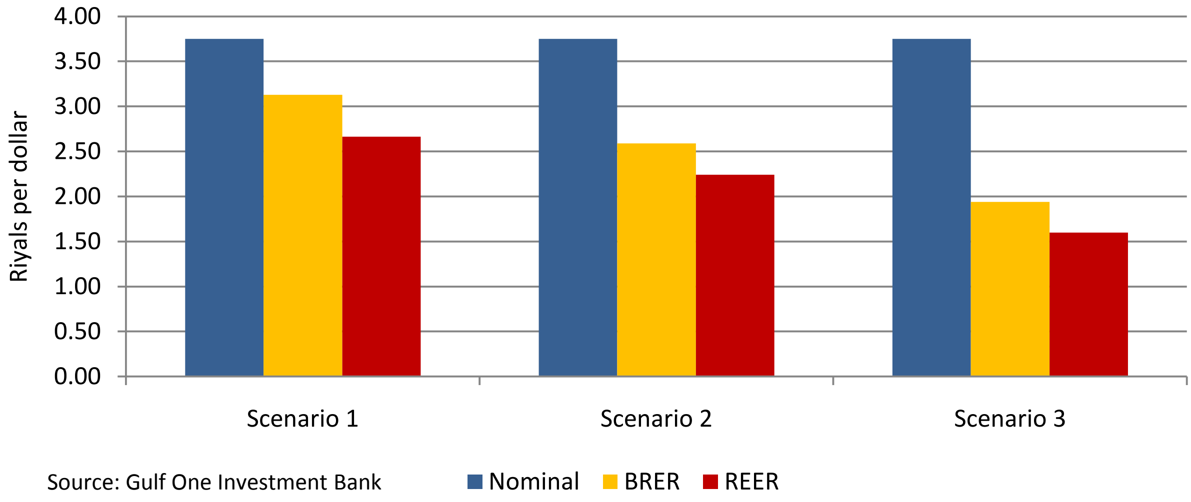
[14] This is likely to jeopardise current and future efforts at diversification away from oil exports to non-oil (manufacturing-based) exports.

Scenario 2 assumes that the ongoing Quantitative Easing and other policies of the US Federal Reserve could lead to a devaluation of the dollar by up to 20 percent in addition to the post-crisis trends in real exchange rates, both BRER and REER. This is a ‘moderate case scenario’.

Scenario 3 is grounded in the assumption that the US would have to devalue the dollar by as much as 40 percent to bring its competitiveness level on a par with that of China, as alluded to earlier in this bulletin, if a big dent is to be dealt to the growing US-China trade deficit. This is a ‘worst case scenario’.

Figure 10 shows the nominal and exchange rates under the three scenarios. As can be seen from the graph, scenario 3 is associated with the steepest appreciation of the real exchange rate and would consequently yield the highest loss of competitiveness. This suggests that the further the devaluation of the US dollar the deeper the loss in competitiveness of Saudi Arabia.

Figure 10: Nominal and Real Exchange Rates Under the Three Scenarios



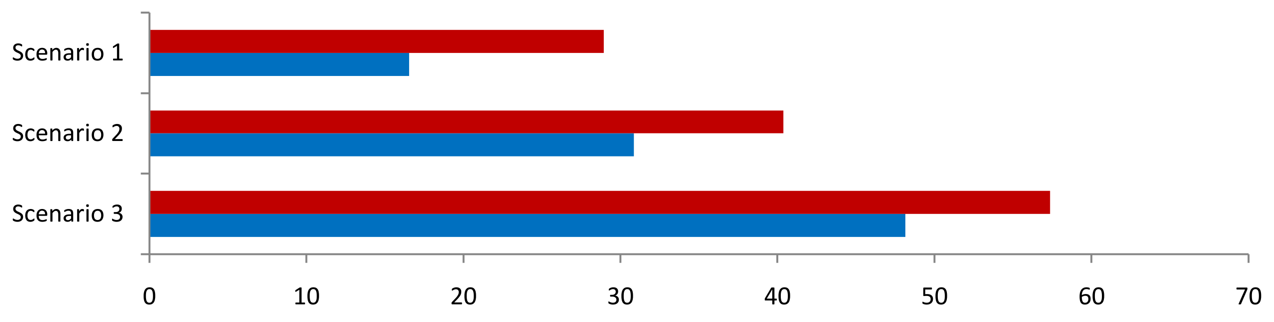
Source: Gulf One Investment Bank

Analysis of the Three Scenarios

In each scenario we assumed that escalation of currency war in 2011 could drive down the real exchange rates of the riyal as illustrated in Figure 10 above. Assuming an average oil price of $85 per barrel in 2011 and crude oil exports of 8.5 million barrels per day, we estimated Saudi Arabia's foreign income earnings and converted it to local currency using the nominal (official) exchange rate to obtain the benchmark indicators. The same income streams were then converted to Saudi riyals using the real exchange rates (BRER and REER) to obtain the counter-factual indicators.

Figure 11 shows the potential loss in competitiveness under the three scenarios using both bilateral and trade-weighted real exchange rates. The latter (REER) is the more widely used indicator for gauging the loss in competitiveness of nations.

Figure 11: Saudi Arabia's Potential Loss of Competitiveness Under the Three Scenarios (%)

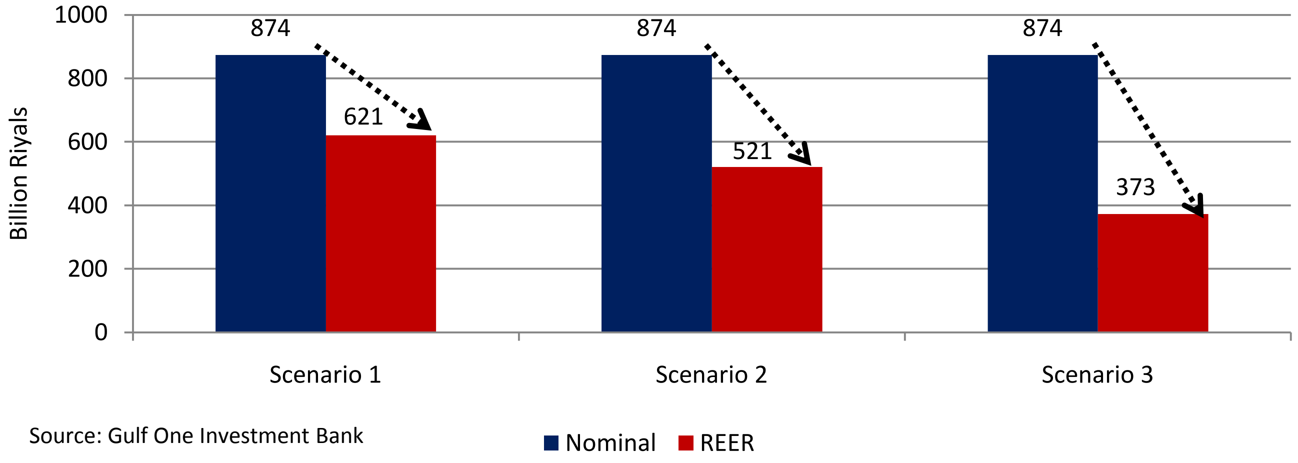


Source: Gulf One Investment Bank

In line with the conventional wisdom we therefore used the REER indicator to illustrate the potential loss in foreign exchange earnings for Saudi Arabia based on each of the three scenarios. As Figure 12 illustrates, in the absence of currency war oil export revenues in 2011 were forecast to be around 874 billion riyals. However, in the presence of currency war oil export earnings could dwindle to 621 billion riyals under our 'base' scenario 1, 521 billion riyals (scenario 2), and 373 billion riyals (scenario 3).

The estimated oil revenues under these scenarios would have serious implications for the Kingdom's fiscal position. For example, in the 2011 budget the government plans to spend 580 billion riyals in 2011 and expects to earn total revenue of 540 billion riyals, resulting in anticipated fiscal deficit of 40 billion riyals[15]. In the presence of currency war, however, fiscal balance could range from a budget surplus of 41 billion riyals (Scenario 1) to budget deficits of 59 billion riyals and 207 billion riyals under Scenarios 2 and 3 respectively (Figure 13).

Figure 12: Potential Impact of Currency War on Saudi Arabia's Oil Export Revenues

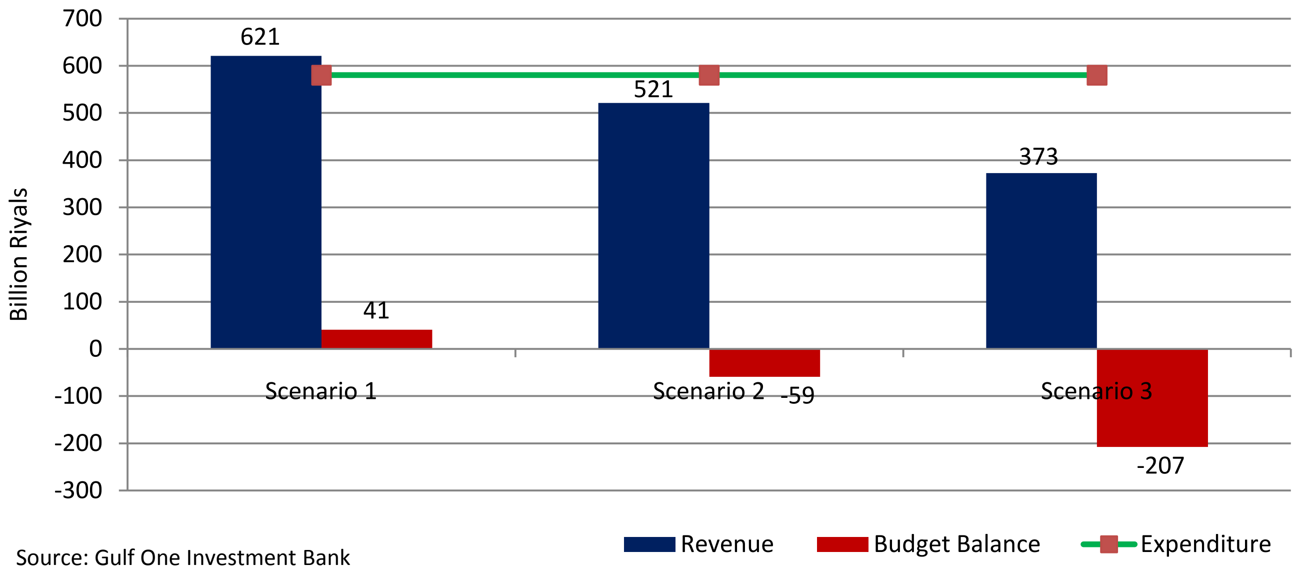


Source: Gulf One Investment Bank

The significance of this exercise is to highlight the potential dangers of currency war on open economies with dollar pegged exchange rate systems. It is often ironically misunderstood that because a country's currency is fixed to the US dollar, a devaluation or appreciation of the dollar would have little or no effect on the economy of the country in question. Of course, the nominal exchange rate will not change, but the purchasing power of the currency will be eroded or boosted depending on whether the US dollar depreciates or appreciates against other currencies.

[15] This is based on the fact that the budget uses crude oil price of around $60 per barrel as a break-even indicator, not the $85 per barrel we used in our scenarios.

Figure 13: Saudi Arabia's Fiscal Position Under the Three Scenarios



Source: Gulf One Investment Bank

Conclusion

Attempts to rebalance the global economic landscape are pushing many countries to look for the easiest way, currency manipulation, to create and sustain competitive advantage in the international marketplace. As a result, the global economic cooperation that was forged at the height of the global financial crisis is ebbing away and giving rise to what is dubbed as ‘currency war’. Although the most notable tension is between the US and China, the world’s two richest nations with contrasting international trade fortunes, the consequences transcends all boundaries as there is a popular adage which says ‘when two elephants fight it is the grass that suffers’.

The analysis in this bulletin suggests that countries with dollar peg system are not immune from the collateral damage that would arise from currency war. The consequences may even be more severe for hydrocarbon dependent countries such as Saudi Arabia whose export products are priced in dollars but the bulk of their imports originate from non-dollarized zones. As the US is determined to reduce its huge trade deficits through a host of other policies including trade and exchange rate policies, escalation of the currency war would see a continuous fall in the value of the dollar.

For countries operating a dollar peg exchange rate system, the nominal value of their currencies will not be affected by the devaluation of the dollar, but the purchasing power of their currencies will be grossly eroded through appreciation of the real exchange rate and thereby creating serious loss of competitiveness that could jeopardise efforts and programmes aimed at creating jobs, boosting income and promoting sustainable economic and industrial development.

Some of the consequences could be mitigated through diversification of production and exports as well as through diversification of reserve currencies. As it now stands, the bulk of Saudi Arabia's foreign reserve is in US dollar, so efforts should be made to gradually shift to a portfolio of currency in order to mitigate the risks against exchange rate exposure. Another 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 and programmes. An alternative strategy is 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.

Equally desirable is a move away from a dollar peg system to a basket of currencies reflecting the portfolio of currency reserves using trade shares to determine the weights of currencies in the basket. The issue of de-pegging and that of revaluing the peg rate were bandied around during 2007 to mid 2008 when the dollar continued its 'free fall', but policy makers in GCC region kicked against these ideas on economic and political grounds. Those reasons are still as strong today as ever, but they would become untenable once the region has adopted a single currency, which increasingly looks unlikely to happen in the short term horizon!

On the global stage, the most desirable action is to avoid the currency war altogether and co-ordinate actions to tackle the root causes of the so-called global imbalances which are largely the result of poorly co-ordinated macroeconomic policies. The spirited unity forged by the G20 leaders a couple of years ago should be resurrected and countries should be encouraged to refocus on domestic policies that will promote a sustainable economic recovery rather than being obsessed with exchange rate devaluation to boost net exports.

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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