Saudi Arabia should ditch its dollar peg

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The double-digit inflation problem in Saudi Arabia and its Gulf neighbours is different from that of other emerging market economies. Although the rising price of imported food affects them all, the inflation problem in the Gulf region is exacerbated by their fixed exchange rate policy.

The peg to the dollar contributes to Saudi inflation in two ways. First, the dollar link forces the Saudi central bank to match US interest rates. As the Fed lowered its interest rate from 5.25 per cent last summer to 2 per cent now, the Saudis had to cut their interest rate. If they had not done so, investors around the world would have flooded Saudi Arabia with funds seeking the higher yield on a currency that is pegged to the dollar. While cutting rates was a good policy for the US as its economy weakened, it was a terrible policy for Saudi Arabia, which is experiencing an overheated domestic economy with rapidly rising inflation.

The dollar peg also raises Saudi inflation by increasing the cost of imports as the dollar declines relative to the euro, the yen and other currencies. The US is the source for only about 12 per cent of Saudi imports. The 15 per cent decline of the dollar relative to those currencies during the past year meant that the prices paid by the Saudis for the goods that they bought from Europe, Japan and elsewhere rose more than 15 per cent. The large US trade deficit is likely to continue to force the dollar to decline against other main currencies. The result will be a continuing source of imported inflation in Saudi Arabia and other countries that tie their currencies to the dollar.

Inflation in Saudi Arabia and the other Gulf states is depressing real incomes of millions of low-income workers. The combination of the dollar peg and the declining dollar is also reducing the value of the remittances that large numbers of foreign workers send home to their families in low-income countries such as India and Pakistan. Since these foreign workers make up more than half of the total workforce in Saudi Arabia and an even larger share in the less populous states of the region, their discontent is a significant risk to local stability.

To avoid these problems, the Saudis could shift from the existing dollar peg, either to a policy of linking the riyal to a basket of currencies with a heavy weight on the euro, or to a market-determined “floating” exchange rate. Shifting to a weighted basket peg would reduce the problem of imported prices but would still limit the ability of the Saudi monetary authorities to pursue an independent anti-inflationary interest rate policy.

A floating exchange rate, even one that is managed by the central bank, would allow the Saudis to pursue an anti-inflationary monetary policy. The potential inflow of funds in response to a higher Saudi interest rate would be limited by the investors' uncertainty about the future value of the riyal. Emerging market countries around the world have been able to pursue successful anti-inflationary policies after abandoning their dollar pegs.

The immediate effect of freeing the currency would be a rise in the value of the riyal relative to the dollar and therefore to other main currencies. This would automatically reduce the cost of imports and therefore lower the price level. The Saudi government could even use this decline in the overall price level to reduce its very wasteful subsidies on domestic energy prices.

Although most countries are reluctant to raise the value of their currency because of the adverse effect on exports, the Saudis do not have that problem because more than 90 per cent of Saudi exports are oil or petroleum products. The world price of oil would not change if the riyal appreciated. And while ending the dollar peg would cause an accounting decline in the riyal value of the Saudis' foreign exchange assets, it would not have any effect on the purchasing power of those assets in world markets.

The decision to float the Saudi currency would not require any change in the way that Saudi Arabia manages its vast foreign exchange reserves. The Saudis could continue their current investment strategy, presumably a gradual diversification from dollar bonds to a mixture of dollar, euro and sterling bonds. While a big shift in Saudi investments away from dollar bonds could cause the dollar to fall relative to the euro, the end of the dollar peg would not by itself have any significant effect on the international value of the dollar.

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