Economic SYNOPSES
short essays and reports on the economic issues of the day
2008 ■ Number 4

A Falling Dollar Raises Inflation in the Gulf

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Since the early 1980s, oil-rich Gulf states such as Qatar, Saudi Arabia, Bahrain, Kuwait, and the United Arab Emirates have pegged their currencies to the U.S. dollar, benefiting from the relative stability of U.S. monetary policy. After 2006, however, the weakening U.S. dollar and rising oil prices have increased inflation in these economies.[1]

A falling dollar contributes to inflation in dollar-pegged economies by raising the domestic-currency prices of tradable goods (such as manufactured goods and many types of food). Rising oil prices make individuals wealthier and encourage them to buy more tradable goods as well as nontradable goods (such as houses and land), increasing the relative prices of goods and services produced within the country.

These Gulf states are now considering whether a dollar peg is in their best interest. In May 2007, Kuwait broke the dollar peg in favor of tracking an undisclosed basket of currencies, albeit one in which the dollar is believed to be heavily weighted. In mid-November, the governor of the United Arab Emirates' central bank stated that the dollar peg has "served the economy…very well in the past. However, we have reached a crossroads."[2] But are the oil-rich Gulf states at a crossroads or merely revisiting the same intersection?

The chart shows the evolution of the dollar's relative value and oil prices starting in 1980, when most currencies were pegged to the dollar; the table shows the inflation rates of these five economies averaged over three distinct time horizons: 1980-81, the last period of persistently high inflation; 1986-2003, which featured low but volatile inflation; and 2006-07, the current inflationary period.

In the first period, a weak U.S. dollar and high oil prices both accompanied high Gulf-state inflation; whereas, in the second period, the more modest levels of exchange rates and oil prices accompanied low inflation. Over the past decade, the openness to international labor movements in some Gulf states might have helped keep inflation lower than it would have been otherwise: Notably, Qatar, which has 12 percent fewer migrant workers today than in the early 1980s, has seen much worse inflation recently.[3]

In sum, oil prices will not continue to rise and the dollar will not continue to fall forever. This recent spike in Gulf-state inflation, therefore, is very likely transitory and will probably not translate into persistent inflation. ■

[1] Two major causes of the weakening dollar are (i) the low domestic savings rate and consequently large current account deficit and (ii) subprime market turmoil and recession concerns.

[2] "Wealthy Nations in Gulf Rethink Peg to the Dollar," *Wall Street Journal*, November 20, 2007.

[3] RPP 2005 Bangladesh country report.

Inflation rates	1980-81	1986-2003	2006-07*
Qatar	7.63	2.61	11.92
Saudi Arabia	3.49	0.49	2.64
Bahrain	7.62	0.27	2.80
Kuwait	7.22	2.41	2.70
UAE	9.00	3.59	8.65

NOTE: *2007 data are International Monetary fund estimates.