How Green Was My Dollar: Increased US Dependence on the Gulf States?

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At a meeting that took place in 1971 during the Nixon administration between then-Treasury Secretary John Connally and European colleagues, Connally charged: "The dollar is our currency, but it is your problem." Although more than 37 years have passed since the saying was coined, it seems that it encapsulates some of the main sources of tension in today's fiscal world as well. While the dollar is US currency, its use as the means of exchange in most international trading, the unit of account for pricing oil and other goods, and the dominant reserve currency of most central banks makes the decline in its value over the past year the problem of many economies around the world. However, in contrast to the saying's original context, the erosion in the value of the dollar is not just "your" problem but also one of the principal economic challenges currently facing the US administration. It may even become a major strategic challenge for US foreign policymakers if the decline of the dollar continues to impact on trade in the coming months as well.

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Evidence of the concern over the dismal performance of the dollar among policymakers in the strategic field was conveyed by Director of National Intelligence Michael McConnell, in a briefing to the Senate intelligence committee in February 2008. Departing from familiar security issues, McConnell surprised the committee when he declared that the decline of the dollar could have considerable impact on US national security. He noted that the decrease in the value of the dollar in 2007 prompted Syria, Iran, and Libya to ask their oil importers for non-dollar currencies, and contributed to Kuwait's decision to stop linking the local currency to the dollar. These trends, he contended, might gain momentum and spill over to other oil exporters, should faith in the US currency continue to decline.[1]

Examination of the current political-economic debate in the Gulf states as well as the discussions among OPEC countries indicates that some of the world's largest oil exporters are trying seriously to initiate moves designed to reduce and even cancel the direct connection between oil and the dollar. Iran and Venezuela, motivated by political considerations, are working to advance the idea of no longer pricing oil in dollars, as they feel that such a move could harm United States hegemony. In contrast, the discussions in Saudi Arabia and the other Gulf states on reducing the dependence of their economies on the performance of the dollar has accelerated, in the wake of the economic challenges confronting them due to the fall of the dollar.

This essay describes the global economic processes that strengthen the voices in the Gulf urging reduced dependence on the US dollar. The decline of the dollar may sharpen both calls for the Gulf states to change the exchange rate regime and cancel linkage of the local currency to the dollar, and calls to end the pricing of oil in dollars. As the dollar's strength comprises a central component in the US standing in the international arena, the increase in such calls will likely be accompanied by a US diplomatic effort to guarantee that its Gulf allies will not surprise it with unilateral financial moves that might damage the dollar's status.

The Problem of a Low Dollar for the Gulf States

The increase in demand for energy products, driven by the growth of emerging markets along with only moderate growth in world oil supply, is the main factor responsible for the rise in oil prices that began in 2002. Most of the oil producers have reached the limit of their production ability, and therefore any concern about heightened political tension that might harm the pace of production among any of them sends the price of oil skyrocketing. However, since the outbreak of the crisis in the US mortgage market in the summer of 2007, a significant part of the economic debate about the energy market has shifted from the real and political factors to over-emphasis on speculative factors. Many economists and oil exporters claim that the sharp increase in the price of oil over the last year is not a result of a supply shortage, rather, primarily a result of a weak dollar and uncertainty in the financial markets.

The inverse relationship between the value of the dollar and the price of oil stems from the fact that investment in the commercial market is viewed as an acceptable way to protect oneself from the ravages of inflation. The concern of investors over an economic crisis that goes with inflation and the concern over further drops in the interest rate in the United States and the value of the dollar fuel demand for tangible assets such as oil. In addition, since oil is priced in dollars, the profits of the oil companies and oil exporters are adversely affected when there is a depreciation in the dollar's value, and therefore a rise in the price of oil is a corrective mechanism for erosion in the value of the dollar. In this way a situation emerges in which the signs and reports of a possible slowdown in the US economy – reports that generally bring the price of oil down as they indicate a possible decline in demand – not only do not lower the price of oil; they actually boost demand for oil contracts and fuel a sharp rise in its price.[2]

Such a process would seemingly arouse much optimism among Gulf oil producers, for whom oil export is the source of most of their product. However, alongside rosy forecasts for continued rapid growth in the Gulf states as a result of the process, a rise in oil prices driven by a fall in the value of the dollar generates challenges and dilemmas. The most acute challenge is the increase in the rate of inflation, which in recent months broke longstanding records among all the members of the Gulf Cooperation Council (GCC – Saudi Arabia, Kuwait, United Arab Emirates, Oman, Qatar, and Bahrain). Indeed, the ongoing sharp rise in the price of oil is driving an unprecedented economic boom in the GCC countries, and this naturally generates a sharp rise in demand for investment products and a range of consumer products. However, the sharp rise in the inflation rate in the Gulf states is not only a result of the increase in demand noted in most of the financial sectors, but is also the result of the drop in the value of the dollar.

The close connection between the state of the dollar and the rise in prices in the Gulf states results from the exchange rate regime. Except for Kuwait, all the members of the GCC use a fixed exchange rate regime (PEG), according to which the local currency is pegged to the dollar. In other words, the nominal value of the exchange rate is fixed according to the dollar and is not influenced by conditions of supply and demand in the foreign currency market. Therefore, the billions of dollars that flow into the Gulf from the rise in oil prices do not bolster the value of the local currency, and the decline in the value of the dollar in relation to the major currencies around the world leads to a real erosion in the value of the local currencies in the Gulf too. Most of the imports of the GCC countries do not come from the US, but from the East and the euro bloc, so the decline in the value of the dollar pushes up the price they have to pay for imported goods and raw materials.

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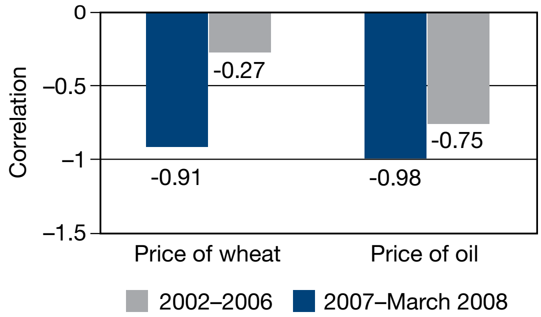
In order to maintain their exchange rate regime the GCC countries have to adopt the monetary policy of the Federal Reserve, which is currently trying to extricate the United States from a recession by aggressive reduction of the interest rate.[3] That is, the Gulf states cannot cool down their economies by raising the interest rate but have to maintain a low interest rate at a time when their economies are growing rapidly. As there is hardly any way to restrain the inflation rate through a monetary policy,[4] the governments are forced to compensate for the erosion in real wages by raising wages in the public sector, expanding government subsidies on a range of products, and increasing supervision of the price of basic food products. In other words, the Gulf states pursue a cyclical policy, which can lead to a further acceleration in the rate of inflation.

In February the rate of inflation in Saudi Arabia broke a 27 year record when it reached 8.7 percent, and the central bank there estimates that in 2008 the annual inflation rate could reach 10 percent. In Qatar and the UAE the picture is even gloomier, with the 2007 inflation rates reaching about 14 and 11 percent, respectively (the highest in 19 years). Bahrain and Oman, oil producers that do not belong to OPEC, likewise have high inflation rates.[5] Significantly, Kuwait, which stopped linking its currency to the dollar and began instead to link it to a basket of currencies in May 2007, is also suffering from high inflation rates. The relative part of the dollar in the basket of currencies to which the Kuwaiti dinar is linked is large, and therefore Kuwait is forced to follow the US monetary policy and reduce its interest rate.

The effect of these figures on the economic-political situation in the Gulf states is better understood when the price rise is broken down into the various economic sectors. A significant part of the inflation in Saudi Arabia is driven by a rise in housing rates (18 percent) and food prices (13 percent). The rise in food prices in the other GCC countries is higher, as they import even more of their food than Saudi Arabia. Indeed, food riots have erupted in Saudi Arabia, the UAE, and Kuwait. Furthermore, most of the factors driving the rise in oil prices are the same elements that have generated a sharp rise (tens of percent) in food prices around the world. Growth in China and India has not only boosted steeply the demand for oil, but also world demand for basic food products. The sharp rise in oil prices has galvanized efforts to find alternative sources of energy produced from sugar cane and corn, and the governments that are encouraging farmers to cultivate these crops to produce ethanol are prompting the price rises. Food prices are also influenced by speculative trading and concern over inflation, and the decline of the dollar expands electronic trading in contracts for food products just as it boosts demand for oil futures contracts.

Correlation between Dollar Value and Price of Commodities



Source: *TD Economics*

As evident from the graph, the negative correlation between the value of the dollar and the price of goods strengthened in the past year and a half, as compared with 2002-2006. In other words, a recent decline of the dollar caused a sharper rise in prices than was caused by the same percentage of decline in 2002-2006.

The close connection between the prices of oil and food products indicates that the Gulf states are able to ease the political tensions to a degree caused by the domestic rise in food prices and elsewhere in the Arab world. A decision to increase oil production will reduce its price and is also likely to reduce the price of food products, and may even contribute to a strengthening of the dollar. However, the oil spare capacity from OPEC, most of which comes from Saudi Arabia, is currently only about 2 million barrels of oil a day and the impact of increasing oil pumping on a drop in food prices is unclear.[6]

In any case, for now the Gulf states are concerned that a possible slide into a world recession will ultimately lead to a decline in the global demand for oil and a drop in price. Thus, they are not looking to increase the rate of production and invite a move that will harm their revenues. At its March meeting, OPEC rejected the US request for an increase in the rate of oil production. OPEC president Shakib Khalil declared that the cartel does not intend to discuss a change in its quota policy before its next meeting in September, as the rise in the price of oil is a result of "mismanagement" of the US economy and the state of the dollar and does not reflect insufficient supply.

The desire of the Gulf states to continue benefiting from the economic surge fueled by the upturn in the oil market, and concern that the adverse effects of inflation will blunt the achievements of growth and generate political tensions, sparked calls to change the exchange rate regime and move away from permanent linkage to the dollar. The release of the February inflation figures along with an increase in the forecasts of a further rise in world food prices ignited a wave of speculation that one or more GCC members might suddenly de-peg their currencies from the dollar to block the price rises.[7]

By early April 2008 these speculations appeared little likely to materialize, once the UAE announced that it did not intend to change its exchange rate regime. The progress made in negotiations between the governors of the major banks – talks designed to establish a monetary union between the GCC member countries by 2010 – also quelled concern somewhat that one of the Gulf states would suddenly announce it is breaking away from the dollar. The governor of the central bank of Saudi Arabia noted during the discussions that the currency of the planned monetary union would be linked to the dollar. He said that over the years pegging to the dollar was a stabilizing factor that helped the Gulf states attract direct foreign investments and promote competitiveness among the sectors outside the energy sector.

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However, these statements did not long satisfy the local media, official elements, and international financial bodies. Many financial institutions estimate that a rise in inflation and a renewed wave of food riots will prompt one of the GCC members to consider seriously the possibility of moving away from dollar linkage in the coming months.

Concern for the United States?

The possibility that one of the Gulf states would announce a change in its exchange rate regime has aroused concern in the US, since a step of this sort would signal a permanent decrease in demand for dollar assets by the country ending its dollar linkage, and in addition, would indicate a further loss of faith in the United States economy and currency.

A loss of faith in the dollar is often perceived as a threat to the national interests of the United States, since the dollar's standing is one of the sources underlying American power. The fact that the United States pays for its imported goods in the currency that it itself issues gives it a unique status in the financial system, and this standing allows it to finance its domestic and international activity easily. The willingness of countries such as China and Saudi Arabia to receive dollars for their product, and their willingness to use these dollars to purchase bonds issued by the American government allows the United States to maintain low interest rates and cut funding costs on its "double deficit" (budget deficit and balance of payments deficit). In addition, the willingness of the world's economies to accumulate dollars gives the US the ability to increase the rate of dollar printing without generating internal inflationary pressure.

Thus, it is not surprising that US adversaries in OPEC are trying to advance the idea of stopping oil pricing in dollars. Ahmadinejad and Chavez claim that one of the factors that sustains the readiness of the world's economies and the financial bodies to accumulate dollars results from the security offered by the possibility of converting the dollars into oil and other goods. Venezuela and Iran – which since the beginning of the year has been trying to introduce electronic trading of oil contracts linked to the Iranian currency – view the fall of the dollar as an excellent opportunity to displace the United States and spearhead moves that will unsettle the historic link between oil and the dollar. Should one of the GCC members abruptly stop pegging its currency to the dollar, it may add momentum to such moves.

To be sure, a breakdown of the petrodollar system is not a simple matter that can take place overnight. The ability of the euro or any other currency to replace the dollar is not guaranteed, but more important, the decline in the value of the dollar does not attest to a drop in its importance. Ahmadinejad can announce at any time that the dollar is "a worthless piece of paper," but this piece of paper accounts for over 65 percent of the reserves of the world's major banks. Consequently, many believe that the United States will continue enjoying the benefits of the dollar for many more years: the fact that many countries have accumulated billions of dollars safeguards the dollar's standing, as those countries will be wary of harming their assets and therefore will not hurry to vary their foreign currency balances radically and reduce demand for dollar assets.[8] According to this logic, the Gulf states have no interest in advancing a unilateral process that may hasten the decline of the dollar. Therefore, they will not abandon linkage to the dollar if they believe that a move of this sort would encourage other countries and financial bodies to sell their dollars. In addition, the decline of the dollar makes US exports more competitive. Thus, some see a change in the Gulf states' currency exchange regime as a move that could improve the international system's balance of trade.[9]

However, in addition to these estimates, there is also considerable research that points in the opposite direction. Numerous studies published in the last two years argue that the rise in the United States' "double deficit" will ultimately reduce the willingness of many countries to accumulate US bonds. This process would eventually lead to a weakening of the dollar's standing as the world's main reserve currency and would harm US hegemony. The countries that have accumulated billions of dollar assets are wary of damaging their assets, but the departure of one major player from the dollar is liable to set off a wave that would sweep many countries, which would seek to quickly offload their dollar assets in order to limit the damages.[10] This logic can also be applied to the issue of the exchange rate in the Gulf states. These states have no specific interest in the fall of the dollar, yet the damages caused by inflation due to the dollar linkage might propel them toward a step that could ultimately damage their dollar assets.

Another phenomenon that increases concern over a decline in the dollar's standing is the expansion of the activities of the government investment funds (sovereign wealth funds – SWF). In recent years, China and the oil exporters have accumulated US bonds worth hundreds of millions of dollars, and are therefore not concerned about looking for riskier investment avenues that would bring them greater yield than the returns on the US bonds. Increased investment in alternative channels around the world through sovereign wealth funds is expected to grow if the dollar and interest rates in the United States remain low. As such, demand for US bonds and dollar assets may decrease.[11]

Conclusion

It is difficult to determine unequivocally which assessments are more indicated by the processes underway in the Gulf in recent months. On the one hand, there is a clear increase in the desire of the oil producers to vary their foreign currency reserves and look for alternative investments to US bonds via government capital funds. On the other hand, the unreserved support Saudi Arabia has given to its exchange rate regime, despite the inflationary pressures it generates, is an excellent example of the difficulty it and other countries face in leading a move that would harm their dollar assets. At the same time, the two processes show that when oil prices rise and when the US economy experiences difficulties, the interdependence between the United States and its allies in the Gulf deepens. This interdependence no longer only stems from the decisions of the Gulf states regarding the rate of oil production, but extends to the international investment policy and their monetary decisions.

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A further decline in the dollar's value along with increased inflation and higher food prices around the world will likely increase the pressure on the Gulf states to abandon the linkage of the local currency to the dollar. The US may react to this scenario in two ways: the administration may invest diplomatic efforts to ensure that the Gulf states do not change their exchange rate regimes. Alternatively, if the US is convinced that one or more GCC members will abandon the linkage out of financial and political pressures caused by inflation, it may sanction the move, in order to demonstrate that there is no crisis atmosphere between it and its Gulf allies.

There is a difference as to how the markets might interpret a unilateral announcement on de-pegging from the dollar versus the same decision made with US approval. Beyond that, a unilateral decision on changing the exchange rate regime by the Gulf states includes long range financial and political implications, as it may be a first step in a review of the petrodollar systems.

Notes

1 Judy Shelton, "Security and the Falling Dollar," *Wall Street Journal*, February 15, 2008.

2 Many analytical surveys foresee that this process will change soon, and the increase in signs of a recession in the United States will ultimately lead to concerns of a significant drop in demand for oil, a process that will fuel a decline in the price of oil. For example, Lehman Brothers contends that one can already detect a weakening of the inverse correlation between the value of the dollar and the price of oil.

3 If the Gulf states do not adopt the United States' monetary policy they might experience a speculative assault on their currency.

4 The principal monetary recourse the Gulf states have is to raise the ratio of the reserve to the commercial banks.

5 "Saudi Inflation Could Top 10 pct before Easing – Cbank," *Guardian*, April 23, 2008.

6 There are different estimates as to the size of the world spare capacity. For example, *Oil Market Intelligence* claims that the Saudi Arabia's surplus supply of is one million barrels a day greater than the figure given by the Saudis.

7 Numerous articles on the subject have been published both in the press focusing on the Gulf economies and the US financial press. See, for example, Chip Cummis, "Inflation Challenge Persian Growth," *Wall Street Jour-*

nal, March 13, 2007.

8 For example, this is the logic behind the position of Chairman of the Federal Reserve Ben Bernanke. A survey of good literature presenting arguments for maintaining the status of the dollar can be found in Craig K. Elwell, "Dollar Crisis: Prospect and Implication," *CSR Report for Congress* RL34311, January 8, 2008.

9 See, for example, Brad Setser, "The Case for Exchange Flexibility in Oil-Exporting Economist," *Petreson Institute for International Economist*, Policy Brief, November 2007.

10 These arguments are made by Jeffrey Frankel, who argues that the euro may overtake the dollar as the world's reserve currency within 15 years. Jeffrey Frankel and C. Menzie, "The Euro May Over the Next 15 Years Surpass the Dollar as Leading International Currency.," *International Finance* (forthcoming), http://ksghome.harvard.edu/~jfrankel/EuroVs$-IFdebateFeb2008.pdf.

11 Conclusions of this report can be found at: Flynt Leverett, "Black is the New Green," *The National Interest* (January 2008). Nonetheless, one can find extensive literature that does not consider an increase in the phenomenon as a threat to US financial stability. See, for example, Robert Kimmitt, "Public Footprints in Private Markets: Sovereign Wealth Fund and the World Economy," *Foreign Affairs* (January/February 2008):119-30.