UAE Exchange Rate Regime Policy Issues

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October 2007

Choices for Exchange Rate Regimes

- Exchange Rate:
  - Fixed
  - Intermediate
  - Floating
- UAE has been pegged to the US$ continuously since 1971

Choices for Exchange Rate Regimes

- Choice depends on predominance of shocks, nominal v/s real and degree of capital mobility
- Mundellian criteria:
  - Nominal Shocks $\Rightarrow$ Fixed rates
  - Real Shocks $\Rightarrow$ Flexible Rates

Anchors & Currency Unions:
Benefits & Costs

- Secure inflation rate of anchor ⇒ credible price stability policy, greater financial stability
- Lower transactions costs: goods, services
- Loss of independent monetary policy/lender of last resort; depends on correlation of shocks with anchor
- Loss of seigniorage/sovereignty; but depends on seigniorage compensation arrangements

Anchors & Currency Unions

Countries most likely to benefit:

- Unable to achieve monetary, price & financial stability
- Economic disturbances highly correlated with potential anchor
- Small countries highly dependent on foreign trade
- Countries close in ‘**distance**’ (geography, language, borders) to potential anchors and large potential multilateral trade
- Evidence: ↑trade by factor of 2 to 3

Anchors & Optimal Currency Areas

Alesina-Barro-Tenreyro evidence

- Pros & Cons of different anchors: US$, Euro and Yen
- Examine alternative criteria: trade, co-movements of prices, co-movements of output

Table 1. Currency Maps: MCD Preferred Country Ranking (Averages)

Scenario 1		Scenario 2		Scenario 3	
Saudi Arabia	2.8	Saudi Arabia	4.2	Saudi Arabia	2.7
Kuwait	3.3	Kuwait	4.6	Kuwait	3.2
United Arab Emirates	4.1	Bahrain	5.8	United Arab Emirates	3.5
Bahrain	5.7	Azerbaijan	6.2	Iran	6.0
Qatar	6.3	United Arab Emirates	6.6	Qatar	6.4
Azerbaijan	7.1	Algeria	7.0	Bahrain	7.7
Iran	7.8	Qatar	7.0	Azerbaijan	8.0
Algeria	9.9	Libya	9.9	Algeria	9.7
Pakistan	10.4	Pakistan	10.3	Pakistan	9.9
Tunisia	11.1	Tunisia	10.6	Turkmenistan	10.4
Lebanon	11.4	Kyrgyz Republic	11.8	Oman	11.4
Libya	11.4	Lebanon	11.9	Lebanon	12.2
Kazakhstan	12.2	Syria	11.9	Tunisia	12.2
Syria	12.6	Turkmenistan	12.9	Egypt	12.4
Oman	13.0	Iran	13.3	Syria	12.7
Egypt	13.5	Oman	13.5	Libya	12.9
Morocco	14.6	Kazakhstan	14.4	Kazakhstan	13.2
Turkmenistan	14.9	Morocco	15.3	Morocco	14.7
Georgia	17.1	Georgia	16.4	Jordan	18.7
Jordan	18.7	Egypt	16.9	Georgia	18.8
Sudan	19.2	Armenia	19.0	Sudan	18.8
Armenia	20.0	Sudan	19.1	Armenia	20.6
Kyrgyz Republic	20.5	Jordan	19.9	Yemen	21.7
Yemen	21.8	Yemen	21.3	Kyrgyz Republic	22.4
Tajikistan	24.4	Tajikistan	24.2	Uzbekistan	23.9
Uzbekistan	24.5	Mauritania	25.0	Tajikistan	24.8
Mauritania	26.0	Uzbekistan	25.7	Mauritania	26.0

Source: Authors' calculations

Scenario 1: Equal weights for distance, GDP, similarity of growth rates, similarity of trade structures, and similarity of inflation performances.

Scenario 2: Weights of 0.1 for distance and GDP, and 0.267 for the remaining variables.

Scenario 3: Weights of 0.25 for distance and GDP, and 0.167 for the remaining variables.

Country	Trade	VP	VY
Algeria	Euro	Euro	Euro
Iran	Euro	Euro	Euro
Jordan	Euro	US	Euro
Mauritania	Euro	Euro	**Euro**
Morocco	Euro	**Euro**	**Euro**
Oman	Euro/Jp	US	**Japan**
Saudi Ara.	Euro	**US**	US/Euro
Syria	Euro	**US**	**Euro**
UAE	Jp/Euro	US	Euro

What to do, Where Should We Head? The other 'Road Map'

- Legal-Institutional: implement/revise laws to create stronger, more independent central banks, accountable for financial stability mandates
- Develop Government Bond Markets⇒finance governments
- Strengthen links between Central Banks: financial safety net and 'Arab Target'
- GCC Monetary Union: currency is a public good
  - Link to Euro & $
  - Foster integration