On the squareness of pegs

By: Emerging Markets Debt Team | June 1, 2020

Boston - For decades, the countries of the Gulf Cooperation Council (GCC) - Saudi Arabia, Oman, Bahrain, Qatar and the United Arab Emirates (UAE) - have pegged their currencies to the US dollar. Historically, the pegs have been a way for the gulf countries to use their huge dollar-denominated revenue streams from oil to maintain the purchasing power of local currencies and political stability.

But the collapse in oil prices and the strength of the US dollar in the wake of the COVID-19 pandemic have brought renewed attention to monetary and foreign exchange (FX) policy in the GCC, and questions about whether continuing the dollar pegs is feasible or desirable. The same conversation is taking place in the Gulf countries as well.

When a country pegs its currency to the US dollar, it means relinquishing policy independence for monetary and FX - tools that are often used for economic trade management. With their dollar-based revenues, the trade-off has usually been a favorable one for Gulf countries, when there was little impetus for reform or need to diversify away from oil.

In today's environment, the deficiencies of the pegs are becoming apparent, as they are artificially inflating the value of GCC currencies. For example, Russia has much better fiscal numbers and FX reserves than Oman, yet the Omani rial has appreciated 15% versus the Russian ruble since January.

Similarly, the UAE's currency has appreciated 15% versus Turkey's. The two countries compete in tourism and airlines, and the relative strength of the UAE's currency is a disadvantage.

Oman's central bank governor said in April that the country was "strongly behind the peg" and had the means to defend it. The Saudi central bank has also reaffirmed its commitment to the policy, and the Gulf state has huge reserves to support the peg, if it chooses to do so.

But we see dollar pegs not as a sign of strength, but as a sign of weakness. Encouragingly, we are starting to see conversations about change locally in the GCC. Perhaps, it's an indication that a reevaluation of policy is finally happening.

GCC countries have made progress in institution-building over the past several years, in paving the way for lessening their dependence on oil. The COVID-19 global slump and the Saudi/Russia oil price war have ratcheted up the urgency for that transition to take place. We believe that the twin shocks of COVID-19 and oil should compel Gulf policymakers to examine all tools available to them.

Bottom line: Now that there is a strong desire and need to reform GCC economies, dollar pegs have outlived their usefulness and are hindering progress toward more appropriate FX policy.

Emerging Markets Debt Team
Eaton Vance Management

"Gulf countries have pegged their currencies to the US dollar for decades as a sign of strength. But now dollar peg policies are more a sign of weakness."

The views expressed in these posts are those of the authors and are current only through the date stated. These views are subject to change at any time based upon market or other conditions, and Eaton Vance disclaims any responsibility to update such views. These views may not be relied upon as investment advice and, because investment decisions for Eaton Vance are based on many factors, may not be relied upon as an indication of trading intent on behalf of any Eaton Vance strategy. The discussion herein is general in nature and is provided for informational purposes only. There is no guarantee as to its accuracy or completeness.

The information on this Web site is for U.S. residents only. The information on this Web site does not constitute an offer to sell, or a solicitation of an offer to purchase, securities in any jurisdiction to any person to whom it is not lawful to make such an offer.

There are no guarantees regarding the achievement of investment objectives, target returns, portfolio construction, allocations or measurements such as alpha, tracking error, stock weightings and other information ratios. The views and strategies described may not be suitable for all investors. Not all of Eaton Vance's recommendations have been or will be profitable. Eaton Vance does not provide tax or legal advice. Investing entails risks and there can be no assurance that Eaton Vance (and its affiliates) will achieve profits or avoid incurring losses. Prospective investors should consult with a tax or legal advisor before making any investment decision.

© Eaton Vance Management. All rights reserved. Two International Place, Boston, MA 02110.