Oil Producers consider severing their link with the dollar

Oil-rich countries of the Gulf are concerned about the value of the dollar. For many years these countries have traded their most valuable commodity, oil, in dollars and often invested the proceeds in dollar-denominated assets. It has made enormous sense for them to fix, or peg their own currencies to the dollar. But with the dollar falling in value these countries are weighing up the options, keep the peg, revalue their currencies, or begin to follow another currency, such as the euro.

Most economies in the Gulf Region would like to move in unison. However, Kuwait showed the way in early 2007 and began tracking a basket of currencies. Since, then its currency has risen in value by 5%.

The weakening dollar is driving inflationary problems for the gulf economies. Once, inflation averaged around 3% per annum. Now, with the falling dollar, double-digit inflation rates are being reported. Even in Saudi Arabia, where inflation has been stubbornly low, rates of 5% are now being observed. A revaluation of the gulf currencies would help cap inflation from imported foodstuffs. But this would not tackle domestic inflation which is being driven by ever rising property prices. With GDP growing at between 8-10%, workers are flocking to these economies and pushing up property and rental prices.

Fast growing economies can usually be cooled by a hitting the monetary breaks. A few rapid increases in the rate of interest are generally sufficient to close the wallets of American and Europeans. But when your currency is pegged to the dollar you have to mimic the Federal Reserve's interest rate policy. With the American economy slowing, the Fed is reducing rates and injecting liquidity into the economy. The opposite of what the Gulf States need.

Such pressures bring speculators into the market. Betting on a revaluation, speculators are piling money into the Gulf. This is forcing down retail interest rates and helping to fuel the current economic boom.

A revaluation seems the most likely option. It will stem imported inflation. Reduce speculative money flows and reduce property inflation by making assets in the Gulf more expensive for foreigners. But it comes with a cost. All dollar-denominated wealth, held by the Gulf economies would be worth less.

Question

1. Why does a depreciating dollar lead to higher inflation in the Gulf?

2. Why are speculators attracted to the Gulf economies?

3. Do you think the oil producing economies will abandon the dollar?