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The Falling Dollar and Its Impact on the Saudi Economy

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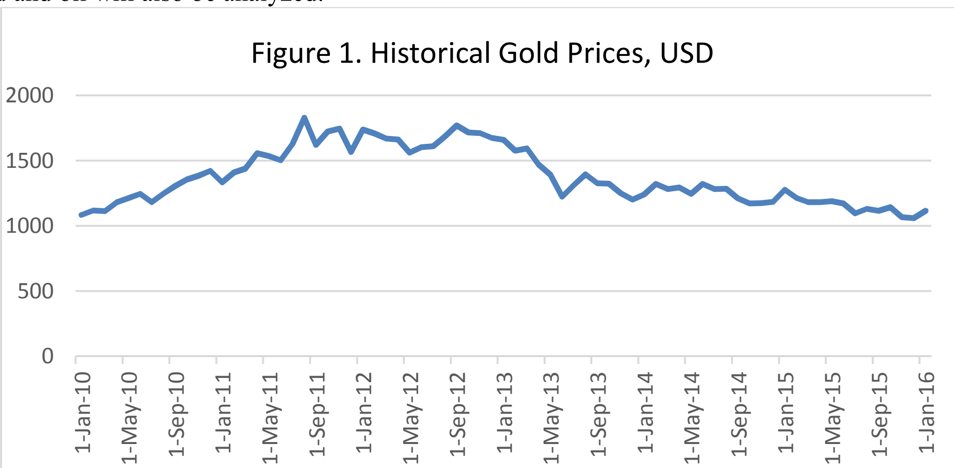
1. Introduction

As foreign exchange studies show, after a fairly strong performance in 2014, the US Dollar (USD) plunged in 2015 in relation to the Euro, British Pound, Japanese Yen, and other global currencies (US Forex 2015). While the trend on US currency fall similarly happened in the past, the weak global confidence now on the US economy has cast serious apprehension on the prospect for any renewed global economic stability. Whenever the USD, as central world currency, declines or appreciates significantly in value, the change impacts the economies of most nations around the world (Amadeo 2015). One of the countries that stand most vulnerable to any serious and unwanted dysfunction of the USD is Saudi Arabia, which, as a matter of key economic policy, has fixed its currency exchange to Saudi Arabia Riyals (SAR) 3.75 to USD 1.00 since 1986 (Al-Hamidy 2013). This paper aims at Highlighting the risks of devaluation of the dollar on the Saudi economy There are seven sections in the paper after the introduction. In sections two The changing price of gold and oil in term of USD…; section three The Impacts of fixed exchange rate on the Saudi Economy …;The rationale and implication for the fixed rate, Policy measures to overcome the risk caused by the depreciation of USD…Possible Policy Options in the Short…, and in the last section Concluding Remarks…

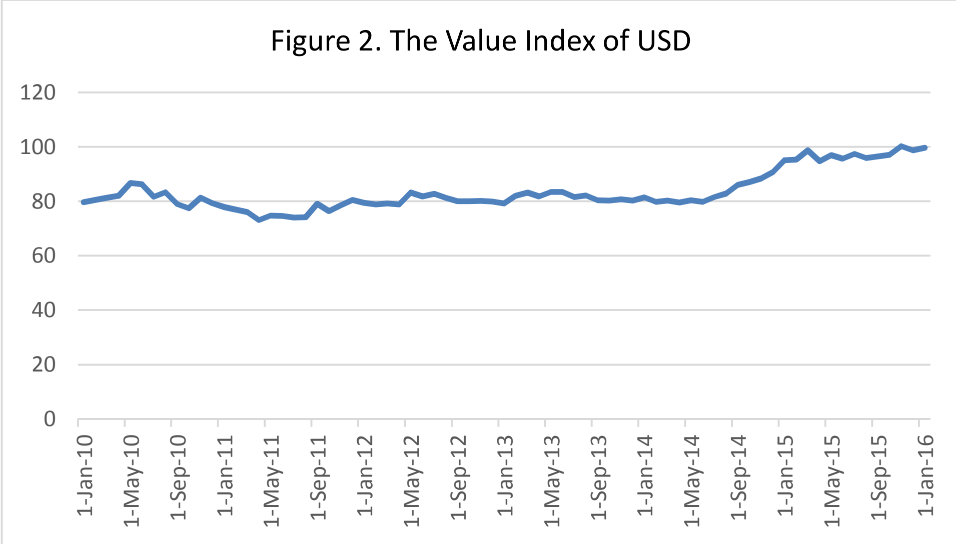
2. The changing price of gold and oil in term of USD

In order to understand the behavior of dollar in international currency markets, it is necessary to not only look at its behavior separately. Comparison to other stable currencies is needed. Moreover, the behavior of commodities such as gold and oil will also be analyzed.



Source: Calculated by the author according to the "Gold Price".

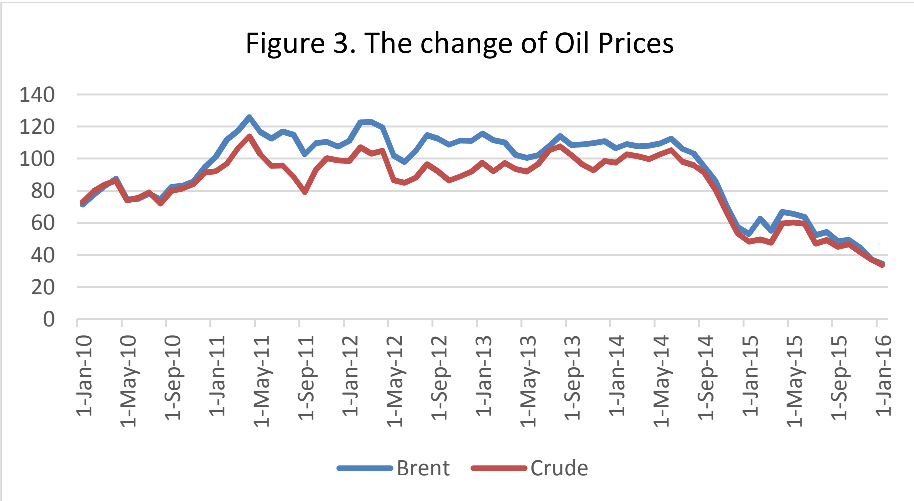
Gold has been behaving as an alternative investment for foreign exchange over the past 5 years. The Figure 1 demonstrates that during the past 5 years gold has been behaving as a volatile commodity with highest values in July 2011. The Figure 2 below visually demonstrates the value of US Dollar Index, which in essence behaves in a less volatile manner, but normally opposite to the price of gold.



Source: Calculated by the author according to "US Dollar Index".

Due to this strikingly differing behavior, gold has been used in hedging strategies against US dollar depreciation (Reboredo). More specifically, it provides diversification benefits and simultaneously reduces downside risk (Reboredo). Baur and McDermott study this claim further and establish that gold does act as a strong form of safe haven for investors concerned with the American dollar. According to Baur and McDermott, this commodity acts as a stabilization mechanism for the financial coordination by smoothening losses in case of negative market shocks

What is about the oil prices? Both Brent and Crude oil have been essentially behaving in the same manner of the gold with slight variation. In 2014, the price of oil has plunged historically, which has affected Saudi economy – the world leader in oil production. The Figure 3 below demonstrates the latest changes in the prices of oil in financial markets.



Sources: Calculated by the author according to "Crude Oil Historical Prices" and "Brent Oil Price".

Potential issues on the long-run SAR fixation to the USD have been exacerbated by the significant drops in the per barrel prices of oil from a high of $97.26 in June 2014 to $ 40.74 in March 2015 (McMahon 2015), oil being the solitary product that brings enormous wealth to Saudi Arabia. A significantly weak-performing USD, apart from other issues, can cause reductions of oil import bills, which, in turn, can lead to oil price increases as suppliers strive to enhance profits from reduced export volumes. Hence, the scenarios of the falling dollar and the falling prices of oil in USD depict a compelling complex situation that defines the central problem this paper seeks to address: What can Saudi Arabia do to address any adverse impacts of the falling US Dollar on its economy?

In light of the central problem, the paper aim at: (1) to assess the context, rationale, and significance on Saudi economy of the policy of pegging the SAR to the USD; (2) to determine the economic implications of a declining USD on Saudi Arabia in light of the fixation of the SAR to the USD; (3) formulating and recommend relevant measures addressing existing or potential issues and enabling the sustainable growth and stability of the

Saudi Arabian economy.

The paper will respond to the following research questions posed by the definition of the central problem: (1) Has the Saudi economy benefitted from the fixation of the SAR to the USD? (2) What is the rationale for the fixation of the SAR to the USD for over a long period of time? (3) What are the implications of a falling USD in the overall economic position of Saudi Arabia? (4) What measures should Saudi Arabia adopt to address any critical issues and risks associated with the fixation of the SAR to the USD and the falling trend of the USD in value?

3. The Impacts of fixed exchange rate on the Saudi Economy

Based on the recent IMF (2015) paper, Saudi Arabia is an economy that has shown strong increased government development spending in significant dimension, and stimulated private sector activity. Over a one-year period, however, oil prices have significantly dropped by around 50%, accentuating the key importance of structural reforms that transition growth focus from the public to the private sector. With the oil price slump, the IMF made the following forecasts for Saudi Arabia in 20--?:

(1) GDP growth of 2.8% in 2015, 2.4% in 2016 as major government spending slides down, and 3% in the medium term –. These numbers are explained by the fact that the Saudi economy is already well developed and thus the low but constant rate of growth will remain. Inflation will be unlikely to hit any time soon -.
(2) Due to the substantial decrease in oil price, exports and fiscal revenues will be lower -. Therefore, Saudi Arabia may reconsider its fiscal system and start to charge higher taxes.
(3) In 2015, fiscal deficit will be equivalent to 19.5% of GDP and will decline in 2016 but remain high across the medium term –. These high numbers are explained by the fact that many projects and investments have been planned for the next several years. However, due to the extremely low debt of the government, deficit is not posing any threat -.
(4) Inflation rate is likely to be contained. However, it seems that IMF's predictions may have been too conservative, because at the beginning of 2016 the inflation rate in Saudi Arabia has grown substantially, which many be a delayed reaction to the oil price crisis (Saudi Arabian Monetary Agency).
(5) Current account surplus will transform into deficit by 2015, and return to surplus within 2016-2020 . This trend is explained by recent slowing deposit incomes to private entities and banks. However, IMF still believes that the banking system of Saudi Arabia is strong enough to withstand oil crisis as well as slow growth.
(6) Erosion of fiscal buffers that have been built over the last decade will occur. Persistent expenditures and plummeting oil prices will contribute to this negative trend . More structural reforms and an increase in taxes are needed.
(7) Intensified fiscal consolidation will be well supported by a more vigorous fiscal mechanism . Spending should be adjusted with the help of budgeting. Moreover, income should flow into the government from other sources than tax revenues. The peg rate to the dollar may be reviewed in relation to other neighboring countries in order to strengthen fiscal consolidation -.
(8) Renewed economic diversification that reduces reliance on oil as a source of revenues is needed. This decision will also be beneficial for the underemployment of nationals, which is currently a problem in Saudi Arabia . Private sector will have to be incentivized and infrastructure will have to be developed in order to increase employment in sectors other than nontradable production .
(9) Increased employment of Saudi nationals in the private sector will also reduce unemployment. The state plans to invest in training and education and motivate more women to seek employment .

Based on the above points, the researcher should be skeptical of these positive and ambitious developments. Inflation rate has already proven to increase more than expected. Whereas increasing inflation is a positive factor for export prices, it still creates fear and negative expectations among citizens discouraging them from investment (Hellerstein). As a result, the economy is likely to suffer as public spends all of its money on consumption.

Another dispositive highlight of the IMF paper relates to the consensus that the fixation of the SAR to the USD remains an appropriate and vital economic measure to continue monitoring. While the IMF paper may be reflective of the current economic developments and plans in Saudi Arabia, it did not indicate, however, the impact of substantially depreciated USD on the Saudi economy, a scenario that needs to be evaluated and addressed. Overall, except for the reported erosion of the fiscal buffers, the IMF's assessment represented a manageable Saudi Arabian economic situation, alluding that the SAR-USD peg represents a correct thing to pursue and depend on.

4.The rationale and implication for the fixed rate

The Saudi Arabia Monetary Agency (SAMA 2015), in its 51st Annual Report, published extensive update about the Saudi Arabian economy based on 2014 fiscal operations. This paper illustrated the state of the world and Saudi economy, and included cogent analyses of situations in money and banking, cost of living, consumer prices, capital market, external sector, national income account, public finance, petroleum and mineral resources, and financial management. The SAMA paper, however, except for the mention of a fixed exchange regime with the USD, was silent about the implications or impact of any major appreciation or decline of the USD on the Saudi economy.

The World Bank (2015) had discussed the impact of oil price decline, more particularly on paramount macroeconomic, financial, and policy implications. The World Bank averred that if the decline is sustained, it could support growth activity, and ease up inflationary and external pressure as well as relieve fiscal burden on oil-importing countries. For oil-exporting countries, revenue generation will slow down, stunting economic development activities and international trade, apart from potentially alienating foreign investors in oil-exporting economies.

On the other hand, from a brighter side, the whole situation can be an opportunity for oil-reliant economies to strategically diversify to non-oil industrial initiatives. Although the World Bank did not discuss the aftermath of a decline in the USD, it, however, propounded that appreciation of the USD has potential negative effect on the price of oil. Countries adversely impacted by the deterioration of their national currencies due to appreciation of the USD, will purposely regulate oil imports, thus reducing aggregate oil demand and undermining the revenue ramp up of oil exporters like Saudi Arabia. In light of the suggestive World Bank manifestation, if the reverse situation of a USD decline is instead sustained, price stability and increased demand gains for oil may be expected to develop based on past similar events (Robinson and Morse 2007). It is notable, though, like the IMF and the SAMA papers, the World Bank did not specifically discuss or make any clear attribution on the possible impact of the declining USD on the Saudi economy. As it appears, the current oil price slump dispels the expectation of price and demand hike from the decline of the USD – which complex situation spells an add-on rationale for this study.

In the midst of scant information from major actionable institutions about the relationship of the USD decline and the economic health of Saudi Arabia, Robinson (2015) presented a fairly comprehensive treatise on the long-run link of the USD with the SAR, a representation that provided a historical account and analysis of the global hegemony of the USD. The Robinson research work included discussion about:

(1) The 1944 Bretton Woods Conference, where 44 nations agreed to install the USD as the global reserve currency.

(2) The rationale of Bretton Woods Conference participants for accepting the USD as the global reserve currency – which involved the fast and certain international convertibility of the USD into gold at a fixed rate of $35.00 per ounce of gold, and created immense global demand for the USD.

(3) The 1971 US unilateral repudiation of the Bretton Woods arrangement, ending the gold convertibility of the USD.

(4) The 1973 petrodollar arrangement between the US and Saudi Arabia which in essence provided: US oil imports from Saudi Arabia would be USD-denominated and every other country buying oil from Saudi Arabia would first have to convert their national currency to the USD. This grand deal again created massive global demand for the USD and sustained the primacy of the USD, while, in return, obligating the US to provide military assistance and defense to Saudi Arabia (Robinson 2015; Cammarosano 2013).

While the work of Robinson was a highly critical representation that exposed the grand political, economic, and military context of the US proposition, Robinson nonetheless presented a new balancing perspective on the USD-SAR currency fixation. Robinson succeeded in describing what could happen to USD-denominated economies, like Saudi Arabia, should the USD fall over an extended period, or should the petrodollar system collapse.

5. Policy measures to overcome the risk caused by the depreciation of USD

Al-Darwish, Ahmed, Naif Alghaith, Alberto Behar et al. (2015) argued that the currency exchange fixation has served Saudi Arabia significantly and has provided appreciable credibility to the country's monetary framework and stability to trade, income flows, and financial assets. The authors, nonetheless, stated the currency peg limits Saudi Arabia's flexibility with regard to monetary policy, as it remains linked with US Federal Reserve interest rates.

Al-AbdulKarim (2004), in a comprehensive analysis of the macroeconomic fluctuations characterizing oil-based economies (i.e. Saudi Arabia), introduced that international financial shocks (i.e. US interest rate changes and USD-based oil price variations) serve as major sources of fluctuations for the Saudi economy. Al-AbdulKarim attributed the SAR-USD currency exchange freeze as contributory to Saudi Arabia's acquired vulnerability to major international shocks. The author added that while the fixed exchange currency regime has helped achieve domestic price stabilization, the currency fixation policy, though, has made Saudi Arabia susceptible to global economic disturbances. By virtue of the currency peg, Al-AbdulKarim argued that the Saudi economy stays dependent on prevailing US interest rates through financial capital access links, with the impact of US interest rates being absorbed more quickly by the Saudi economy than the effect of export expansion. This paper maintains that any skeptical view on the potential impact of the USD decline on the Saudi economy is premature. The USD has gone through similar plunges in the past, and in all occasions, the USD decisively rebounded to positions of sustainable strength. Hence, it is not unlikely that Saudi Arabia can replicate the US feat.

In fact, even the prospect of inflation, which is largely a function of food and rent price shocks in Saudi Arabia, remains effectively subdued despite the USD drops because food prices react on global agricultural demand, while the rental rates respond to inflow of foreign workers in Saudi Arabia (Robinson and Morse 2007).

To insulate the Saudi economy against critical risks associated with external pressures, including the continued drops of the USD, Al-Darwish et al. (2015) emphasized the importance of fiscal and monetary reforms, as well as structural adjustments, including the rationalization of public spending in relation to incoming streams of revenues. With continued negative oil price shocks, the authors stressed it is vital for revenue generation and fiscal spending to behave in a manner that builds surpluses for strategic considerations. Incrementally, public investment needs to be enhanced for higher efficiency to best support the impetus for economic diversification of Saudi Arabia. The Al-Darwish et al. (2015) treatise provides insights as to how the dollar and oil price declines can be effectively managed.

In the appraisal of relevant literatures, the IMF (2015), Robinson (2015), Al-Darwish et al (2015), and Al-AbdulKarim (2004) representations provided superior inputs to the analysis.

6. Possible Policy Options in the Short and Long run

Options and proposals to reduce the impact of the falling dollar on the currency: The reality now and the experiences of many countries indicate that link the SAR to the dollar (3.75) is not an acceptable or logical option. This option is supposed to be subject to periodic review in the changing reasons for linking the SAR to dollar and the dollar lost more than 46 % of its value due to the changes in the global economy as well as a great disparity between the situation of the American and the Saudi economies. Today there are several options:

First of all, in the short-run, it is possible for the situation to remain as it is with increasing risks. The dollar value does not contradict U.S. policy as the state is achieving its goal of increasing competitiveness of U.S. exports around the world, which is reflected in the Saudi economy's preference for US imports during the times of SAR appreciation. However, in accordance with Al-AbdulKarim, the Saudi economy is subject to global economic shocks because of its pegged rate to dollar, which means that during the times of SAR depreciation the state pays more for goods denominated in the US currency.

Secondly, in the middle term, it is possible to unlink SAR from the US dollar and link it to a basket of major currencies of the world. This option would mean that SAR would be worth 46% lower than its value against a basket of major currencies unless it is repriced before the disengagement. According to Al-Darwish et al., SAR gets its financial stability from the link to the dollar, which means that breaking the peg could also have negative consequences for the currency.

Thirdly, in the long run, it will be possible to improve the value of the SAR against the dollar and return quotation to the number that achieves the highest benefit for the economy. Any change in the exchange rate against the dollar would not be as hurtful to the economy as long as it is less volatile than in the few past years. Sound fiscal and private state reforms would allow improving the value of SAR, especially considering the fact that inflation is explained by global, not just American, trends (Robinson and Morse).

All things considered, the first option seems to be the most appropriate solution to the initial research question. Moreover, this is an exact solution adopted by the government – keeping the peg rate and using a strong financial framework to support it (Al Omran and Lohade). As Amadeo argues, dollar has its ups and downs, and its value is usually reflected in the prices for other currencies throughout the world. This statement means that recent dollar depreciation is an acceptable occurrence that is likely to reverse soon.

Even though it is advisable for Saudi Arabia to adjust its peg rate because it has not been revised in 30 years (Al-Hamidy), the state stays loyal to its currency value. However, growing speculation of exchange rate adjustments has already affected the futures market (Sharif and Nereim). While the financial and economic indicators in the country are stable, growing speculation is the only factor that should be addressed by the state immediately.

7. Concluding Remarks

The paper posits the fundamental idea that Saudi Arabia cannot marginalize the USD without careful and indicative study. Despite the USD's recent downtrend in comparative value, the USD remains a global reference currency and has deep roots in a petrodollar system (Robinson 2015) that involves overarching economic and political context quite critical to the economic growth and sustainability of Saudi Arabia. The recommendations mitigating the impact of the USD fall on the Saudi economy illuminates added usefulness of the paper as a reference.

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