Currency pegged to a foreign currency- GCC and Europe models

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Abstract

The currency exchange rate is very important in trading operations between countries. The working paper aims to present what impact of pegging currency in US dollar or in Euro have on economic and social development for a number of countries from GCC and Europe areas, within last ten years. This working paper is aimed to be unique because will study the effect of pegging the exchange rate to US dollar during the period 2006 – 2016 and will present also those cases in which currencies are pegged to Euro. The research will also be focused on the effect of these fixed exchange rates on the economic and social development level. The research developed revealed that there are two models: GCC model – currency pegged in US dollar; and European model – currency pegged in Euro. The analysis was conducted based on official data and conducted to the result that is a very strong connection between currency pegged into well trade foreign currency, keeping the exchange rate fixed, and the level of economic growth, inflation and unemployment rate.

1. Introduction

This working paper aims to analyze the impact of pegging the currency to US dollar or Euro have on a country's economic development, and if the pegging the exchange rate is a good strategy for those countries which adopted it. The research started with the literature review, analyzed the data and concluded that almost all the literature was about pegging the currency in to US dollar, in the last years. Very few economists written about pegging the currency into Euro, or about unique currency. That was the reason that this research focused more on impact of this fixed exchange rate agreements on economic and social development level, in the last 10 years. Currency pegs allow importers and exporters to know exactly what kind of exchange rate they can expect for their transactions, simplifying trade. This, in turn, helps to curb inflation and temper interest rates, thus allowing for increased trade, will increase the trade and the investment, and in the same time will lead to a reduction in the level of unemployment rate, which means less governmental expenses on social side, and much more revenue to the state budget on the other side.

2. Literature review

Several studies have been conducted to analyze and study the effect of exchange rate pegged to one international currency, with fix rate in gold or used in many countries as an official currency – US dollar or Euro. Most of these studies refer them analyze to exchange rates pegged to US dollar (Kimberly A., 2016) and their implications in those countries, the majority from GCC, MENA area and some countries from Latin America. Majority countries from Africa have their exchange rates pegged to Euro.

The majority of literature presented the meaning of the pegging the local currency into one international currency without a concrete analyze related to the effect on a country economic development, specified only the crucial role of central bank in maintaining the exchange rate the same over the years. Some studies (Ala El Alami, 2013) examined the advantages which countries have because of peg currency, as there is an economic crisis in one country with which the currency has been fixed there could impact on other countries also because of this, and, presented that the transactions which happen with foreign currencies are having an important role in the foreign trade operations which are reflected in trade, international investments, migration and accumulation of

capital (Yevchenko, 2010). Some authors analyzed the resistance of the pegged exchange rates over the time (Coudert, V., Couharde, C., Mignon, M., 2012) and present the effect and the reasons for ruptures of exchange rate peg from a new point – the fluctuations in the anchor currency.
Based on what it could be found out, such analyze related to the effect of pegging the currency to US dollar or euro was not conducted for the last years and it does not make any connection to macroeconomic indicators considered in evaluation the level of development, both from the economic and social point of view.

3. Research methodology

The research objective is to present that currency pegging with US dollar or Euro (by case) have a crucial impact on the economic development of those countries which choose this monetary strategy. This working paper is aimed to be unique because will study the effect of pegging the exchange rate toUS dollar during the period 2006 – 2016 and will present also those cases in which currencies are pegged to Euro. The research will also be focused on the effect of these fixed exchange rates on the economic and social development level.

Based on the research purpose, data would be collected from the public authorities (official website of central bank, ministry of finance, ministry of economics), international relevant financial organizations database (World Bank, International Monetary Fund, European Commission, European Central Bank) and other public database site which is also using data from public institutions presented above.

Research methodology consists in analyzing critical macroeconomic country indicators which are directly correlated to the exchange rate, and in the same time representative for economic and social development framework. These indicators are related to economic growth (GDP), GDP per capita, revenue, total investment, and foreign direct investment, the current account balance of payment, unemployment rate, and inflation. The qualitative research is the focus in analyzing the data in to demonstrate that currency pegged into one international most traded currency have a crucial impact on each country economic level of development.

4. Data analysis and results

From the very beginning, the research chooses two types of countries, based on the currency in which their national currency is pegged, and based also on geographical location and on the similarity of challenges that they are facing (table no.1). In this respect, we may find 2 models: GGC Model and European Model. For a better analyze we took the data translated into US dollar, for all of the countries.

Table no.1: Exchange rate, during the period 2006 – 2016 (unites of national currency for 1 Euro, or for 1 US dollar, depend on of the countries)

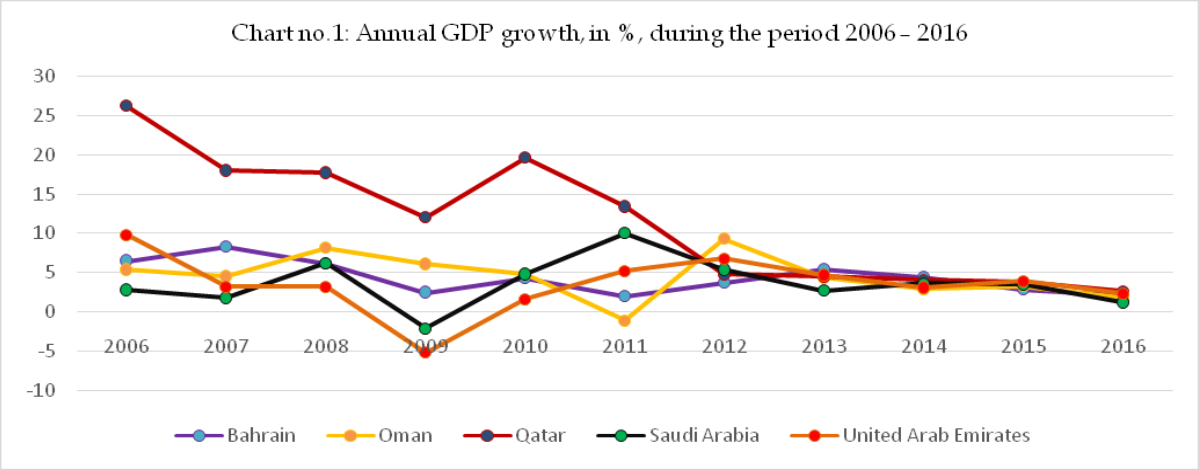
	Country	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Pegged in Euro	Bosnia and Hezegovina	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558
	Bulgaria	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558
	Denmark	7.4604	7.4604	7.4604	7.4604	7.4604	7.4604	7.4604	7.4604	7.4604	7.4604	7.4604
	Romania	3.4804	3.3373	3.6827	4.2373	4.2099	4.2379	4.4560	4.4190	4.4446	4.4450	4.4908
Pegged in US dollar	Bahrain	0.3670	0.3670	0.3670	0.3670	0.3670	0.3670	0.3670	0.3670	0.3670	0.3670	0.3670
	Oman	0.3845	0.3845	0.3845	0.3845	0.3845	0.3845	0.3845	0.3845	0.3845	0.3845	0.3845
	Qatar	3.6400	3.6400	3.6400	3.6400	3.6400	3.6400	3.6400	3.6400	3.6400	3.6400	3.6400
	Saudi Arabia	3.7500	3.7500	3.7500	3.7500	3.7500	3.7500	3.7500	3.7500	3.7500	3.7500	3.7500
	United Arab Emirates	3.6725	3.6725	3.6725	3.6725	3.6725	3.6725	3.6725	3.6725	3.6725	3.6725	3.6725

Note: Source of data http://www.investmentfrontier.com/2013/02/19/investors-list-countries-with-fixed-currency-exchange-rates/, last updated February 2016, and, for Romania, source is Central Bank website http://www.bnr.ro/Cursul-de-schimb-3544.aspx

4.1.1 GCC model – currency pegged to US dollar

GGC countries face almost the same economic challenge, their economies relayed on oil and gas, so from this perspective, any change into US dollar will affect the price of oil and gas. The research noticed that the most important trade partners(https://www.cia.gov/library/publications/the-world-factbook/) are China, USA, UK, Japan, Germany for imports, and China, Japan, India, and UAE for export. For this reason, the main transactions are in US dollars.

From economic growth, research revealed that, during the financial crisis, all these countries experienced a slowdown in GDP, during the year 2009 (Chart no.1). However, based on their specific economic characteristics (producing and exporting oil) and their Islamic banking and financial system, all the country succeeds to recover their slowdown very quickly in 2010 and 2011. Refer to the difference between Islamic banking and conventional banking, it would be necessary to specify that, in this system, the transactions between banks and clients work as a contract of buy-sale (e.g. *Murabaha* is a loan but treated as a commercial transaction). Since it is just a simple commercial transaction, it affects only the seller and the buyer, without the complicated and unforeseen repercussions on the social level. From all these five GGC countries taken into consideration, Saudi Arabia and the United Arab Emiratesremain the most developed, from an economic point of view (Chart no.2), Qatar is the 3rd one.



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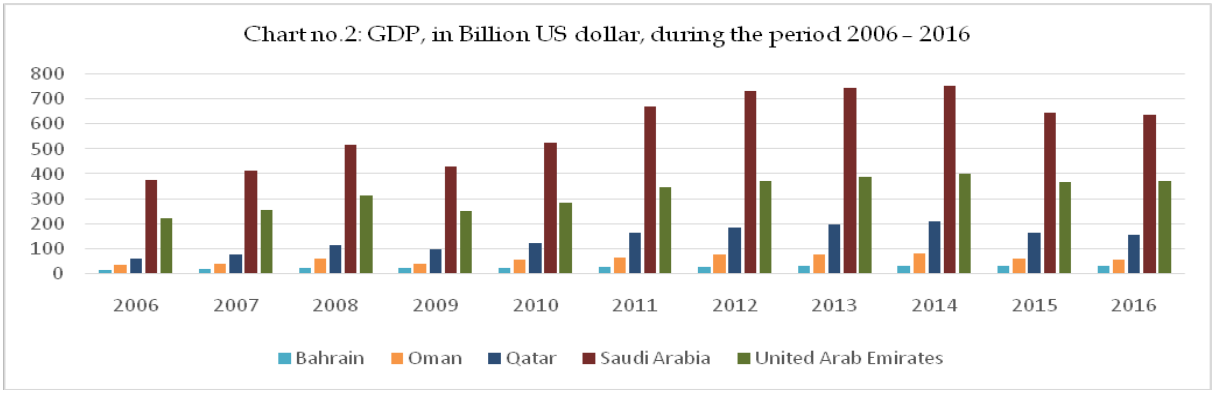

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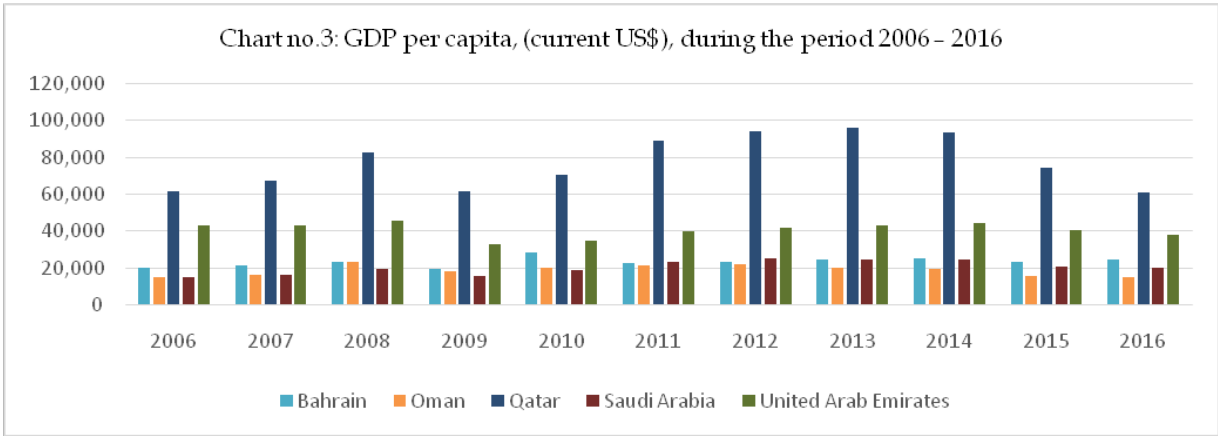
From GDP per capita perspective, it can be observed that the first three countries are Saudi Arabia, United Arab Emirates and Bahrain (which is a very small country – only 760 sq km). All these increases in GDP and GDP per capita were due largely from pegging their national currency into US dollar, facilitating smooth trade transactions without losses arising from the economic translation (Chart no.3).



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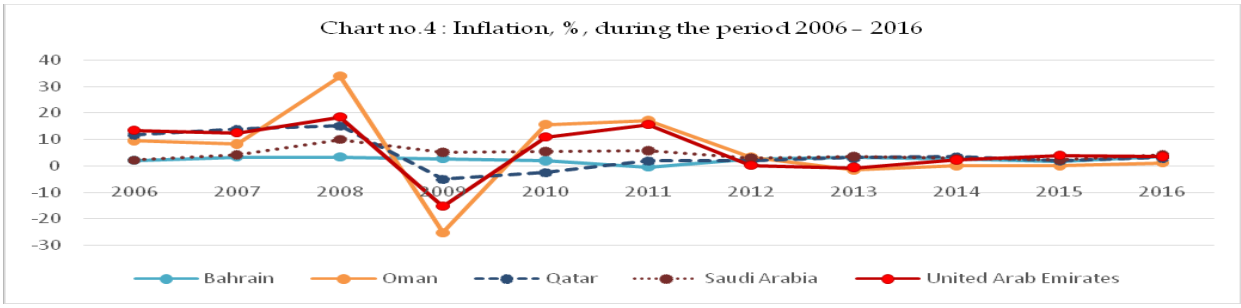

Source: based on data published on http://data.worldbank.org/country;https://www.cia.gov/library/publications/the-world-factbook/;http://www.theglobaleconomy.com;http://world.bymap.org/InflationRates.html

There is a is a close connection between inflation and keeping national currency pegged to US dollar (or other well trade currency). A common element with all fixed or pegged foreign exchange regimes is the need to maintain the fixed exchange rate. This requires large amounts of reserves as the country's government or central bank is constantly buying or selling the domestic currency. The problem with huge currency reserves is that the massive amount of funds or capital that is being created can create unwanted economic side effects – namely higher inflation[1]. During the financial crisis, all these countries faced a higher inflation because the dollar was appreciated. When a financial crisis occurred all over the world, all the countries sold stocks and liquid assets to raise cash. But the cash they want to raise was usually dollars. When a crisis hit the USA, everyone started selling assets for dollars. This demand for cash appreciated dollar (McCauley, R.N., McGuire P.,2009). In all GCC countries analyzed (Chart no.4), it was recorded a higher inflation variation, during and after the financial crises, till the US dollar become stable on the financial international market. Higher inflation comes in the same packet with prices increase.

There is also a strong correlation between unemployment rate and a currency pegged to US dollar. As the research presented before, pegging the national currency into US dollar helped the foreign trade, increase the confidence and the investment. Increasing the investment and the activity it led to an increase in jobs, thus the unemployment rate is below 6% (Chart no.5). The study revealed a peculiarity of the GCC member states in terms of population component and unemployment rate. Prom the composition of population, all countries have huge percentage of immigration out of total number of population: Bahrein (50% immigrants); Oman (40% immigrants); Qatar (60% immigrants); Saudi Arabia (30% immigrants) and United Arab Emirates (85% immigrants) – based on https://www.cia.gov/library/publications/the-world-factbook/. The study found that the unemployed people are only among local people or family members who accompany immigrants, and thus because all immigrants are coming with a work contract, according to the labor law. Also, countries in which the percentage of immigrants is higher than 50%, register the lower level of unemployment.

Source: compilation drawn based on data provided by http://www.theglobaleconomy.com

4.1.2 European model – currency pegged into Euro

European countries face almost the same economic challenge, their economies relayed on oil and gas, so from this perspective, any change into US dollar will affect the price of oil and gas. The research noticed that the most important trade partners

[1]http://www.investopedia.com

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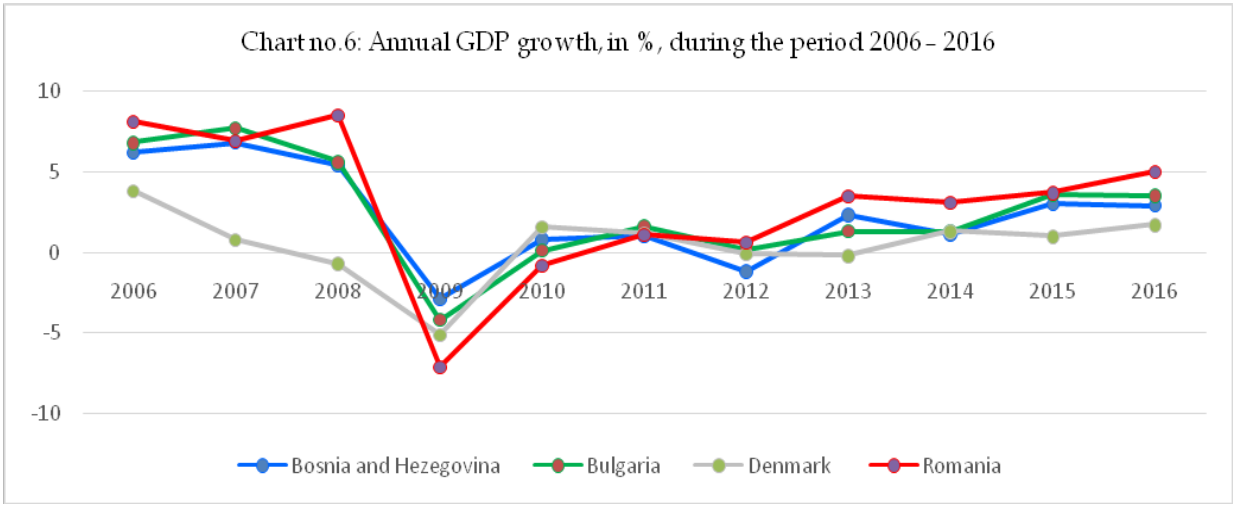

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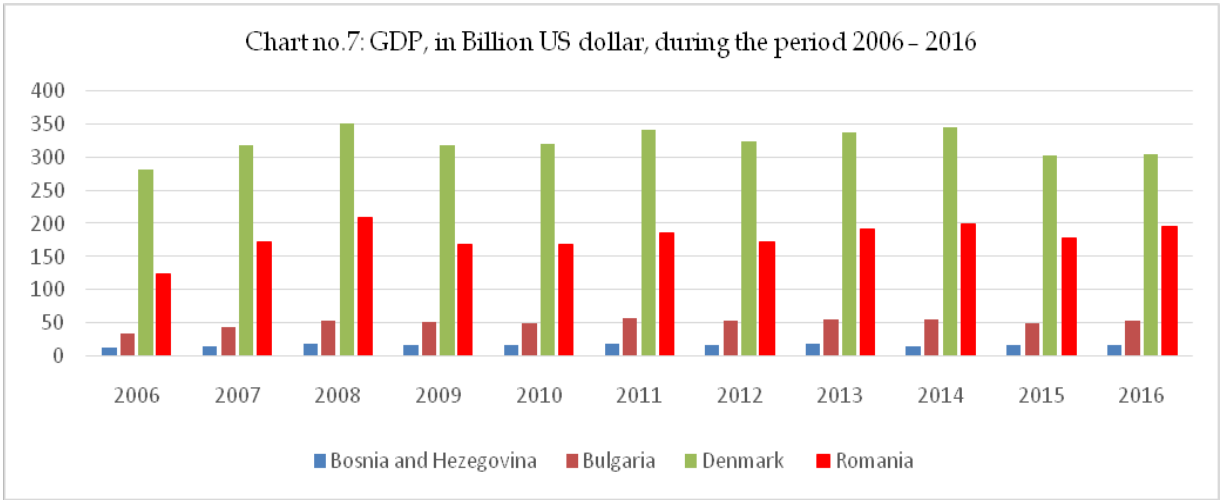
From economic growth, research revealed that, during the financial crisis, all these countries experienced a severe slowdown in GDP, during the years 2009 - 2010 (Chart no.6). The economic growth starts to recover since 2011, but more slowly than GCC countries. Economic growth and social situation of these countries were heavily affected and this was because also of banking and financial system, the conventional type. In these countries, the vast majority (we can say: all) transactions between financial institutions, banks, and individuals or companies are charged with an interest. For the majority of banks and financial institutions, these interests are linked to the central bank's benchmark interest rate or benchmark interest on financial markets. Any changes in the financial markets or coming from the Central Bank has as consequence a change in the interest rates level applied to these transactions. Given that, the income does not change, and the interest increased (which actually happened), significantly increases the debt associated with that transaction. The same thing happens if transactions are conducted in a currency other than the national one, and the exchange rate is not fixed. any variation produces deficits and damage individuals and companies that have turned to banking and financial services. From all these four European countries taken into consideration, Denmark and Romania remain the most developed, from an economic point of view (Chart no.7).Even if Romania do not peg its currency into Euro, its proves that this country tried to maintain its currency stable faced Euro and US dollar. The exchange rate between Romanian currency and Euro was modified with 5.89% since 2009 (when the financial crisis was felt) untilpresent time (table no.1).



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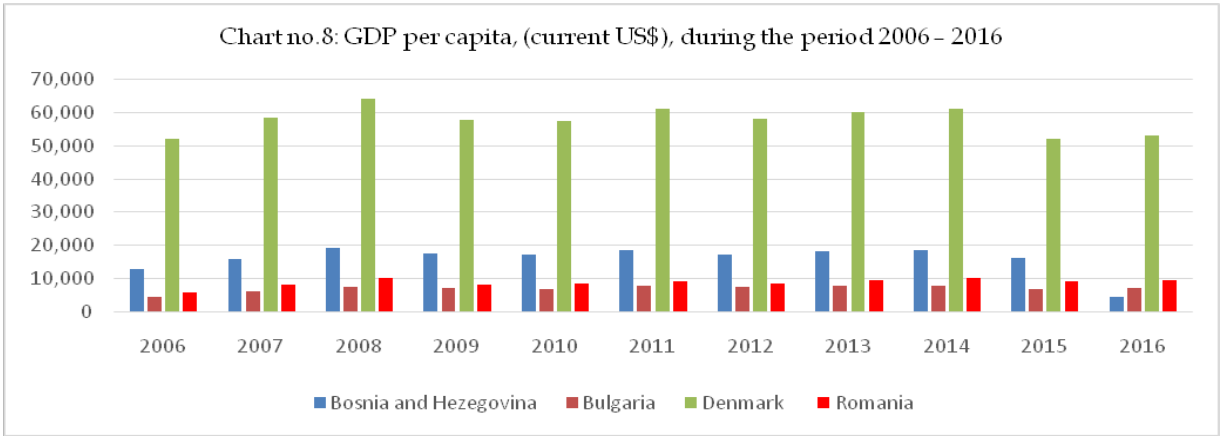
From GDP per capita perspective (Chart no.8), it can be observed that indeed Denmark recorded the highest values, followed by Romania and Bulgaria.



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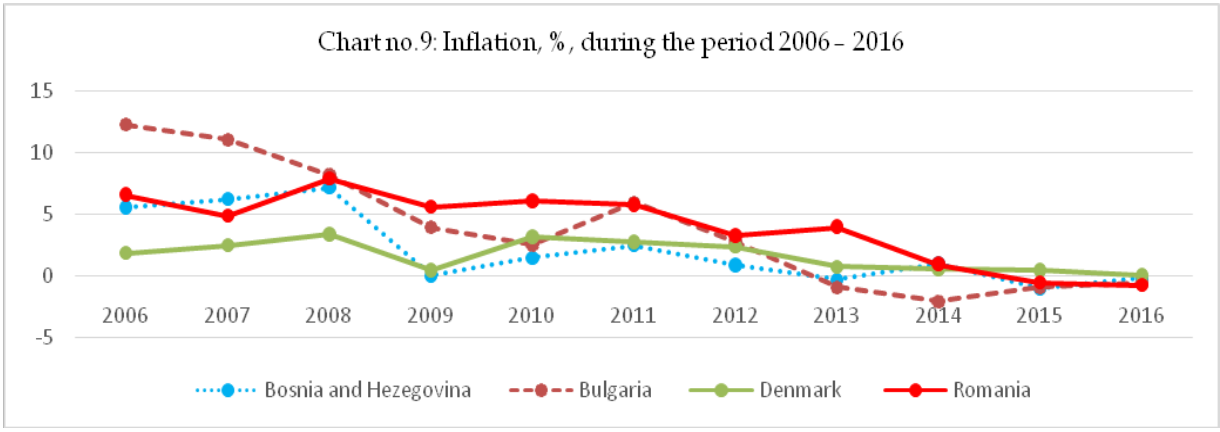
___As in all countries, there is a is a close connection between inflation and keeping national currency pegged to Euro, in this case in order to keep pegged foreign exchange regimes is the need to maintain the fixed exchange rate. This requires large amounts of reserves as the country's government or central bank is constantly buying or selling the domestic currency. As we said before, this action has an economic side effects –higher inflation. During the financial crisis, all these countries faced a higher inflation because the dollar was appreciated. When a financial crisis occurred all over the world, all the countries sold stocks and liquid assets to raise cash. But the cash they want to raise was usually dollars. When a crisis hit the USA, everyone started selling assets for dollars. This demand for cash appreciated dollar (McCauley, R.N., McGuire P.,2009).



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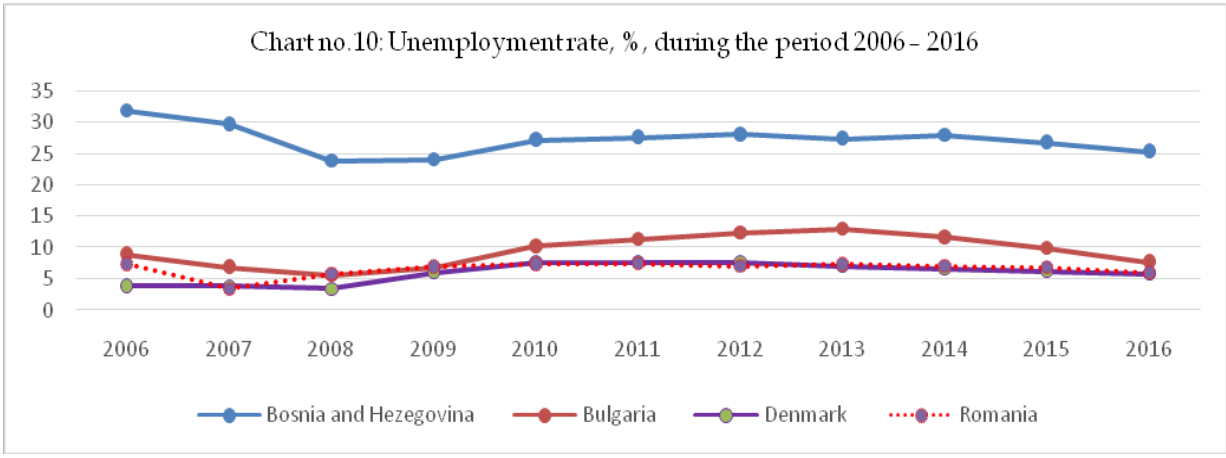
The financial crisis has triggered sharp and unexpected currency movements, with the US dollar appreciating significantly against virtually all currencies. A repatriation of capital to the USA by USA investors, a sight-to-safety phenomenon by the US and non-US investors, an increased need for US dollar liquidity and an unwinding of carrying trade positions may all have played a role in the sharp appreciation trend of the US dollar (Fratzsher M.,2009). Countries which conducted foreign trade in Europe and USA were exposed to US dollar exchange rate movement. European countries (with or without national currency as Euro) which also had foreign trade with the USA were exposed to US dollar exchange rate movement. During the entire financial crisis, the exchange rate of Euro against many currencies including US dollar has remained extremely volatile (Ehrmann M., Osbat C., Strasky J., 2013).



Source: compilation drawn based on data provided by http://www.theglobaleconomy.com

In all four European countries analyzed (Chart no.9), it was recorded a variation of inflation, during and after the financial crises, till the US dollar become stable on the financial international market. During the last 3-4 years, these countries registered a level of inflation very close zero or even disinflation.

The research noticed that (Charts no.4 and no.9), from the inflation point of view and exchange rate (pegged to US dollar or Euro) the currency Euro is more stable on financial markets than US dollar. this stability of Euro, let the countries which reflect their economic activities in Euro to register a low level of inflation and a higher level of annual economic growth (Charts no.1 and no.6).

Peg currency agreement has a strong correlation with the unemployment rate even in those European countries which pegged their national currency into Euro. The research revealed that the European member countries (Bulgaria, Denmark, and Romania) registered an unemployment rate below 7.7% (which is below EU average unemployment rate: 8.5%). Thus as an effect of increasing the percentage of investment (pegging the currency into euro increase the investors' confidence) and new jobs opportunities, together with an active policy of employment.

Bosnia and Herzegovina still faced problems with the unemployment rate, particularly among ethnic minorities. However, since September 2016, European Union agreed with the Bosnia and Herzegovina's application to become a member of European Union. Nevertheless, the country needs to improve and continue the economic and social reforms.

5. Conclusion

During the analysis, the working paper divided currency pegged regime into two models: GCC model – currency pegged to US Dollar; and, European model – currency pegged to Euro. Since the beginning of this research, it was observed that it is dealing with two different types of economies and with different resources. GCC countries rely heavily on oil and gas production, trade, and services, tourism; the others, European countries rely on industry, services equally, and also in a small part of agriculture. For all that, the strategy of pegging the domestic currency with one foreign currency which is highly used in international transactions is to establish a fix exchange rate. The research has shown that a fixed exchange rate leads to a strong confidence of investors, increase the number of investments which conduct to economic growth and reduce the unemployment rate. A fix exchange rate creates a stable trading environment and will reduce or eliminate many risks as related to inflation; country; interest rate.

As a particularity, GCC countries pegged their currency into to the US dollar also for the stability - the oil-rich nations need the United States as a major trading partner for oil (Zucchi K.,2016).

For GGC countries which have the majority of their transactions in US dollar and the source of revenue are also comes from the US dollar, pegging their currency was, in the research opinion, a very good monetary policy. The fact that all these have a fix exchange rate compare with US dollar, and run a huge part of their international trade in US dollars made also a very good impact on the exchange rate between them, made a stable one. The GCC countries' strong orientation towards oil and gas implies that the diversification of their economies is a key challenge (Sturm M.,Strasky J,, Adolf Petra, and Peschel D.,2016). Nowadays, Bahrain and the UAE appear to be most advanced in terms of reducing their dependency on oil. This new challenges might sustain a not too old idea: one single currency in GCC area, based on the same principle as Euro. The GCC countries' economy proved that a peg exchange rate improved and help the economic growth and social stability (from unemployment and inflation perspective), and from this respect, all this achievement can be a very good start in creation a unique GCC currency, also pegged to US dollar.

For European countries, pegging their currency into Euro have a higher impact and advantage on that country's exports and trade, especially between a nation with low production costs and another country with a stronger currency. In Europe, there is a free movement of capital and labor force. Pegging the currency into Euro will help all European country economies to grow up, and it will be created a win/win situation for both countries. This strategy demonstrates that can protect the country from volatile swings in the foreign exchange rate. Romania, which is a European Union member state still did not peg its national currency to Euro, despite the fact that many transactions carried with countries from Europe. However, if Romania will decide to peg its currency it can gain trading advantages, increase in a level of wages and protect its economic interest.

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