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Kuwait kicks sand on the dollar

Kuwait recently waved goodbye and stopped pegging its currency to the U.S. dollar. Here's why Kuwait pulled out and what the weakening dollar means to your wallet.

By [Jim Jubak](#)

The U.S. dollar took a big hit last week. From Kuwait. On May 20, Kuwait stopped pegging its currency, the dinar, to the U.S. dollar.

You know your currency has become a 98-pound weakling when Kuwait can kick sand on it.

Even worse, Kuwait wasn't acting out of any animus toward the United States. The tiny kingdom wedged between Iraq and Saudi Arabia remains a U.S. ally. So the country wasn't trying to make any political point. It had simply become too expensive for Kuwait to keep the dinar linked to the dollar. I expect other countries, not tomorrow but soon, to take the same action. And that will be just one more milestone in the decline of the dollar.

You should care about that in the short run because a dollar declining in both price and prestige makes everything from imported goods to home mortgages more expensive in the United States.

In the long run, Kuwait's action is just one more piece of evidence that the world is increasingly working with an ad hoc monetary system where each country attempts to extract momentary advantage from exchange rates.

A careful decision

Here are the bare-bone facts. On May 20, Sheikh Salem Abdulaziz Al-Sabah, governor of the Central Bank of Kuwait, announced that his country would end the peg that linked the Kuwaiti dinar to the U.S. dollar. Up until that point, the central bank had managed the dinar, intervening in the currency markets as required, to keep its price within 3.5% of the price of the U.S. dollar. Going forward, the bank will use a basket of currencies to set the price of the dinar. According to the bank, the U.S. dollar is likely to make up about 75% of that new currency basket. In effect, the move reduces the country's exposure to the U.S. dollar by about 25%.

Kuwait's central bank didn't make this decision lightly. A small country -- even a small, rich country such as Kuwait -- faces a daunting task if it decides to go it alone in the global currency markets. Currency speculators have access to so much capital these days that they can easily overwhelm the efforts of a central bank like that of Kuwait and run the value of a currency massively higher or lower. Actually, that can happen to not-so-small countries, too. In 1992, currency traders drove the English pound down and out of the European Exchange Rate Mechanism, creating billions in profits for traders such as George Soros, who had shorted the pound.

By linking the dinar to the dollar, Kuwait had avoided the worst of those dangers. The dollar market is so huge and so liquid that it is harder to stampede one way or another. Pegging the dinar to the dollar gave business the confidence to trade in the dinar, since businesses wouldn't see their profits decimated by a rapid change in exchange rates. And pegging the dinar to the dollar prevented a huge rise in the value of the dinar at just the time that Kuwait, like so many oil-producing countries, was trying to diversify its economy by creating export industries based on oil. A big rise in the dinar would have made those exports uncompetitive on tough global markets.

The threat of inflation

Kuwait broke the dinar-dollar peg only when it became too painfully expensive to keep it. The steady decline of the U.S. dollar, which hit a record low against the euro in April, meant that the dinar fell gradually but steadily in price, too. That left Kuwait facing rising prices for everything it imports.

Not exactly a small problem for a country that imports almost everything. For example, only 1% of Kuwait is arable, so the country imports all its food except for fish and shrimp. Kuwait even imports much of its drinking water: 75% of the drinking water used by the population is either distilled from seawater or imported.

The decline in the dollar-pegged dinar had recently driven inflation to 4% in Kuwait, about two times the historic average.

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[Shifting off the dollar](#)

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That's not terribly high as inflation rates go, but as every central banker in the world knows, inflation gets out of control very easily. Expectations by consumers, workers and governments rapidly adjust so people get accustomed to rising prices and costs -- and include the assumption that prices will be even higher tomorrow in their thinking. Once these inflationary expectations take hold, they're hard to stomp out. That's why central bankers these days apply the brakes so heavily at the first sign of inflation.

Kuwait has only to look down the Persian Gulf to see what could happen. In neighboring Qatar, inflation climbed to a record 15% annualized rate in May. Soaring oil prices have left the country awash in cash, which has, in turn, led to huge increases in residential and commercial rents. With the

Qatari riyal pegged to the dollar, the central bank there, like the one in Kuwait, has been handicapped in its fight against inflation.

[Continued: Fallout in the U.S.](#)

But as long as the dinar was pegged to the U.S. dollar, there was very little Kuwait's central bank could do to fight inflation. For example, raising interest rates, a standard tool used by the U.S. Federal Reserve to fight inflation, was out because an increase in Kuwaiti interest rates would have sent the dinar soaring and broken the dinar-dollar peg. Breaking the peg put monetary control back in the hands of the Central Bank of Kuwait.

But the bank may have just traded one problem, inflation, for another -- currency speculation. In the weeks before Kuwait went off the peg, speculators had been buying dinar hand over fist in anticipation of the move. If the dinar soared in price, they'd make a huge profit on their currency holdings. In an effort to beat back those speculators and to prevent the dinar from the kind of rapid increase in price that is often followed by a wrenching plunge, the central bank on May 28 suspended sales of short-term central bank certificates of deposit. The country's banks use these CDs as a place to park short-term funds, and the suspension had the effect of driving short-term interest rates in Kuwait to 4.125% from 5.1875% a few days earlier.

Fallout in the U.S.

This all leaves the U.S. dollar in a very uncomfortable position. On the one hand, we are seeing a gradual move away from the dollar by the world's central banks in favor of baskets of currencies. This puts gradual downward pressure on the price of the dollar and leads to a gradual increase in U.S. inflation and U.S. interest rates, as well as a gradual decline in relative U.S. standards of living and U.S. financial market performance.

As in Kuwait, where such a move resulted in a 25% shift away from the U.S. dollar in favor of other currencies, I don't think the result is a stampede out of the U.S. dollar. The dollar balloon isn't about to burst. But we are witnessing the air gradually leak out of the currency.

I think this reflects global fundamentals. The U.S. economy is less dominant in the global economy today, with the rise of China, India and the European Union, than it was in, say, 1980. The size of the U.S. trade deficit also argues for a gradual depreciation of the dollar in order to bring global trade flows closer into balance.

On the other hand, it's clear that some countries in the world are quite happy to preserve as much of an unofficial dollar peg as they can. It's to the benefit of a country with an export driven economy like China, which uses what I'd call an unofficial, mostly-dollar-peg monetary policy, to keep their currencies pegged to the dollar. That way their own currency doesn't appreciate, and their exports retain a price advantage in the marketplace. Saudi Arabia, which has an official dollar peg, falls in that category because that country is trying to build up value-added, export industries to diversify its economy. Russia, a country with an aging industrial base that wasn't globally competitive to begin with, certainly doesn't want to see the ruble appreciate so that the country's exports become even less competitive.

The combination seems to be heading toward a jury-rigged global monetary system. This system doesn't rely on market mechanisms to adjust the relative value of currencies. Instead, individual countries opt in and out of those market mechanisms as they choose with their policy moves designed to maximize their own return from the rules of the market.

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This system as a whole relies upon a touching faith that enough countries will play by the rules of the market, so that the market will continue to function with rules that *can be* exploited as national self-interest dictates.

Interesting concept. Don't think I'll sell my position in gold stocks just yet.

New developments on past columns

["China's Olympian stock-market sprint"](#): It was a huge overreaction -- which just shows you exactly how big the speculative bubble is on China's Shanghai stock market. The Shanghai Composite Index fell 6.5% on May 30 as investors reacted to news that the Beijing government had raised the tax on stock trades. How big was the increase in what is called the stamp tax? Well, it went from 0.1% up to a whopping 0.35%. On a \$10,000 trade, that's an increase from \$10 to \$30 in taxes.

By itself the tax increase won't change a thing on the Shanghai market -- an increase of \$20 won't stop the speculators or individual Chinese who see the stock market as the best route to wealth from trading. But I'd read the tax increase as another warning from Beijing to the Shanghai market of the government's intention to act when the time is right (in my opinion, after the Beijing Olympics in August 2008). Judging from the market's drop, traders in Shanghai got the message.

Meet Jim Jubak at the Money Shows

MSN Money's Jim Jubak will be among the dozens of renowned money experts, advisers and analysts sharing their wisdom in free workshops at two upcoming Money Shows -- in San Francisco, July 26-28, and in Washington, D.C., Sept. 6-8. You'll also have a chance to network with fellow market enthusiasts, exchange investment ideas, share your experiences and enjoy the fellowship of like-minded investors. Admission is free for MSN Money readers. For complete details or to register for free admission, visit the [San Francisco Money Web site](#) or the [Washington D.C. Money Show Web site](#). Or phone 1-800-970-4355 (*be sure to mention priority code #007420*) and tell them which show you're interested in.

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