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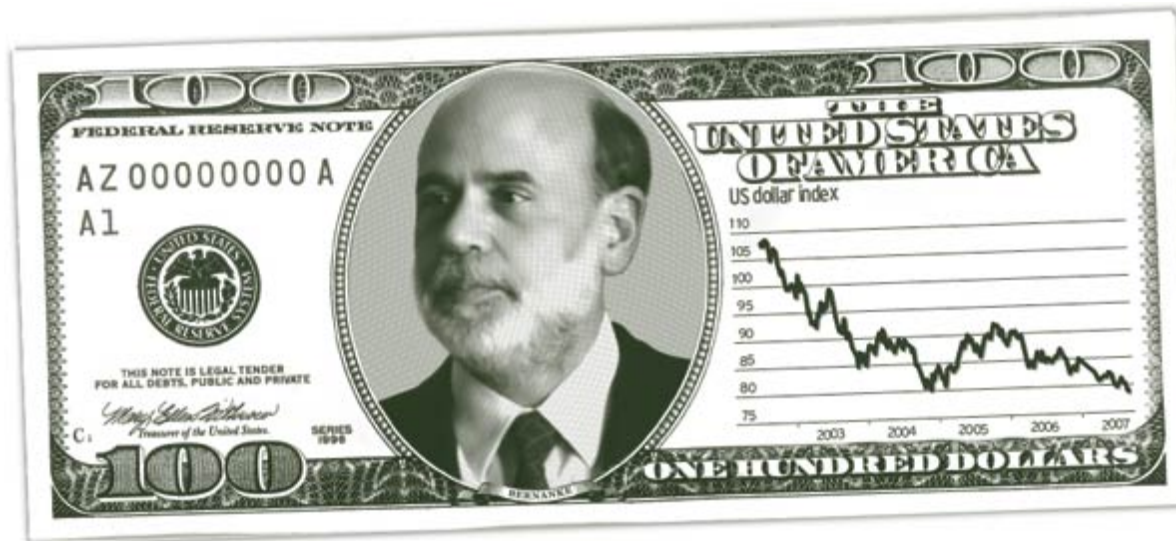
Fears of dollar collapse as Saudis take fright

By Ambrose Evans-Pritchard, International Business Editor

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Saudi Arabia has refused to cut interest rates in lockstep with the US Federal Reserve for the first time, signalling that the oil-rich Gulf kingdom is preparing to break the dollar currency peg in a move that risks setting off a stampede out of the dollar across the Middle East.

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Ben Bernanke has placed the dollar in a dangerous situation, say analysts

"This is a very dangerous situation for the dollar," said Hans Redeker, currency chief at BNP Paribas.

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"Saudi Arabia has \$800bn (£400bn) in their future generation fund, and the entire region has \$3,500bn under management. They face an inflationary threat and do not want to import an interest rate policy set for the recessionary conditions in the United States," he said.

The Saudi central bank said today that it would take "appropriate measures" to halt huge capital inflows into the country, but analysts say this policy is unsustainable and will inevitably lead to the collapse of the dollar peg.

As a close ally of the US, Riyadh has so far tried to stick to the peg, but the link is now destabilising its own economy.

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The Fed's dramatic half point cut to 4.75pc yesterday has already caused a plunge in the world dollar index to a fifteen year low, touching with weakest level ever against the mighty euro at just under \$1.40.

There is now a growing danger that global investors will start to shun the US bond markets. The latest US government data on foreign holdings released this week show a collapse in purchases of US bonds from \$97bn to just \$19bn in July, with outright net sales of US Treasuries.

The danger is that this could now accelerate as the yield gap between the United States and the rest of the world narrows rapidly, leaving America starved of foreign capital

flows needed to cover its current account deficit - expected to reach \$850bn this year, or 6.5pc of GDP.

Mr Redeker said foreign investors have been gradually pulling out of the long-term US debt markets, leaving the dollar dependent on short-term funding. Foreigners have funded 25pc to 30pc of America's credit and short-term paper markets over the last two years.

"They were willing to provide the money when rates were paying nicely, but why bear the risk in these dramatically changed circumstances? We think that a fall in dollar to \$1.50 against the euro is not out of the question at all by the first quarter of 2008," he said.

"This is nothing like the situation in 1998 when the crisis was in Asia, but the US was booming. This time the US itself is the problem," he said.

Mr Redeker said the biggest danger for the dollar is that falling US rates will at some point trigger a reversal yen "carry trade", causing massive flows from the US back to Japan.

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Jim Rogers, the commodity king and former partner of George Soros, said the Federal Reserve was playing with fire by cutting rates so aggressively at a time when the dollar was already under pressure.

The risk is that flight from US bonds could push up the long-term yields that form the base price of credit for most mortgages, the driving the property market into even deeper crisis.

"If Ben Bernanke starts running those printing presses even faster than he's already doing, we are going to have a serious recession. The dollar's going to collapse, the bond market's going to collapse. There's going to be a lot of problems," he said.

The Federal Reserve, however, clearly calculates the risk of a sudden downturn is now so great that the it outweighs dangers of a dollar slide.

Former Fed chief Alan Greenspan said this week that house prices may fall by "double digits" as the subprime crisis bites harder, prompting households to cut back sharply on spending.

For Saudi Arabia, the dollar peg has clearly become a liability. Inflation has risen to 4pc and the M3 broad money supply is surging at 22pc.

The pressures are even worse in other parts of the Gulf. The United Arab Emirates now faces inflation of 9.3pc, a 20-year high. In Qatar it has reached 13pc.

Kuwait became the first of the oil sheikhdoms to break its dollar peg in May, a move that has begun to rein in rampant money supply growth.

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