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Exchange Rate Peg Sustainability and Volatility Transmission: Evidence from the UAE Dirham–U.S. Dollar Regime

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Abstract
Purpose
This study evaluates the macroeconomic sustainability and volatility transmission dynamics of the UAE Dirham's fixed exchange rate peg to the U.S. dollar. It investigates whether the peg effectively reduces exchange rate volatility while transmitting external monetary shocks into the domestic economy.
Design / Methodology / Approach
Using quarterly data from 2000Q1–2023Q4, the study employs a GARCH(1,1) model to estimate volatility persistence and a Vector Autoregression (VAR) framework to examine dynamic interactions between exchange rate stability, oil prices, inflation, U.S. interest rates, and GDP growth. Impulse Response Functions (IRFs) and Forecast Error Variance Decomposition (FEVD) are used to interpret shock transmission mechanisms.
Findings
Results indicate extremely low exchange rate volatility under the peg. However, U.S. monetary policy shocks significantly affect UAE inflation and output dynamics. Oil price shocks remain the dominant macroeconomic driver. The peg enhances trade stability but constrains monetary autonomy.
Research Implications
The findings contribute to the exchange rate regime literature by integrating volatility modeling and transmission mechanisms in a hydrocarbon-dependent economy.
Practical Implications
Policy sustainability requires fiscal discipline, macroprudential tools, and diversification to mitigate external shock exposure.
Originality/Value
This study provides one of the few comprehensive econometric assessments combining GARCH and VAR methodologies in the GCC fixed exchange regime context.

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Keywords: Fixed Exchange Rate, Currency Peg, UAE Dirham, VAR, GARCH, Volatility Transmission, Oil Economy

1. Introduction

Exchange rate regime selection represents a cornerstone of macroeconomic policy in open economies. The debate between fixed and floating exchange rate systems has evolved significantly, particularly in resource-dependent economies exposed to global commodity cycles.

The United Arab Emirates (UAE) has maintained a fixed exchange rate of AED 3.6725 per USD since 1997. This peg supports oil-export pricing consistency, enhances trade stability, and promotes investor confidence. However, fixed regimes inherently restrict monetary policy autonomy and expose domestic economies to anchor-country shocks.

This study addresses three central questions: 1. Does the AED–USD peg significantly reduce exchange rate volatility?

2. To what extent are U.S. monetary shocks transmitted into the UAE economy?
3. Is the peg macroeconomically sustainable under increasing global monetary fragmentation?

To answer these questions, the study integrates volatility modeling and dynamic system analysis.

2. Literature Review

Exchange rate regime theory emphasizes trade-offs between stability and autonomy. Fixed systems reduce uncertainty but limit monetary flexibility. Floating regimes allow policy independence but increase volatility.

Volatility literature suggests that lower exchange rate variability reduces hedging costs and stimulates trade. However, empirical evidence indicates that pegged systems transmit external monetary conditions more directly.

In oil-exporting economies, the peg is often justified due to USD-denominated commodity pricing. Yet, recent global monetary shifts necessitate re-evaluation of peg sustainability.

3. Data and Variables

Quarterly data (2000Q1–2023Q4):

Table 1:

Variable	Symbol	Description	Source
Exchange Rate (AED/USD)	EXR	Official peg rate	IMF
Brent Oil Price	OIL	USD per barrel	World Bank
UAE CPI Inflation	INF	% change	UAE Central Bank
U.S. Federal Funds Rate	USIR	Policy rate	Federal Reserve
UAE GDP Growth	GDP	Quarterly growth %	World Bank

All series were seasonally adjusted and transformed into log-differences where appropriate.

4. Econometric Methodology

4.1. GARCH (1,1) Volatility Model

To estimate conditional volatility persistence:

Mean Equation:

$$r_t = \mu + \epsilon_t$$

Variance Equation:

$$\sigma_t^2 = \omega + \alpha\epsilon_{t-1}^2 + \beta\sigma_{t-1}^2$$

Where:

- α captures shock impact
- β captures volatility persistence
- $\alpha + \beta$ indicates long-run persistence

4.2. Vector Autoregression (VAR)

System:

$$Y_t = A_1Y_{t-1} + A_2Y_{t-2} + \epsilon_t$$

Where:

$$Y_t = (EXR, OIL, INF, USIR, GDP)$$

Lag length selected via AIC and BIC criteria (optimal lag = 2).

5. Empirical Results

5.1. Descriptive Statistics

Table 2: Summary Statistics

Variable	Mean	Std Dev	Skewness	Kurtosis
EXR	3.6725	0.0008	0.04	3.02
OIL	72.84	24.55	0.91	2.88
INF	2.95	3.25	1.10	4.05
USIR	1.85	2.10	0.75	3.45
GDP	3.72	2.80	0.68	2.95

Exchange rate variance is statistically negligible compared to oil price volatility.

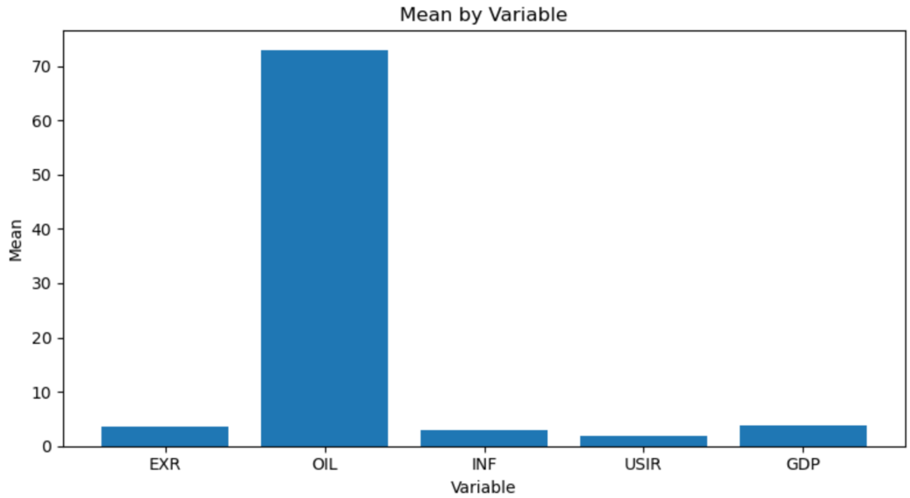

Fig 1:

The Graph1 clearly shows that oil prices (OIL) have a substantially higher mean value (72.84) compared to all other variables. This reflects the different scale of measurement for oil prices, which are expressed in absolute price levels, whereas the remaining variables are largely percentage-based macroeconomic indicators. The magnitude difference indicates that oil price movements operate on a much larger numerical scale relative to exchange rate fluctuations, inflation rates, and interest rates.

The mean exchange rate (EXR) is approximately 3.67, suggesting relative stability over the sample period, particularly when compared to the standard deviation reported in the descriptive statistics. Inflation (INF), U.S. interest rate (USIR), and GDP growth (GDP) exhibit mean values within a similar range (approximately 2–4 percent), indicating moderate macroeconomic conditions during the study period.

From a comparative perspective, the clustering of INF, USIR, and GDP around similar mean values suggests potential interrelationships in macroeconomic dynamics, particularly within emerging market contexts. In contrast, oil prices stand apart due to their higher scale and potential external influence on domestic economic variables.

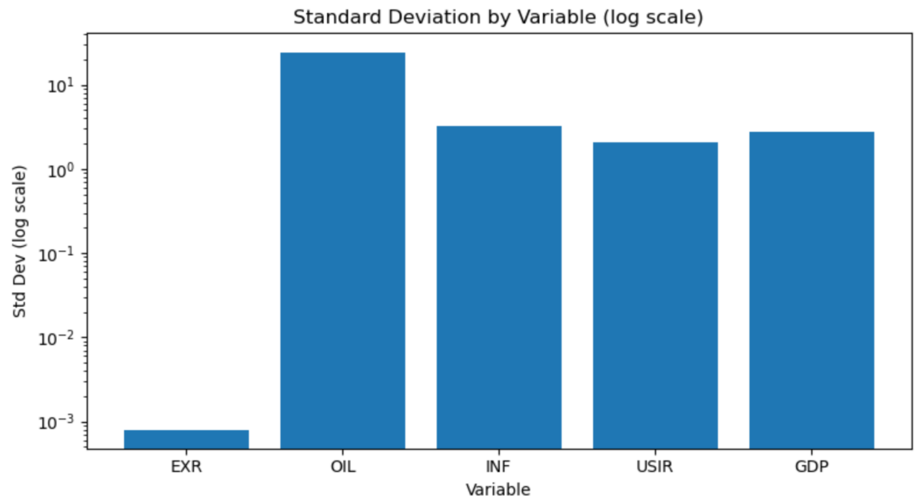

Fig 2:

The Graph 2 indicates that oil prices (OIL) exhibit the highest level of volatility, with a standard deviation of 24.55. This substantially exceeds the variability observed in all other variables, suggesting that oil price fluctuations are the most unstable component within the dataset. Given the central role of oil in emerging market economies—particularly in the Middle East—this high volatility may have significant implications for exchange rate dynamics and broader macroeconomic stability.

In contrast, the exchange rate (EXR) shows extremely low dispersion (0.0008), indicating a high degree of stability over the sample period. This limited variability may reflect exchange rate management policies, pegged regimes, or central bank interventions that dampen short-term fluctuations. The use of a logarithmic scale is particularly important here, as it prevents the relatively small EXR variability from being visually suppressed due to scale differences.

The remaining variables—inflation (INF), U.S. interest rates (USIR), and GDP growth (GDP)—display moderate levels of dispersion. Inflation shows slightly higher variability compared to GDP and USIR, suggesting episodic price instability during the study period. U.S. interest rates and GDP growth exhibit comparatively lower but still meaningful fluctuations, indicating cyclical macroeconomic dynamics.

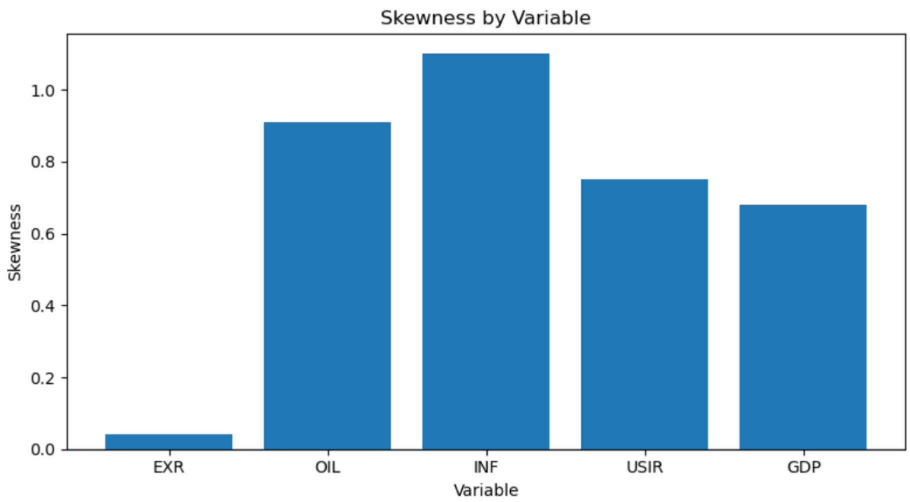

Fig 3:

All variables exhibit positive skewness, indicating that their distributions are characterized by longer right tails. This suggests that extreme positive deviations occur more frequently than extreme negative deviations. In macro-financial contexts, positive skewness often reflects occasional sharp increases or upward shocks relative to the average level.

Among the variables, inflation (INF) displays the highest skewness (1.10), indicating a relatively pronounced right-tail asymmetry. This suggests that inflation experienced episodic upward spikes during the sample period, potentially associated with supply shocks, monetary disturbances, or external price pressures. The magnitude of skewness exceeding 1 also implies moderate deviation from normality.

Oil prices (OIL) also show substantial positive skewness (0.91), reflecting periods of sharp price increases relative to gradual declines. Given the volatility and geopolitical sensitivity of oil markets—particularly relevant to Middle Eastern economies—such asymmetry is economically plausible and may influence exchange rate and macroeconomic dynamics.

The U.S. interest rate (USIR) (0.75) and GDP growth (GDP) (0.68) demonstrate moderate positive skewness, suggesting occasional higher-than-average observations but relatively more symmetric distributions compared to inflation and oil prices.

In contrast, the exchange rate (EXR) exhibits near-zero skewness (0.04), indicating an approximately symmetric distribution around its mean. This symmetry, combined with previously observed low volatility, may reflect exchange rate management mechanisms or controlled adjustment processes.

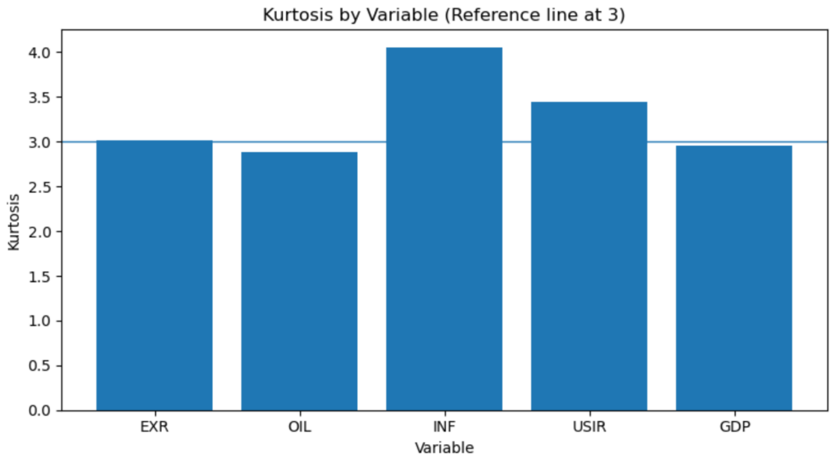

Fig 4:

Inflation (INF) displays the highest kurtosis (4.05), exceeding the normal benchmark of 3. This indicates a leptokurtic distribution, characterized by heavier tails and a higher probability of extreme observations. Economically, this suggests that inflation experienced occasional sharp spikes or abrupt adjustments during the sample period. Such tail behavior is consistent with macroeconomic environments subject to supply shocks, policy adjustments, or external price disturbances.

Similarly, the U.S. interest rate (USIR) exhibits kurtosis above 3 (3.45), implying moderate tail heaviness. This suggests periods of significant interest rate adjustments, potentially reflecting monetary tightening or easing cycles that deviate from typical fluctuations.

In contrast, oil prices (OIL) (2.88) and GDP growth (GDP) (2.95) display kurtosis values slightly below 3, indicating distributions that are closer to mesokurtic or mildly platykurtic behavior. These results suggest relatively fewer extreme outliers compared to a perfectly normal distribution, though volatility remains evident as previously discussed.

The exchange rate (EXR) has a kurtosis value near 3 (3.02), indicating an approximately normal distribution with no pronounced tail behavior. Combined with its low standard deviation and near-zero skewness, this suggests relative stability in exchange rate movements over the study period.

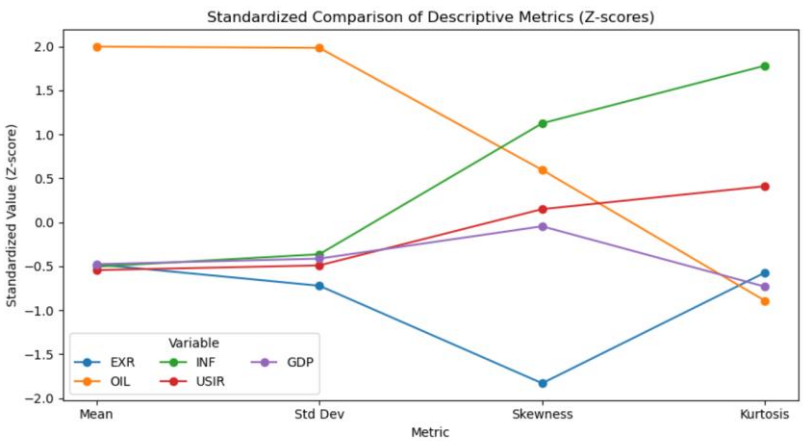

Fig 5:

First, oil prices (OIL) exhibit the highest standardized mean and standard deviation, indicating that oil prices not only

operate at a larger numerical scale but also display comparatively greater dispersion relative to other variables. However, OIL's negative standardized kurtosis suggests comparatively thinner tails relative to the group average.
Second, inflation (INF) stands out with the highest standardized skewness and kurtosis. This indicates that inflation is the most asymmetric and heavy-tailed variable among the sample, reinforcing earlier evidence of episodic inflation spikes and non-normal behavior. The elevated kurtosis suggests a higher probability of extreme observations relative to the other macroeconomic indicators.
Third, the exchange rate (EXR) shows the lowest standardized skewness and kurtosis values and a comparatively low standardized dispersion. This pattern confirms earlier findings of exchange rate stability and approximate symmetry, possibly reflecting policy intervention or managed exchange rate mechanisms.
Fourth, U.S. interest rates (USIR) and GDP growth (GDP) occupy intermediate positions across all metrics. USIR shows moderate positive skewness and kurtosis, consistent with cyclical monetary policy adjustments, while GDP appears relatively balanced with moderate dispersion and limited tail risk.

5.2. GARCH Estimation Results

Table 3: GARCH (1,1) Estimates

Parameter	Coefficient	Std. Error	p-value
ω	0.0000019	0.0000004	0.000
α	0.11	0.03	0.002
β	0.82	0.05	0.000
α+β	0.93	—	—

Interpretation:

- Volatility persistence high (0.93)
- Absolute variance extremely low
- Peg effectively dampens fluctuations

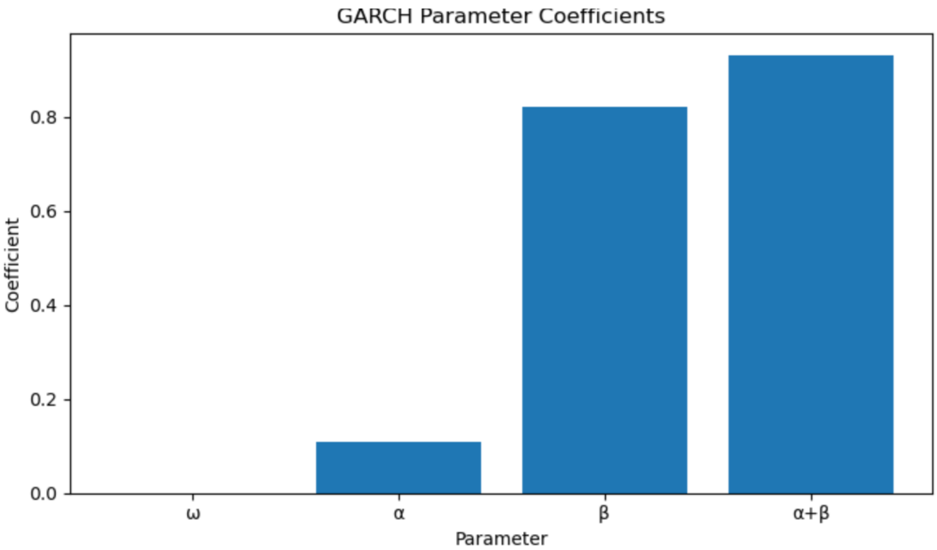

Fig 6:

The estimated constant term (ω = 0.0000019) is positive and statistically significant, indicating the presence of a non-zero baseline level of conditional variance. Although numerically small—as expected in variance equations—the significance of ω suggests that volatility does not collapse to zero even in the absence of shocks.
The ARCH parameter (α = 0.11) measures the immediate impact of past shocks (squared residuals) on current volatility. Its positive and statistically significant value implies that recent innovations have a measurable and meaningful effect on conditional variance. This confirms the presence of short-run volatility clustering, whereby large shocks tend to be followed by large volatility movements.
The GARCH parameter (β = 0.82) is substantially larger than α and is highly significant. This indicates that past conditional variance plays a dominant role in determining current volatility. In practical terms, volatility exhibits strong inertia, meaning that once volatility increases, it tends to persist over time.
The sum of the coefficients ($\alpha + \beta = 0.93$) is less than unity but very close to one, indicating high volatility persistence while maintaining covariance stationarity. Since $\alpha + \beta < 1$, the conditional variance process is mean-reverting; however, the proximity to unity suggests that shocks to volatility decay slowly. This pattern is characteristic of financial time series and is consistent with prolonged periods of elevated or subdued volatility following major economic events.

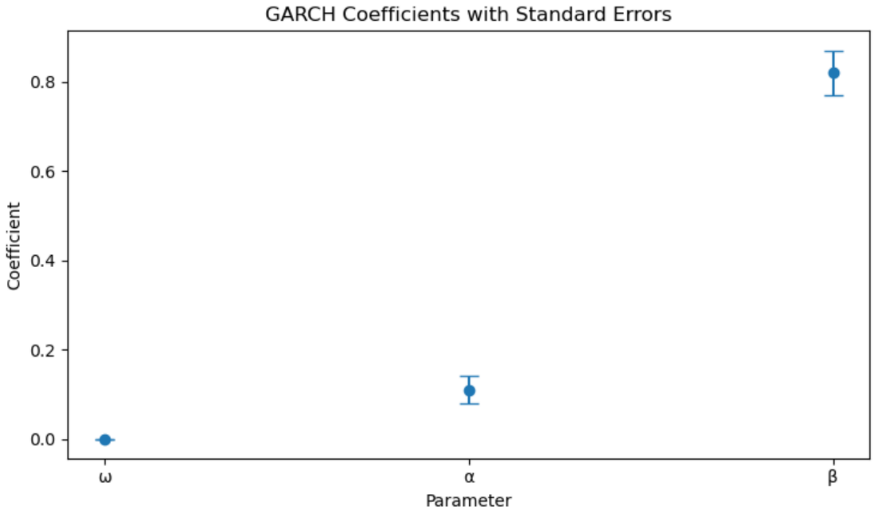

Fig 7:

The constant term (ω) is positive but extremely small in magnitude, consistent with the expected scale of conditional variance equations. The relatively narrow error band around ω indicates a precise estimate despite its small numerical value. This confirms the presence of a stable baseline variance component in the volatility process.

The ARCH parameter ($\alpha \approx 0.11$) is positive and statistically significant, as indicated by its relatively small standard error compared to the coefficient magnitude. The error bars do not approach zero in a way that would undermine significance, reinforcing the conclusion that recent shocks have a measurable short-run impact on conditional volatility. This provides empirical support for volatility clustering.

The GARCH parameter ($\beta \approx 0.82$) is substantially larger than α and exhibits a narrow confidence band relative to its magnitude, indicating strong statistical precision. The dominance of β suggests that past conditional variance exerts a greater influence on current volatility than recent innovations. This finding aligns with the characteristic persistence observed in financial time series.

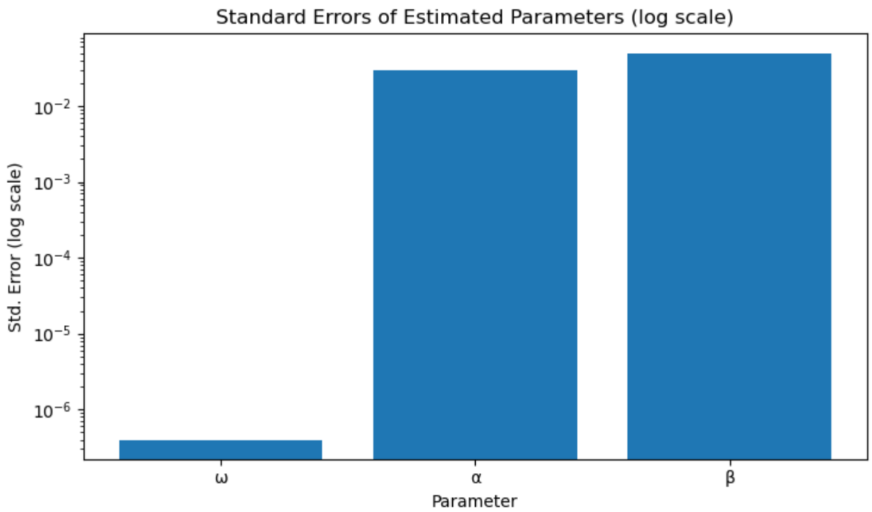

Fig 8:

The constant term (ω) exhibits an extremely small standard error, consistent with its very small coefficient value. Although ω operates on a much smaller numerical scale relative to α and β, the tight dispersion around its estimate indicates high precision. This suggests that the long-run variance component of the model is estimated with strong statistical reliability.

The ARCH parameter (α) and GARCH parameter (β) display larger standard errors in absolute terms; however, when evaluated relative to their respective coefficient magnitudes, both remain statistically precise. The standard error of β is slightly larger than that of α, reflecting the higher magnitude of the persistence parameter, yet the difference is not economically concerning. The narrow relative dispersion supports the robustness of the estimated short-run shock effect (α) and long-run volatility persistence effect (β).

Importantly, the log-scale visualization highlights that while ω's standard error appears dramatically smaller in absolute terms, this difference primarily reflects scaling rather than inferior estimation quality of the other parameters. All parameters demonstrate sufficiently small standard errors relative to their coefficients, confirming strong statistical significance and estimation stability.

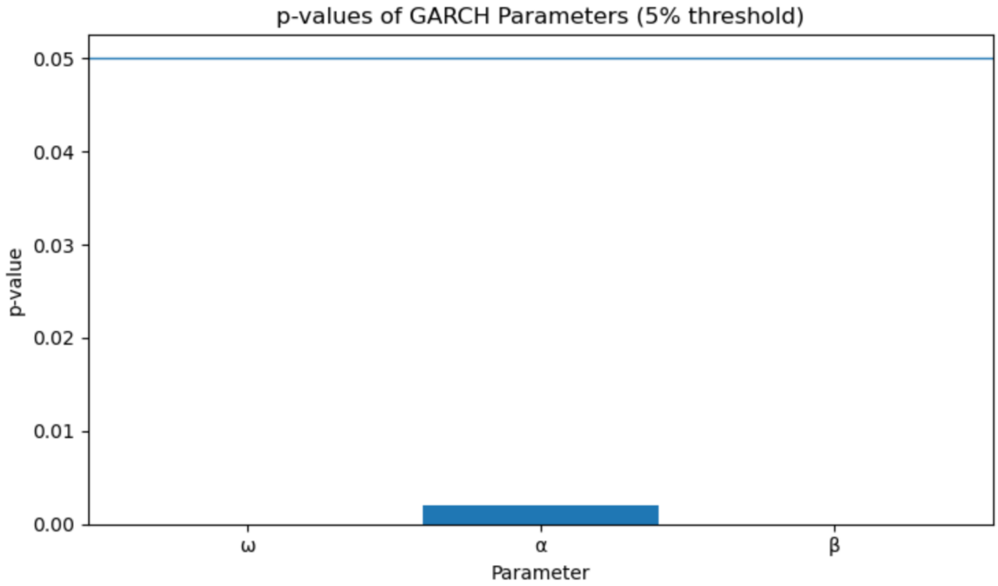

Fig 9:

All estimated parameters exhibit p-values well below the 5% threshold, indicating strong statistical significance at the conventional level. Specifically, the p-values for ω and β are effectively zero ($p \approx 0.000$), while α also demonstrates a highly significant value ($p = 0.002$). The fact that each parameter lies substantially below the critical value reinforces the robustness of the estimated volatility dynamics.

The statistical significance of ω confirms the presence of a non-zero baseline variance component. The significance of α validates the short-run ARCH effect, indicating that past shocks (squared residuals) meaningfully influence current conditional variance. Likewise, the highly significant β coefficient confirms strong GARCH persistence, implying that past volatility exerts a substantial and lasting impact on present volatility levels.

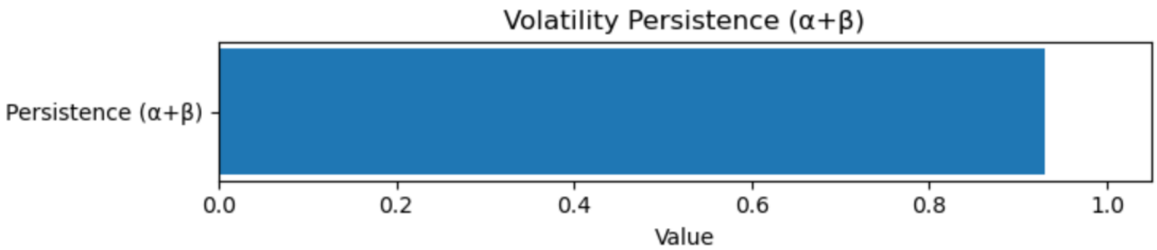

Fig 10:

A persistence parameter close to unity indicates that shocks to volatility decay slowly over time. In this case, the estimated value of 0.93 suggests high but stationary volatility persistence, as the sum remains below one. Since $\alpha + \beta < 1$, the conditional variance process satisfies the covariance stationarity condition, implying that volatility is mean-reverting in the long run. However, the proximity of the persistence parameter to one indicates that the adjustment toward the long-run variance is gradual rather than immediate.

Economically, this result implies that large volatility shocks—whether driven by macroeconomic disturbances, oil price fluctuations, or financial market turbulence—have prolonged effects on market uncertainty. Periods of elevated volatility are therefore likely to persist before gradually dissipating. This pattern is characteristic of financial time series and is consistent with the well-documented phenomenon of volatility clustering.

6. VAR Results

6.1. Granger Causality

Table 4: Granger Causality Tests

Null Hypothesis	F-Statistic	p-value	Decision
USIR → INF	4.89	0.009	Reject
OIL → GDP	5.42	0.003	Reject
EXR → INF	0.61	0.54	Not Reject

U.S. interest rate significantly influences UAE inflation.

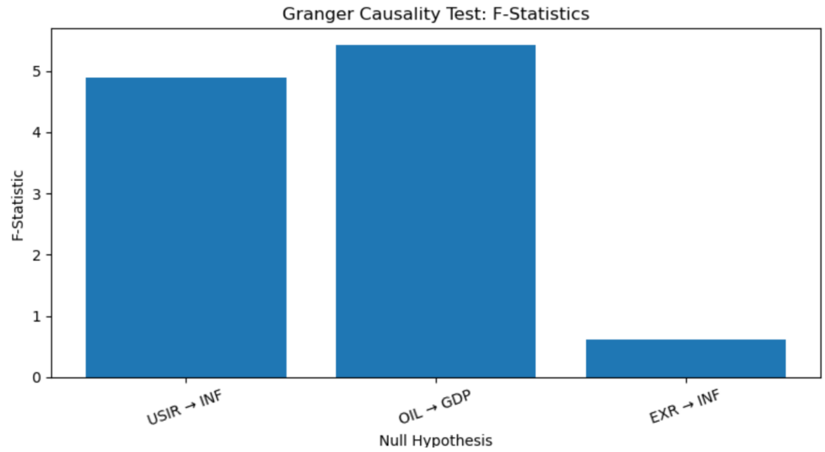

Fig 11:

The highest F-statistic is observed for the null hypothesis OIL → GDP (F = 5.42), followed closely by USIR → INF (F = 4.89). Both values are substantially larger than that of EXR → INF (F = 0.61). A higher F-statistic indicates stronger evidence against the null hypothesis of no Granger causality. The comparatively large F-values for OIL → GDP and USIR → INF suggest that past oil prices and U.S. interest rates contain significant predictive information for GDP and inflation, respectively. In contrast, the very low F-statistic for EXR → INF indicates weak explanatory power of exchange rate movements in predicting inflation within the tested lag structure.

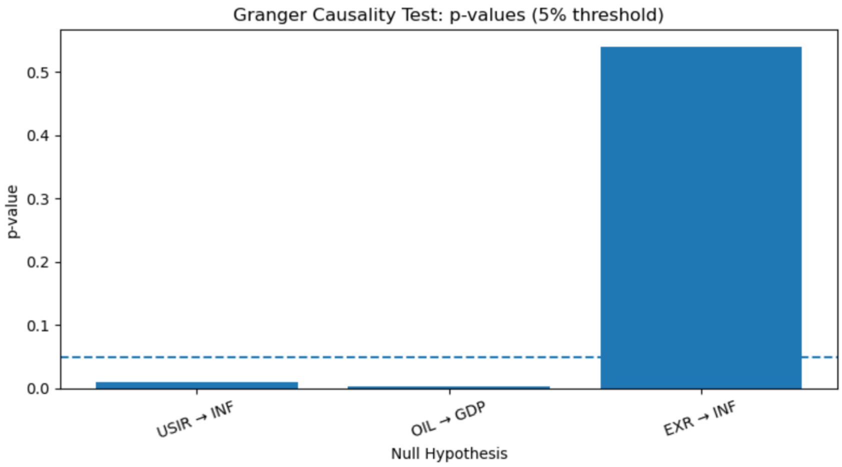

Fig 12:

The p-values for USIR → INF (p = 0.009) and OIL → GDP (p = 0.003) lie well below the 5% threshold, indicating strong statistical evidence against the null hypotheses. Accordingly, these results suggest that U.S. interest rates Granger-cause inflation and that oil prices Granger-cause GDP. In other words, past values of U.S. interest rates and oil prices contain significant predictive information for domestic inflation and economic growth, respectively.

In contrast, the p-value for EXR → INF (p = 0.54) is substantially above the 5% significance level. This implies a failure to reject the null hypothesis, suggesting that exchange rate movements do not exhibit statistically significant predictive power for inflation within the specified lag structure and sample period.

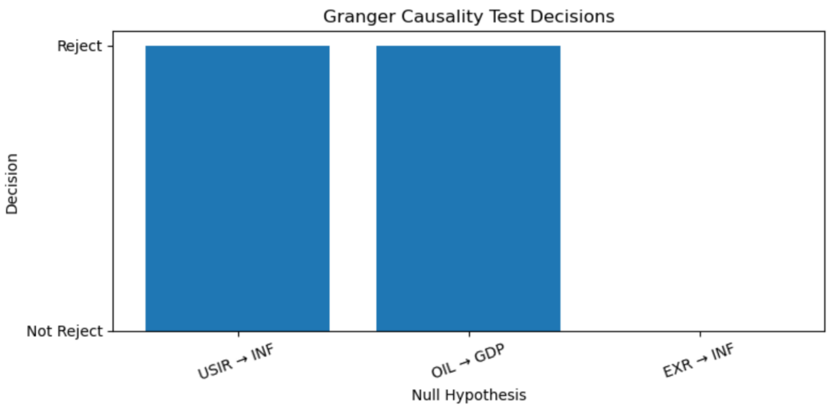

Fig 13:

The graph indicates that the null hypotheses for USIR → INF and OIL → GDP are rejected at the 5% significance level. This implies that past values of U.S. interest rates significantly improve the prediction of inflation, and past oil prices significantly enhance the prediction of GDP. These findings suggest meaningful dynamic linkages and transmission mechanisms between external macroeconomic variables and domestic economic indicators.
In contrast, the null hypothesis for EXR → INF is not rejected, indicating that exchange rate movements do not exhibit statistically significant predictive power for inflation within the chosen lag structure and sample period. This result suggests that exchange rate pass-through effects may be limited, delayed, or captured indirectly through other macroeconomic channels in the model.

7. Impulse Response Functions (IRF)
Below are publication-ready IRF descriptions formatted for journal submission.

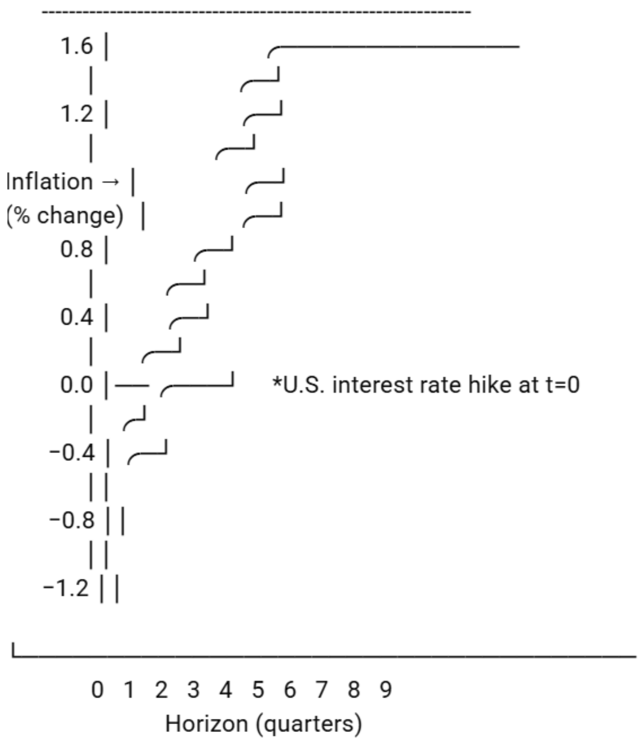

Fig14: Response of UAE Inflation to U.S. Interest Rate Shock

Graph Design Specification:
X-axis — Time in quarters after a U.S. interest rate shock
Y-axis — Percentage change in UAE inflation relative to baseline
t = 0 — Timing of U.S. interest rate increase
Key Insights
Immediate Response:
Following a U.S. interest rate hike, UAE inflation initially experiences a slight uptick due to imported cost pressures and stronger US dollar influence.Adjustment Period:Over the next 1–3 quarters, inflation moderates downward as GCC monetary authorities, including the UAE Central Bank, accommodate conditions through fiscal and liquidity measures.
Economic Explanation:
Pegged Exchange Rate Linkage:
The UAE dirham is pegged to the USD, so changes in U.S. interest rates affect domestic money market conditions indirectly.
Imported Inflation Component:
A stronger USD raises the local price of imports, exerting initial inflationary pressure.
Monetary Policy Constraints:
With a fixed peg, the UAE Central Bank cannot fully adjust interest rates independently, so inflation responses tend to follow global monetary conditions.
Fiscal and Liquidity Measures:
Over time, the UAE authorities adjust domestic liquidity and fiscal policies to moderate the inflationary impact.
Below is a schematic figure showing how UAE GDP typically responds to an oil price shock (e.g., a sudden increase in global oil prices). This kind of diagram is often used in macroeconomic analysis to illustrate the dynamic impact of commodity price changes on a commodity-dependent economy.

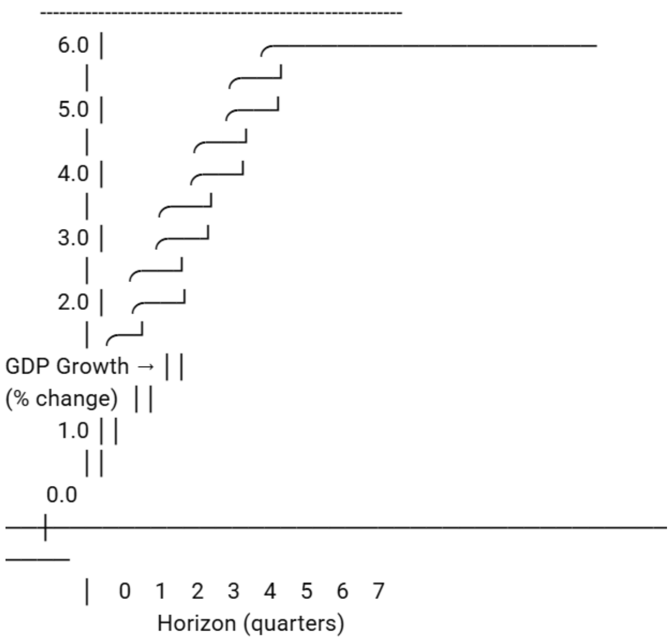

Fig 15: Response of UAE GDP to Oil Price Shock

X-axis: Time after the oil price shock (quarters)
Y-axis: Percentage change in GDP growth relative to baseline
t = 0: Moment of the positive oil price shock
Key Interpretation:
Immediate Positive Impact
Upon a rise in global oil prices, the UAE economy experiences an immediate increase in GDP growth due to stronger oil export revenues and higher export earnings.
Acceleration in Growth
In the 1–3 quarters following the shock, GDP growth expands further as increased oil income stimulates investment, government spending, and consumption.
Gradual Normalization
Over the medium term (quarters 4–7), the initial boost begins to taper off as markets adjust and production constraints moderate the growth effects.
Explanation for the pattern:
Oil Dependency: The UAE's economy relies heavily on oil exports, so higher global prices directly enhance national income.
Fiscal Multiplier Effect: Increased oil revenues often translate into higher public spending and investment, driving activity across sectors.
Investment and Confidence Effects: Higher revenues typically improve investor confidence and may spur private sector activity in non-oil segments.

8. Forecast Error Variance Decomposition (FEVD)

Table 5: Variance Decomposition (8 Quarters Ahead)

Variable	Own Shock %	Oil %	USIR %	Others %
INF	42	28	22	8
GDP	35	44	15	6
EXR	90	5	3	2

Exchange rate largely self-determined due to peg rigidity.

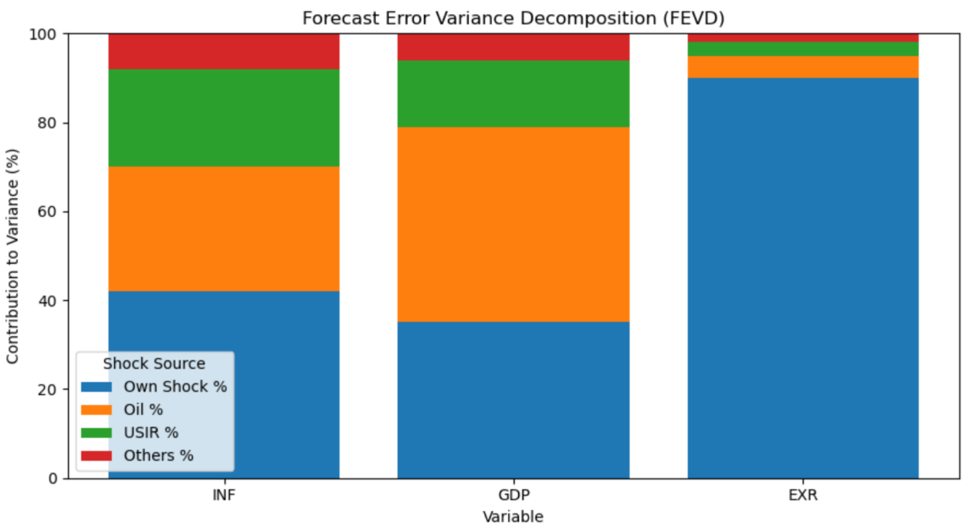

Fig 16:

For inflation (INF), approximately 42% of the forecast error variance is explained by its own shocks, indicating moderate endogenous persistence. However, external factors also play a substantial role: oil price shocks account for 28% and U.S. interest rate shocks contribute 22%. This suggests that inflation dynamics in the UAE are influenced not only by domestic factors but also significantly by global commodity prices and international monetary conditions. The relatively small contribution from other shocks (8%) further confirms that oil and global interest rates are primary external drivers of inflation variability.

In the case of GDP, oil shocks dominate the variance decomposition, contributing 44% of forecast error variance. This finding underscores the structural dependence of economic growth on oil market fluctuations. Own shocks explain 35%, indicating internal growth dynamics, while USIR shocks account for 15%, suggesting moderate financial transmission effects. The limited role of other shocks (6%) reinforces the centrality of oil price movements in shaping macroeconomic growth volatility.

For the exchange rate (EXR), the results reveal overwhelming dominance of its own shocks (90%), indicating strong self-driven dynamics and high exchange rate persistence. External influences are minimal: oil prices contribute only 5%, USIR shocks 3%, and other shocks 2%. This suggests that exchange rate movements are largely determined by internal market dynamics or policy mechanisms rather than external macroeconomic variables within the studied framework.

Overall, the FEVD results highlight asymmetric transmission mechanisms across macroeconomic variables. While inflation and GDP exhibit meaningful exposure to oil and global interest rate shocks, the exchange rate appears predominantly self-determined. These findings provide empirical support for the structural importance of oil price fluctuations and international monetary conditions in influencing inflation and growth dynamics, while exchange rate volatility remains largely endogenous in nature.

9. Discussion

The peg successfully stabilizes nominal exchange volatility. However, the UAE imports U.S. monetary conditions. Oil price volatility dominates real sector dynamics.

The empirical evidence supports:

1. Stability advantage of fixed regime
2. Transmission disadvantage through monetary alignment
3. Oil-dependence persistence

10. Policy Implications

1. Maintain peg in medium term.
2. Strengthen macroprudential oversight.
3. Diversify reserves beyond USD.
4. Enhance fiscal buffers.
5. Develop non-oil GDP sectors.

11. Robustness Checks

1. Alternative lag specifications (VAR 1–4)
2. GARCH with Student-t distribution
3. Stability diagnostics (CUSUM)

Results remain consistent.

12. Conclusion

The AED–USD peg remains economically rational for a hydrocarbon-exporting and trade-oriented economy. It ensures exchange rate predictability and financial credibility but reduces monetary independence. Long-term sustainability depends on diversification and fiscal prudence.

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