

Weekly Analysis:

Which Arab Currencies are Overvalued Using the Big Mac Index?

The Big Mac Index

	Big Mac Prices		Implied PPP* of the Dollar	Actual Dollar exchange rate**	Under (-) or over (+) valuation against the Dollar, %
	In Local Currency	In US Dollar			
United States	\$2.49	2.49	-	-	-
Select Arab Countries					
Jordan	JD1.80	2.53	0.72	0.71	+1.4%
Egypt	EGP6.5	1.41	2.61	4.61	-43.3%
Saudi Arabia	SR9.0	2.40	3.61	3.75	-3.7%
UAE	DH9.0	2.40	3.61	3.65	-1.1%
Lebanon	LL4300	2.84	1,726	1,514	+14.0%
Oman	OR1.0	2.60	0.402	0.385	+4.4%
Kuwait	KD0.65	2.13	0.261	0.305	-14.4%
Bahrain	BD0.90	2.38	0.361	0.377	-4.1%
Other Countries					
Euro Area	Euro 2.67	2.45	1.07 (0.93)	1.10 (0.91)	-2.7%
Japan	Yen 262	2.10	105.2	124.5	-15.5%
Switzerland	SF 6.3	3.98	2.53	1.58	+60.0%

Source: Marketing Department of McDonald's Offices of various Arab Countries, The Economist, April 27, 2002.

*PPP is Purchasing Power Parity defined as the local price of the Big Mac divided by price of the Big Mac in the US, PPP in the US is therefore equals to 1. ** Actual exchange rates (per US\$ 1) as of 21 May, 2002.

The Big Mac index was devised by The Economist magazine 16 years ago as a light-hearted indicator of whether currencies are at their correct valuation level. This innovative notion, referred to by The Economist as "Burgernomics", is based on one of the oldest concepts in international economics; the Purchasing Power Parity (PPP), which holds that in the long-run currencies should move towards the exchange rate that equalized the prices of an identical basket of goods and services in each country. The consumer basket in this case was limited to the Big Mac hamburger claimed by Mac-Donald's to be identical in all the company's outlets worldwide. The Big Mac PPP, calculated by dividing the local currency price of a Big Mac in a certain country by its American price, is the exchange rate that would leave hamburgers costing the same in the US as in other countries. Comparing actual exchange rates with PPPs reveals, albeit simplistically, whether currencies are over or under valued against the dollar. If the current exchange rate of a currency is above its Purchasing Power Parity level, it is considered to be overvalued, if it is below that level, it is undervalued.

The first column of the table shows the local-currency prices of a Big Mac. The second converts these into dollars at the current exchange rate. The average American price of a Big Mac is put at \$ 2.49. The cheapest Big Mac in the region is in Egypt at \$ 1.41, while the most expensive is in Lebanon at \$ 2.84. By this measure, the Egyptian pound is the most undervalued currency and the Lebanese Lira is the most overvalued. The third column calculates Big Mac's Purchasing Power Parity (PPPs). Dividing the Jordanian price of Big Mac by the American price, for instance, gives a dollar PPP of JD 0.72, against an actual exchange rate of JD 0.71. This implies that the Jordanian dinar is slightly (1.4%) overvalued.

Internationally, the euro is only 2.7% undervalued relative to its Big Mac PPP of 0.93 to the dollar, far less than many economists claim. The euro area may have a single currency, but the price of a Big Mac varies widely, from €2.15 in Greece to €2.95 in France. However, that range has narrowed from a year ago. This is why the Economist magazine uses the average price of Big Mac in the Eurozone countries. In 1999, for instance, the Big Mac index suggested that the euro was already overvalued at its launch, when nearly every economist predicted it would rise.

Applying the above concept to a select number of Arab countries reveals that by Big Mac standards the currencies of Egypt, Saudi Arabia, Kuwait and Bahrain are undervalued, while the Jordanian dinar and the Lebanese pound are overvalued. The UAE dirham/dollar exchange rate is close to its Big Mac PPP, suggesting that the currency is at or close to its correct valuation level.

According to the Big Mac index, the Egyptian pound is significantly undervalued against the dollar by 43.3%, with a PPP of EGP 2.61 to the dollar compared to the current exchange rate of EGP 4.61. However, the market indicates otherwise with a recurrent shortage of dollars in the Egyptian market putting pressure on the pound. Continued demand for the dollar in 2001 brought down the country's international reserves to \$ 15 billion, their lowest level in the least three years. Other economic indicators that point to a high devaluation risk is a widening balance of payment deficit. The Egyptian currency has been successfully devalued from 3.40 to the dollar in 1999 to 4.61 now. It is likely that the cost of non-traded inputs, particularly low labor costs and rents in Egypt, may have distorted the price of a Mac Burger, thereby biasing the country's Big Mac PPP downward.

The Big Mac index shows that the Saudi Riyal, at an exchange rate of SR 3.75 to the dollar and the Bahraini dinars at 0.377 are only slightly undervalued by 3.7% and 4.1% respectively. However, with oil prices trading above \$ 25 a barrel, the outlook for SR/\$ and BD/\$ exchange rates remains quite stable with no pressure whatsoever on the two currencies. The Kuwaiti dinar is undervalued against the dollar by 14.4% and its exchange rate may be adjusted upward without losing market competitiveness.

At the other end, the slight overvaluation of the Jordanian dinar by Big Mac standards reflects the country's strong macroeconomic performance over the past three years, with economic growth averaging around 4%. The gradual decline in the debt burden and the smaller budget and current account deficits have rendered support to the fixed JD/\$ exchange rate. More privatization deals and the surge in exports especially from the QIZ boosted the country's foreign reserves and allowed the Central Bank to reduce interest rates on the Jordanian dinar while maintaining throughout positive interest rates differentials to dollar rates. The Jordanian dinar is close to its PPP and given the country's positive economic fundamentals there is no risk of devaluation anytime soon.

Similarly, the Lebanese pound at its current exchange rate of LP 1,514 to the dollar is 14% overvalued by Big Mac standards. A tight monetary policy anchoring the Lebanese pound to the dollar with regular intervention in the FX market, maintaining an attractive interest rate differential in favor of the local currency, and continuous capital inflows from the Lebanese Diaspora have enabled the authorities to support the value of the currency at the overvalued level. However, the country's deteriorating economic fundamentals suggest that devaluation risks for the Lebanese currency remain high.

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