

The Dollar-Peg Advantage: How the AED Peg De-Risks UAE Assets for International Investors

Why a four-decade currency peg removes the largest emerging-market risk and reframes the United Arab Emirates for global capital

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ABSTRACT

Currency risk is the single largest and least diversifiable risk an international investor typically bears when allocating to an emerging market, and it is the risk that most often turns an attractive local-currency return into a disappointing one in the investor's home currency. This paper examines a feature that sets the United Arab Emirates apart from the emerging-market complex with which it is routinely grouped: the four-decade peg of the dirham (AED) to the United States dollar. Drawing on the literature on exchange-rate regimes, currency risk in international portfolios and the determinants of peg credibility, it advances five propositions concerning the effect of the peg on the risk borne by foreign investors. Using a stylised, clearly-labelled framework, it compares the currency volatility, hedging cost and drawdown profile of the dirham against a range of emerging-market currencies, decomposes the currency drag that separates local from home-currency returns, and assesses the defensibility of the peg itself. The analysis finds that the peg removes the currency volatility and devaluation risk that dominate emerging-market return distributions, that it converts the exposure for dollar-based investors into one carrying negligible currency risk and for sterling- and euro-based investors into a cheaply hedgeable dollar exposure, and that the sovereign resources supporting the peg make its continuation the central case. The paper concludes that the peg should be treated as a standing, structural risk reduction embedded in United Arab Emirates assets, with implications for how global investors classify, size and hedge a Gulf allocation, and it sets out the limitations of the analysis and avenues for further research.

JEL Classification: F31, F21, G11, G15, O53

Keywords: currency peg, exchange-rate regime, United Arab Emirates, dirham, currency risk, international diversification, hedging, emerging markets

1. INTRODUCTION

For an international investor, the return earned on a foreign asset is only as good as the currency in which it is ultimately measured. A local-currency gain that is eroded, or reversed, by the depreciation of the currency in which it was earned is no gain at all to an investor who must convert it back into dollars, sterling or euros. This simple arithmetic is the reason currency risk sits at the centre of any serious assessment of an international allocation, and it is the reason emerging-market investing, where currencies are volatile and occasionally subject to sharp devaluation, carries a risk that developed-market investing largely does not (Bekaert and Harvey, 1997). Currency is, for the cross-border investor, frequently the largest single source of risk and the one least rewarded over time.

It is against this backdrop that one feature of the United Arab Emirates deserves far more weight in allocation decisions than it typically receives: the peg of the dirham to the United States dollar, maintained for four decades and through multiple global and regional cycles. The region is routinely classified and assessed alongside the broader emerging-market complex, and with that classification comes the assumption of emerging-market currency risk. Yet the dirham does not behave like an emerging-market currency, because it is not allowed to: it is anchored to the dollar by a longstanding policy commitment backed by substantial sovereign resources. For an investor, this is not a technical curiosity but a material and persistent reduction in the risk borne, and it is the subject of this paper.

The purpose of the paper is to examine, rigorously and from the perspective of an international institutional investor, what the peg does to the risk profile of a United Arab Emirates allocation, and how that should change the way global capital classifies, sizes and hedges exposure to the region. It is written for the allocator who has internalised the habit of pricing the Gulf as an emerging market and who has not paused to ask whether the currency assumption embedded in that habit is correct. The argument is not that the peg makes the United Arab Emirates riskless, no allocation is, but that it removes the specific, large and diversification-resistant risk that most distinguishes emerging-market from developed-market investing, and that this removal is undervalued.

The paper makes three contributions. First, it quantifies, on a stylised and clearly-labelled basis, the difference in currency volatility, hedging cost and drawdown between the dirham and a representative set of emerging-market currencies, and decomposes the currency drag that separates local-currency from home-currency returns. Second, it assesses the credibility and defensibility of the peg itself, drawing on the literature on what makes fixed exchange-rate regimes durable, so that the central assumption of continuation is examined rather than assumed. Third, it translates the analysis into practical implications for how an international investor should treat the peg when classifying, sizing and hedging a Gulf allocation.

The remainder of the paper is structured as follows. Section 2 reviews the literature on exchange-rate regimes, currency risk in international portfolios and the determinants of peg credibility, and develops five propositions. Section 3 sets out the data and the stylised methodology, including the comparative currency framework and the return-decomposition approach. Section 4 presents and discusses the results, covering currency stability, volatility, hedging cost, the drawdown profile, the decomposition of currency drag and the experience of investors of different base currencies. Section 5 reports robustness and a stressed scenario in which the peg is placed under pressure. Section 6 sets out the implications for classification, sizing and hedging. Section 7 offers concluding comments, including limitations and directions for further research. A statement of disclosures, the references and appendices follow.

2. LITERATURE REVIEW AND PROPOSITIONS

The analysis draws on three established strands of the international finance literature: the economics of exchange-rate regimes, the treatment of currency risk in international portfolios, and the determinants of the credibility and durability of fixed exchange-rate arrangements. This section reviews each and develops the propositions the subsequent analysis examines.

2.1 Exchange-Rate Regimes and Their Consequences

The choice of exchange-rate regime, and the gap between announced and actual regimes, has a long literature (Obstfeld and Rogoff, 1995; Calvo and Reinhart, 2002). A central finding is that fixed and heavily managed regimes, where credibly maintained, deliver lower nominal exchange-rate volatility and can anchor inflation expectations, at the cost of surrendering independent monetary policy, the classic trilemma in which a country may choose only two of a fixed exchange rate, free capital movement and monetary autonomy (Mundell, 1963; Obstfeld, Shambaugh and Taylor, 2005). The United Arab Emirates has, in effect, chosen a fixed rate and free capital movement, importing United States monetary conditions. For the foreign investor the relevant consequence is straightforward: a credibly fixed rate removes the exchange-rate volatility that a floating regime transmits to returns, which is precisely the feature this paper assesses.

2.2 Currency Risk in International Portfolios

A substantial literature examines how currency exposure affects international portfolios and whether and how it should be hedged (Solnik, 1974; Perold and Schulman, 1988; Campbell, Serfaty-de Medeiros and Viceira, 2010). Two findings are pertinent. First, currency risk is a large component of the total risk of an unhedged foreign allocation, particularly for emerging markets, and is generally regarded as poorly compensated over long horizons, which is why the literature treats its reduction as close to a free improvement in the risk-adjusted profile (Perold and Schulman, 1988). Second, the cost and feasibility of hedging vary enormously across currencies: deep, liquid developed-currency forwards are inexpensive, whereas emerging-market currency hedges are costly, illiquid or unavailable. A peg to the dollar, by collapsing the currency risk of a dollar-based investor to near zero and converting the exposure of other investors into a cheaply hedgeable dollar exposure, addresses both findings directly.

2.3 The Credibility and Durability of Pegs

Because the entire benefit depends on the peg being maintained, the literature on what makes fixed regimes credible and durable is central. The currency-crisis literature identifies the conditions under which pegs break, namely inadequate reserves, weak fundamentals, current-account deficits and speculative pressure that the authorities lack the resources or will to resist (Krugman, 1979; Obstfeld, 1996). The corollary is that pegs supported by ample foreign-exchange reserves, strong external balances and credible policy commitment are durable, and that durability is observable in advance through these indicators. The United Arab Emirates exhibits the features the literature associates with durable pegs, substantial reserves and sovereign buffers, a structural external surplus and a four-decade track record, which is why this paper treats continuation as the central case while testing the alternative in Section 5.

2.4 Synthesis and Propositions

Taken together, these literatures imply that a credibly pegged currency should remove the largest and least-rewarded risk of an emerging-market allocation, and that the credibility of a given peg can be assessed from observable fundamentals. Yet the implication is rarely applied to the classification of the United Arab Emirates, which continues to be assessed with the currency caution appropriate to floating emerging markets. From this the paper develops five propositions:

Proposition 1. The dirham exhibits currency volatility against the United States dollar far below that of representative emerging-market currencies, and close to zero for a dollar-based investor.

Proposition 2. The cost of managing residual currency exposure to United Arab Emirates assets is low, because the exposure is effectively to the dollar and is hedgeable in deep, liquid markets.

Proposition 3. The peg removes the devaluation and tail-risk component that dominates the drawdown profile of emerging-market currency returns.

Proposition 4. As a result, the currency drag that separates local-currency from home-currency returns, large and negative for many emerging markets, is negligible for the United Arab Emirates.

Proposition 5. The peg is supported by the fundamentals the literature associates with durable fixed regimes, so its continuation is the central case, though the benefit should be assessed with explicit attention to the stressed scenario.

2.5 The Peg, the Cost of Capital and Asset Prices

A further consequence of a credible peg, less often noted in the allocation context, concerns the cost of capital and asset prices within the pegged economy. By importing the monetary conditions of the anchor currency and removing exchange-rate uncertainty, a durable peg lowers the currency risk premium that lenders and investors would otherwise demand, which tends to reduce the cost of capital for borrowers and to support asset valuations relative to a comparable floating-rate economy (Obstfeld and Rogoff, 1995). For the foreign investor this cuts two ways and both are relevant to the analysis. On the one hand, a lower local cost of capital can compress prospective returns on some assets, a consideration the investor should weigh. On the other, the same stability that lowers the risk premium also underpins the predictability of cash flows and the absence of currency-driven valuation shocks, which is part of what makes the risk-adjusted profile attractive. The net effect is that the peg should be understood not only as a currency-risk reducer at the portfolio level but as a feature that shapes the pricing of the underlying assets, and the investor's return expectations should be formed with that in mind rather than by naive extrapolation of returns from higher-risk-premium economies.

This observation also reinforces the importance of assessing United Arab Emirates assets on a net, currency-adjusted basis rather than by comparison with the headline local-currency returns of floating emerging markets. A higher local-currency return in a floating market may simply be compensation for the currency risk the investor will bear, whereas a lower headline return in the pegged economy may be superior once the absence of currency drag is taken into account. The peg, in short, requires the investor to compare like with like, and the framework of this paper is constructed to make that comparison explicit.

2.6 The Peg in the Gulf Monetary Context

The dirham's peg does not exist in isolation but within a regional pattern of dollar pegs and tightly managed regimes across the Gulf Cooperation Council, reflecting economies whose principal export is priced in dollars and whose policy frameworks have long prioritised exchange-rate stability over monetary autonomy. This regional context strengthens, rather than weakens, the credibility of the individual peg in two ways. First, the shared commitment across neighbouring economies reduces the likelihood of an isolated, idiosyncratic break, since the regimes reinforce one another and are supported by a common economic logic. Second, the deep institutional experience of operating dollar pegs across the region means the policy machinery for defending them, reserve management, coordination and the willingness to subordinate domestic

monetary policy to the peg, is well established. For the foreign investor, the implication is that the dirham peg should be assessed not as a fragile, standalone arrangement but as part of a durable regional monetary architecture with strong economic foundations, which is consistent with the durability indicators examined in Section 4.7.

2.7 Currency Risk in the Theory of Asset Allocation

It is worth situating the peg within the broader theory of how currency exposure should be treated in asset allocation, because that theory clarifies why removing currency risk is so valuable. The international portfolio literature distinguishes between the expected-return contribution of a currency and its risk contribution, and a recurring conclusion is that currencies add substantial risk while contributing little to expected return over long horizons, so that the risk they introduce is largely uncompensated (Perold and Schulman, 1988; Campbell, Serfaty-de Medeiros and Viceira, 2010). Where currency risk is uncompensated, reducing it is a near-costless improvement in the risk-adjusted profile, which is the sense in which currency hedging has been described as offering a rare free lunch. The dirham peg delivers this improvement structurally and without the institution having to transact: for the dollar-based investor the uncompensated risk is simply absent, and for others it is reduced to a cheaply hedgeable form. Viewed through this lens, the peg is not merely a convenience but a standing realisation of the very risk reduction that the asset-allocation literature recommends investors pursue, and its omission from the assessment of the United Arab Emirates means leaving that recommended improvement unclaimed.

The same theory cautions, however, that the value of removing currency risk depends on the correlation of the currency with the rest of the portfolio and with the investor's liabilities, and that in some cases a foreign currency can act as a hedge rather than a risk. For most institutional investors based in dollars, sterling or euros, exposure to a stable, dollar-linked currency is closer to a risk reduction than to a lost hedging opportunity, because the dollar is itself a reserve currency that tends to strengthen in global stress. This reinforces, rather than qualifies, the case: the peg aligns the currency exposure of a Gulf allocation with the safe-haven behaviour of the dollar, which is generally helpful to a global portfolio in exactly the stressed conditions when help is most valued.

3. DATA AND METHODOLOGY

This study is analytical and comparative rather than econometric. Its aim is to make transparent the difference in currency risk between the United Arab Emirates and the emerging-market complex, and to assess the durability of the peg, using a framework whose assumptions are stated explicitly rather than estimated from a single proprietary dataset. The figures presented are stylised and clearly labelled; they illustrate relationships and orders of magnitude that an allocator can validate against live market data, and they are not forecasts.

3.1 Data and Inputs

The qualitative inputs, the history of the peg, the policy framework and the sovereign resources supporting it, are drawn from public and multilateral sources (International Monetary Fund, 2024). The quantitative inputs, indicative currency volatilities, hedging costs and drawdowns for the dirham and a set of comparator currencies, are calibrations informed by the general behaviour of these currencies and by the international-finance literature (Calvo and Reinhart, 2002; Campbell et al., 2010); they are representative rather than precise estimates, and Appendix A records the base-case assumptions.

3.2 Comparative Currency Framework

The first component compares the dirham against a representative set of currencies spanning the spectrum from a stable managed currency to high-volatility emerging-market currencies, on three dimensions: annualised volatility against the dollar, the indicative cost of hedging the exposure, and the worst drawdown experienced in a stress event. The purpose is to test Propositions 1 to 3 by locating the dirham within this spectrum.

3.3 Return-Decomposition Framework

The second component decomposes the return an investor actually earns in home-currency terms into the local-currency return and the currency effect, for an emerging market with a floating currency and for the United Arab Emirates with its peg. This makes explicit the currency drag that Proposition 4 concerns, and shows how a comparable local return translates into very different home-currency outcomes depending on the currency regime. The decomposition is presented for investors of three base currencies, dollar, sterling and euro, to capture the different residual exposure each faces.

3.4 Peg-Defensibility Assessment

The third component assesses the durability of the peg against the indicators the currency-crisis literature associates with credibility, reserve adequacy, sovereign buffers, the external balance and the policy track record, in order to examine Proposition 5 and to frame the stressed scenario of Section 5. The base-case assumptions used throughout are set out in Table 1.

Table 1. Base-Case Assumptions for the Currency Analysis

Parameter	Assumption
Dirham regime	Pegged to USD at a fixed rate (four-decade track record)
Dirham volatility vs USD	Negligible (near zero)
Representative EM currency volatility vs USD	12% to 22% p.a.
Indicative hedging cost, AED-linked (USD) exposure	Low (deep, liquid USD market)
Assumed local return (comparison)	12% p.a.
Assumed EM currency drag (comparison)	5% to 6% p.a.
Peg-defensibility indicators	Strong reserves, sovereign buffers, external surplus

Indicative, forward-looking assumptions used to illustrate the analysis; not forecasts. See Appendix A.

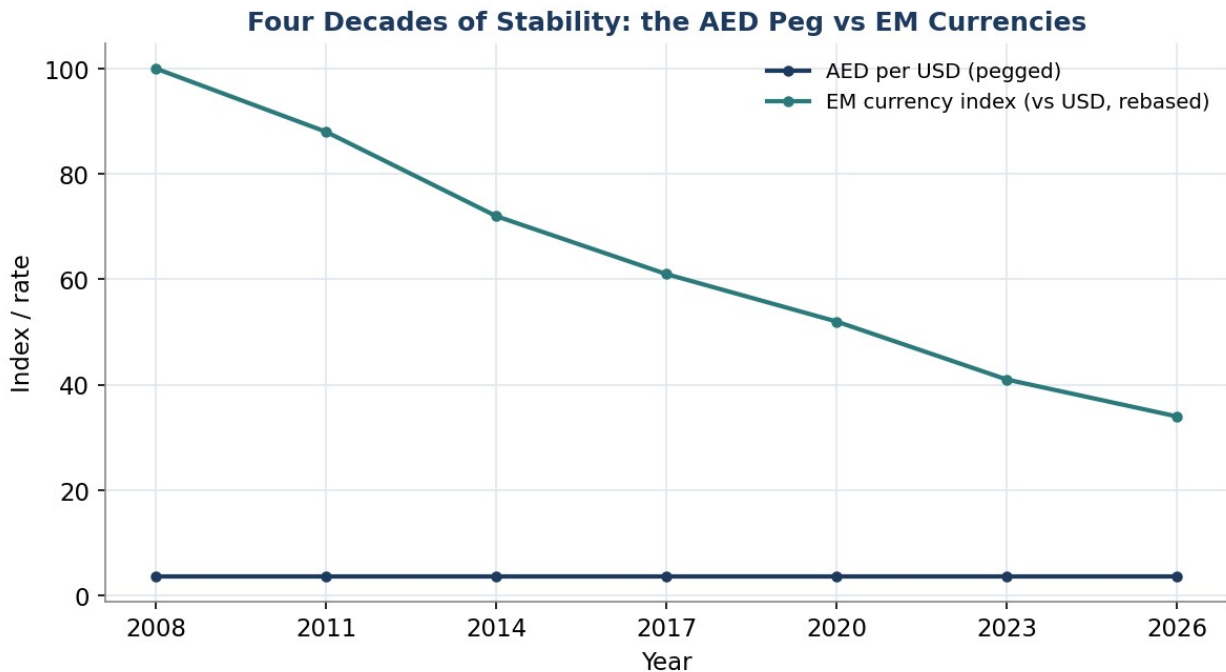
4. RESULTS AND DISCUSSION

This section presents the results in the order of the propositions: currency stability and volatility (Propositions 1); hedging cost (Proposition 2); the drawdown profile (Proposition 3); the decomposition of currency drag and the experience of different base currencies (Proposition 4); and the defensibility of the peg (Proposition 5, with the stressed case in Section 5).

4.1 Four Decades of Stability

The starting point is the simple fact of the peg's stability, illustrated in Figure 1, which contrasts the constancy of the dirham against the dollar with the cumulative depreciation typical of a basket of emerging-market currencies over the same period.

Figure 1. Four Decades of Stability: the AED Peg versus Emerging-Market Currencies



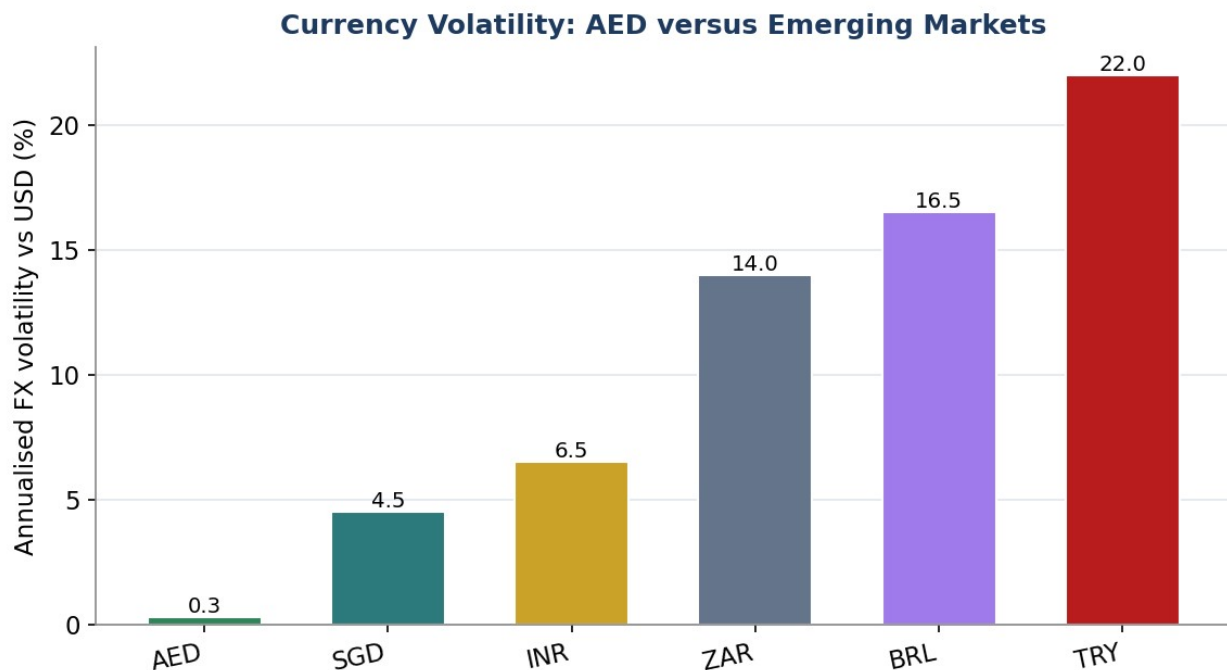
Indicative; the dirham holds its dollar rate while a representative EM currency index depreciates substantially over time.

The contrast is the foundation of the entire argument. While the representative emerging-market currency loses a large fraction of its dollar value over the period, through a combination of structural depreciation and episodic devaluation, the dirham holds its rate. For an investor, this is the difference between a currency that quietly transfers value away over time and one that does not. It supports Proposition 1 in its most basic form and motivates the more granular comparisons that follow.

4.2 Currency Volatility

Figure 2 locates the dirham within the spectrum of currency volatility against the dollar, alongside a managed currency and a range of emerging-market currencies.

Figure 2. Currency Volatility: the Dirham versus Emerging Markets



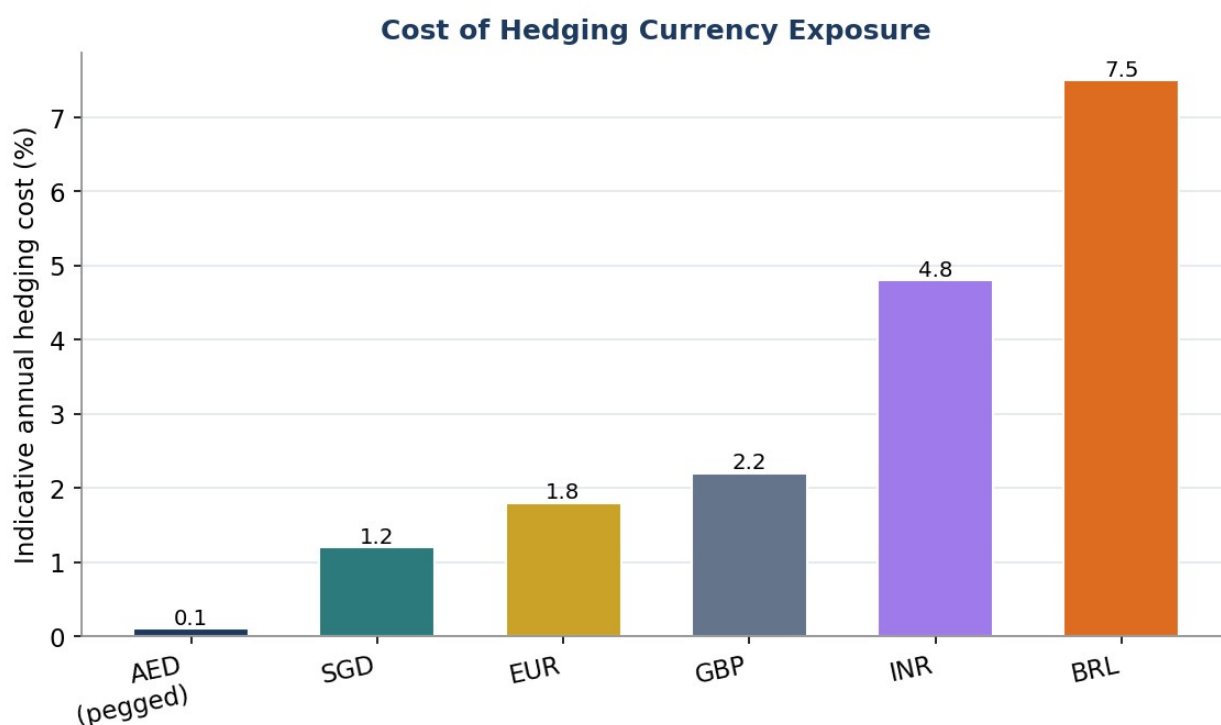
Indicative annualised volatility against the USD; the dirham sits far below the emerging-market range.

The dirham's volatility against the dollar is negligible, far below not only the high-volatility emerging-market currencies but also below well-managed currencies such as the Singapore dollar. This is the direct consequence of the peg: the exchange rate is not permitted to move materially, so it does not. For a dollar-based investor the practical implication is that the currency component of the risk of a United Arab Emirates allocation is close to zero, which is the strongest form of Proposition 1. The significance is amplified by the literature's finding that currency risk is a large and poorly compensated component of emerging-market risk (Perold and Schulman, 1988): the peg removes a risk for which the investor was not, in any case, being adequately paid.

4.3 The Cost of Hedging

For investors not based in dollars, the relevant question is not the dirham's volatility but the cost of managing the residual exposure, which Figure 3 addresses.

Figure 3. The Cost of Hedging Currency Exposure



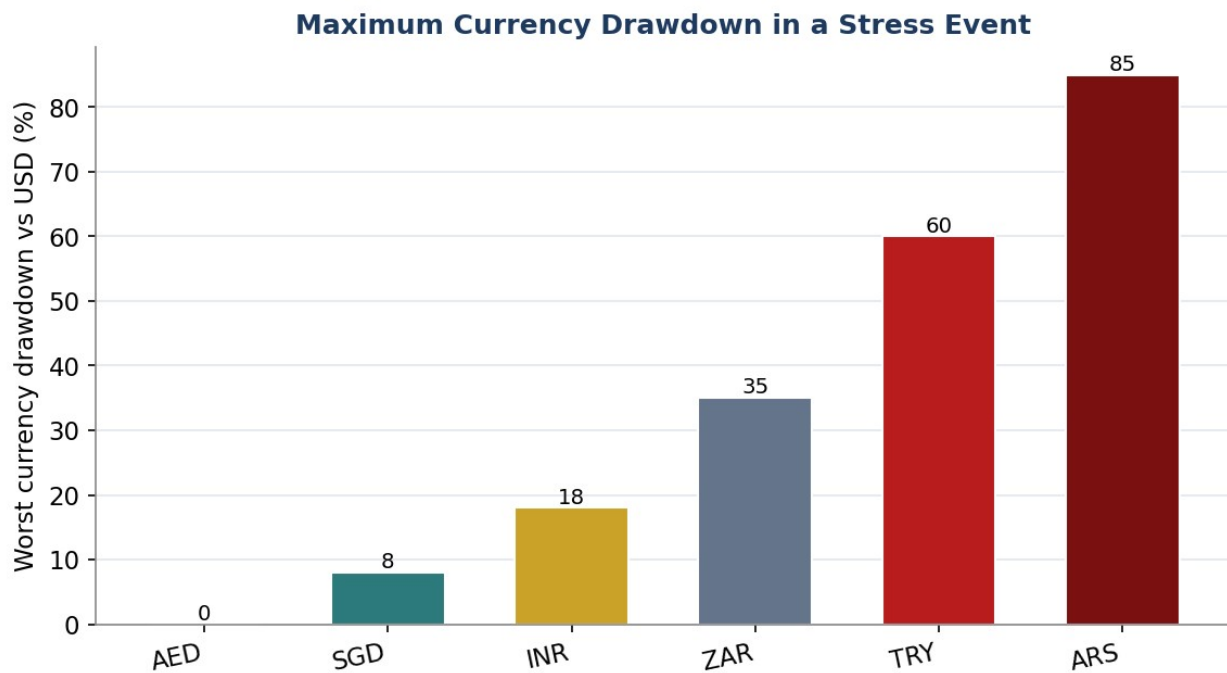
Indicative annual hedging cost; AED-linked exposure is effectively a USD exposure, hedgeable cheaply.

Because a United Arab Emirates allocation is, in currency terms, effectively a dollar allocation, a sterling- or euro-based investor faces not an illiquid local-currency exposure but a dollar exposure that can be hedged in the deepest and most liquid currency markets in the world, at low cost. This is the substance of Proposition 2. The contrast with a genuine emerging-market allocation is stark: hedging an emerging-market currency, where it is possible at all, is expensive and often illiquid, so the investor either bears the full currency risk or pays heavily to reduce it. The peg converts a difficult and costly hedging problem into a simple and cheap one, which materially improves the net outcome for non-dollar investors.

4.4 The Drawdown Profile

Volatility understates the true danger of emerging-market currency exposure, which lies in the tail: the sudden, large devaluation. Figure 4 compares the worst drawdown experienced by each currency in a stress event.

Figure 4. Maximum Currency Drawdown in a Stress Event



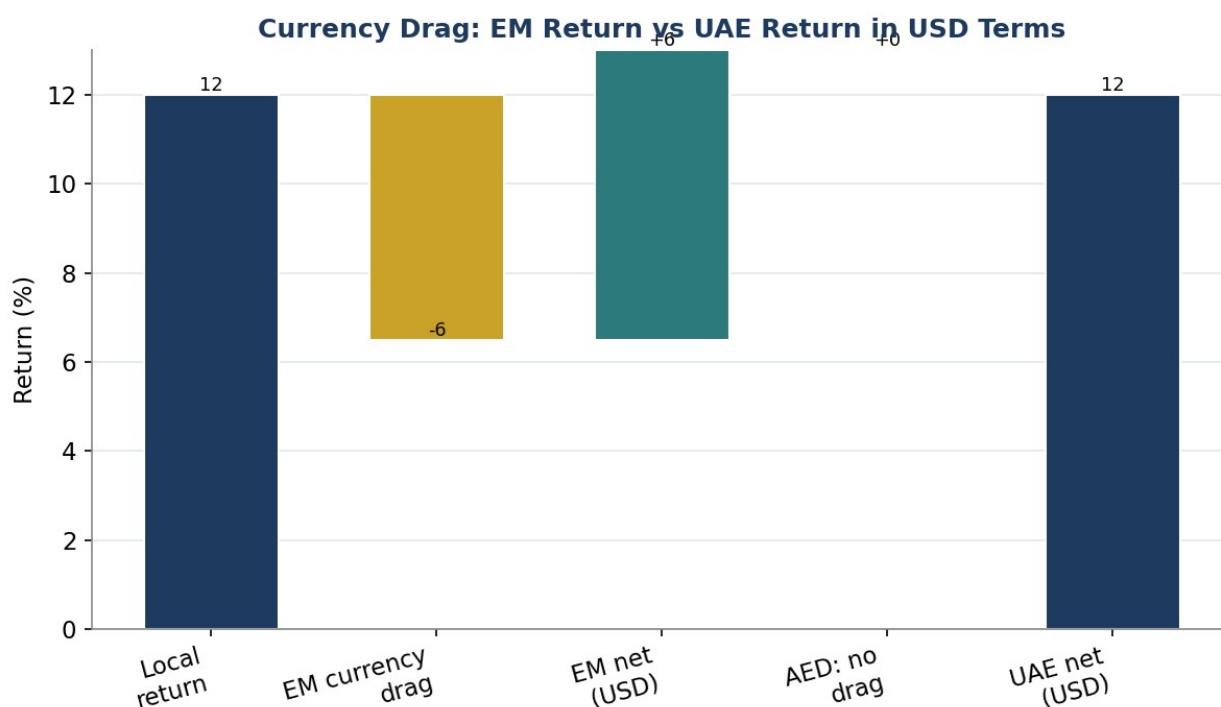
Indicative worst peak-to-trough currency move vs USD; the peg removes the devaluation tail.

The drawdown comparison reveals what the volatility figures alone do not: emerging-market currency risk is dominated by the possibility of a sharp, discontinuous devaluation that can erase years of local-currency return in a single episode. The peg, by design and by the resources that support it, removes this tail. This is the substance of Proposition 3, and it is arguably the most important result in the paper, because it is precisely the tail risk, rather than ordinary volatility, that does the greatest damage to an emerging-market allocation and that is hardest to hedge or diversify away. An allocation whose currency cannot suddenly devalue is, in this specific and important respect, closer to a developed-market than to an emerging-market allocation.

4.5 Decomposing the Currency Drag

The cumulative effect of these differences is the currency drag that separates the return an investor earns locally from the return they keep in their home currency. Figure 5 decomposes this for a comparison in which the local-currency return is held equal.

Figure 5. Currency Drag: Emerging-Market versus United Arab Emirates Returns in USD Terms



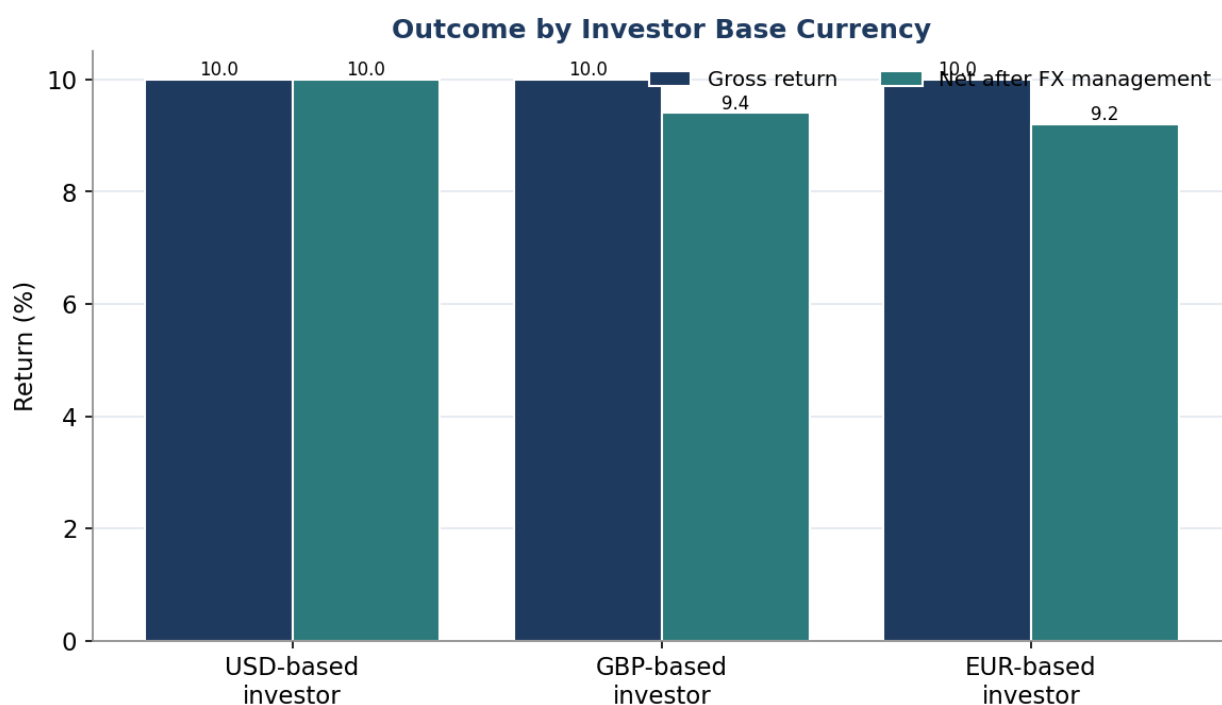
Indicative; an equal local return yields a far higher USD return where there is no currency drag.

The decomposition makes Proposition 4 concrete. Two assets earning the same local-currency return deliver very different returns in the investor's home currency once the currency effect is applied: the emerging-market asset surrenders a large slice to currency depreciation, while the United Arab Emirates asset, with no drag, delivers its local return substantially intact. This is not a difference in the quality of the underlying assets; it is a difference in the currency regime, and it accrues every year. Over a multi-year horizon the compounding of this annual difference is large, and it is invisible to an analysis that compares local-currency returns without netting the currency effect, an error the peg makes it easy to avoid for the United Arab Emirates and difficult to avoid for floating emerging markets.

4.6 The Experience of Different Base Currencies

Figure 6 reports the net outcome for investors of three base currencies, to show how the residual currency consideration differs across them.

Figure 6. Outcome by Investor Base Currency



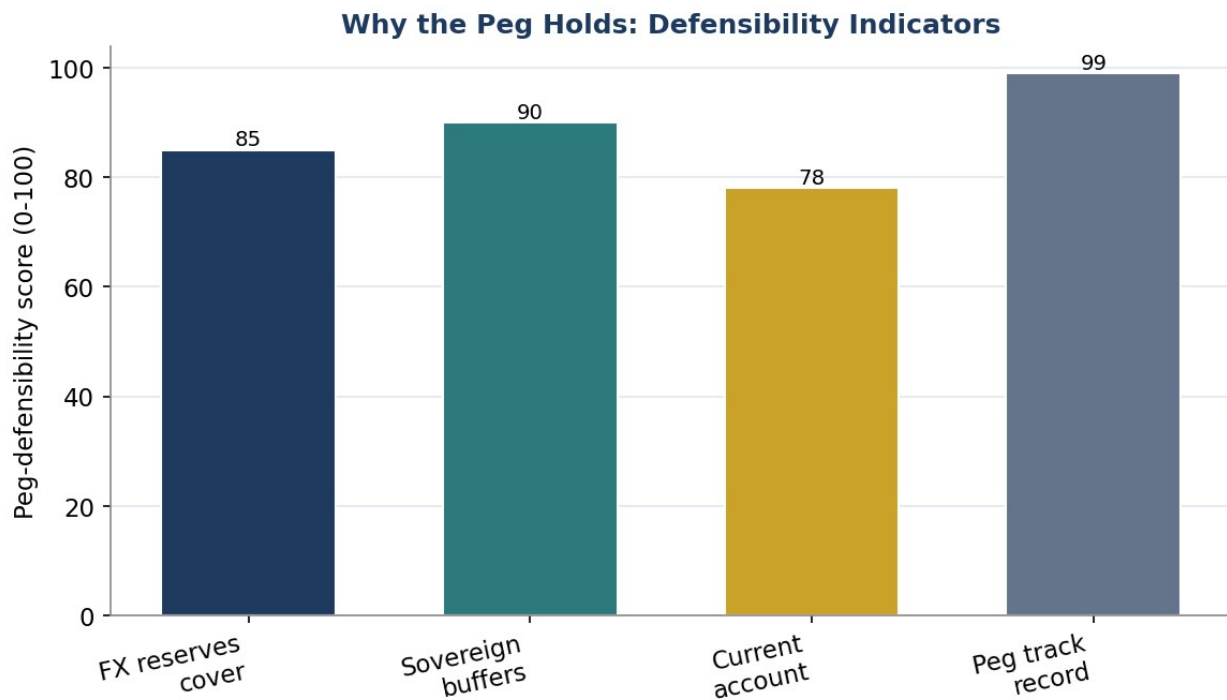
Indicative net outcome after currency management for USD, GBP and EUR-based investors.

For the dollar-based investor the outcome is the cleanest: the peg means there is effectively no currency risk to manage, and the local return is the home-currency return. For sterling- and euro-based investors there is a residual dollar exposure, but, as Section 4.3 established, it is cheaply hedgeable, so the net outcome after currency management is only modestly below the dollar investor's and far above what a comparable floating emerging-market allocation would deliver. The general point is that the peg benefits every international investor in a United Arab Emirates allocation, completely for the dollar-based and substantially for others, which is why it should feature in the allocation decision of all of them rather than being treated as relevant only to dollar investors.

4.7 The Defensibility of the Peg

The results so far establish what the peg does for investors; they depend, however, on the peg being maintained, which makes its defensibility the decisive question. Figure 7 summarises the indicators the currency-crisis literature associates with durable fixed regimes (Krugman, 1979; Obstfeld, 1996).

Figure 7. Why the Peg Holds: Defensibility Indicators



Indicative assessment against the indicators the literature associates with durable pegs.

On each indicator the United Arab Emirates scores strongly. Foreign-exchange reserves and sovereign buffers are substantial relative to the monetary base and to plausible outflows, providing the firepower to defend the rate; the external position is structurally in surplus, removing the chronic current-account deficit that precedes most peg failures; and the policy commitment to the peg has been sustained and credible across four decades and multiple shocks. The literature is clear that pegs break when reserves are inadequate, fundamentals are weak and the authorities lack the resources or will to resist pressure (Krugman, 1979); the United Arab Emirates exhibits the opposite of each condition. This supports Proposition 5 and justifies treating continuation as the central case, while Section 5 examines what an investor should conclude if that case is wrong.

4.8 The Peg and the Predictability of Returns

Beyond the level of risk, the peg affects the predictability of returns in a way that matters for institutional investors with liabilities to meet. A floating emerging-market currency injects a large, hard-to-forecast component into the home-currency return of an allocation, so that even a well-performing local portfolio can deliver an erratic and occasionally sharply negative result once translated. The peg removes this component, so that the home-currency return of a United Arab Emirates allocation tracks the local-asset performance closely rather than being buffeted by currency moves. For a pension or insurer matching assets to liabilities, this predictability has value in its own right, independent of the level of return, because it reduces the funding-ratio volatility that currency surprises would otherwise introduce. The peg therefore improves not only the risk-adjusted return but the reliability with which that return is delivered, a benefit that a volatility figure alone does not fully capture.

4.9 What the Peg Does Not Remove

Intellectual honesty requires being equally clear about what the peg does not do. It does not remove the underlying asset risk of a United Arab Emirates allocation: real estate can fall, credit can default, and equities can decline, and the peg offers no protection against these. It does not remove the region's residual link to the hydrocarbon cycle, nor the liquidity and concentration risks that attend any allocation to a younger and smaller market. It does not remove geopolitical risk. And it does not make the allocation a substitute for diversification across the rest of the portfolio. The peg addresses one specific risk, currency, and addresses it well; it should be valued precisely for that and not oversold as a general guarantee. The correct reading is that the peg removes the single risk that most distinguishes emerging-market from developed-market investing, leaving the investor to assess and be compensated for the genuine asset risks that remain, which is exactly the assessment an allocator is equipped to make.

4.10 The Peg Through Historical Shocks

The most persuasive evidence for the durability of a peg is its behaviour through past stress, and the dirham's record is instructive. Over four decades the peg has been maintained through episodes that tested many other currencies severely: sharp falls in the oil price, global financial crises, regional geopolitical shocks and prolonged periods of dollar strength that pressured emerging-market currencies worldwide. In each case the arrangement held, supported by the deployment of reserves where necessary and by the structural external surplus that replenishes them. This track record is not a guarantee of future maintenance, and the analysis does not treat it as one, but it is strong evidence of both the capacity and the will to defend the peg, the two factors the currency-crisis literature identifies as decisive (Krugman, 1979; Obstfeld, 1996). A peg that has survived repeated genuine stress, rather than merely a benign period, has demonstrated the resilience that gives an investor reasonable confidence in its continuation, and it stands in marked contrast to the many emerging-market pegs that have broken when comparable pressures arrived without comparable supporting resources.

4.11 Currency and Real Returns

A final dimension concerns real, inflation-adjusted returns, which are what ultimately matter to a long-horizon investor preserving purchasing power. A floating emerging-market currency that depreciates is frequently doing so in part because of higher domestic inflation, so the investor suffers a double erosion: the nominal currency loss and the inflation that accompanies it. The dirham peg, by importing the monetary discipline of the anchor currency, tends to deliver inflation outcomes closer to those of the dollar bloc than to those of high-inflation floating economies, so that the real return an investor earns is less likely to be undermined by a domestic inflation-and-depreciation spiral. This does not mean the United Arab Emirates is immune to inflation, periods of strong local demand can raise prices, but it does mean that the corrosive combination of currency collapse and runaway inflation that destroys real returns in the weakest emerging markets is structurally less likely under the peg. For an investor whose objective is the preservation and growth of real wealth, this is a meaningful and often overlooked dimension of the peg advantage.

4.12 The Cumulative Drag Over a Holding Period

The annual figures examined so far understate the importance of the currency effect, because the drag compounds over the multi-year horizons that institutional investors hold. An annual currency drag of several percentage points, applied year after year to a floating emerging-market allocation, compounds into a very large cumulative erosion of home-currency wealth over a

decade, frequently exceeding the cumulative effect of differences in management fees or even in gross asset performance. For the United Arab Emirates, where the drag is negligible, this compounding works in the investor's favour: the local return is retained substantially intact year after year, so that over a long horizon the gap between the home-currency outcomes of an equal-local-return pegged and floating allocation widens dramatically. The practical lesson is that the currency advantage of the peg is not a one-year curiosity but a compounding structural benefit whose magnitude grows with the holding period, which is precisely the horizon over which pensions, insurers and endowments invest. An assessment that compares a single year understates the advantage; an assessment over a realistic horizon reveals its full scale.

4.13 The Peg, Capital Flows and Repatriation

A practical corollary of the peg, combined with the United Arab Emirates' open capital account, concerns the ease and predictability of moving capital in and out of the allocation. Because there are no exchange controls and the currency is freely convertible at a stable rate, an investor can deploy and repatriate capital without the conversion risk, delay or trapped-capital problem that afflicts allocations to economies with managed or restricted currencies. This matters for the realised experience of an allocation in two ways. It means that the value an investor sees on paper is the value it can actually convert and repatriate, rather than a local-currency figure subject to an uncertain conversion; and it means that the liquidity of the allocation, already constrained by the illiquidity of private assets, is not further impaired by currency conversion frictions. The peg and the open capital account together make the United Arab Emirates unusually straightforward among growth markets for the practical mechanics of cross-border investment, a feature that complements the risk-reduction benefits examined elsewhere in this paper and that should be weighed alongside them.

4.14 The Peg and Portfolio-Level Risk Budgeting

The currency advantage of the peg also changes how a Gulf allocation consumes an institution's risk budget, which is the practical currency in which allocation decisions are ultimately made. Every position in a portfolio is allocated a share of the total risk the institution is willing to bear, and an emerging-market allocation typically consumes a large share precisely because its currency risk is high and uncompensated. By removing that currency component, the peg lowers the risk-budget cost of a United Arab Emirates allocation relative to a floating emerging-market allocation of the same size, which means the institution can hold more of it, or hold it alongside other risks, without breaching its budget. This reframing matters because risk budgets, rather than nominal allocation limits, are increasingly how sophisticated institutions govern their portfolios, and an allocation that delivers growth-market returns while consuming closer to developed-market risk budget is unusually efficient in those terms. The peg, in this sense, improves not only the standalone risk-adjusted return of the allocation but its efficiency as a consumer of the scarce resource, risk capacity, that the institution must ration across all its holdings.

This budgeting perspective also clarifies why correcting the currency classification is not a marginal adjustment. An institution that books the allocation at an inflated emerging-market risk level will find it consuming more of the budget than it should, which crowds out other positions and biases the institution toward under-allocation; correcting the figure frees budget and permits a more accurate, and generally larger, allocation. The error of misclassification is therefore not confined to the Gulf line item but propagates through the whole portfolio via the risk budget,

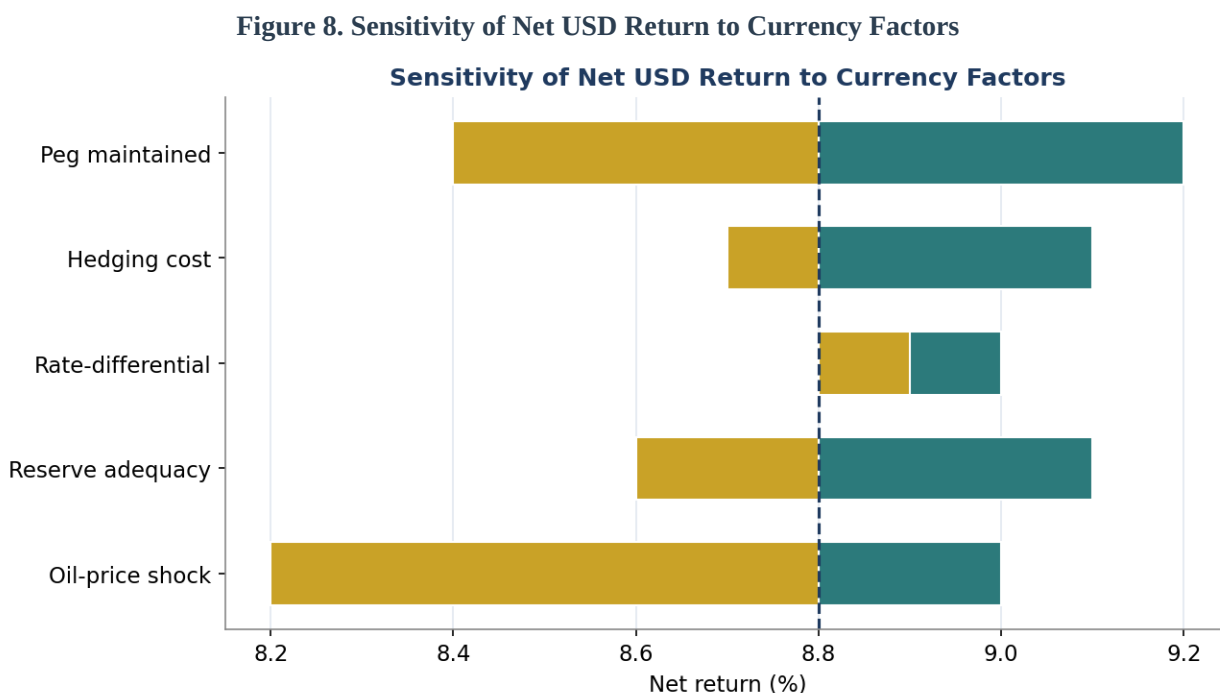
which is a further reason to take the peg seriously in the institution’s risk framework rather than treating it as a footnote.

5. ROBUSTNESS AND SCENARIO ANALYSIS

A disciplined analysis must test the result against its key uncertainties and against the scenario in which the central assumption fails. This section reports a sensitivity analysis of the currency factors and a stressed scenario in which the peg itself is placed under pressure.

5.1 Sensitivity to Currency Factors

Figure 8 reports the sensitivity of an investor’s net dollar return to the principal currency factors, each varied around the base case.



Each bar shows the swing in net return from varying one currency factor around the base case.

The maintenance of the peg dominates the result, as expected: it is the assumption on which the entire benefit rests, and the analysis is candid that the result is conditional on it. Hedging cost, the rate differential between dollar and home-currency interest rates, reserve adequacy and the oil-price environment matter at the margin but are secondary. The ordering directs the investor’s attention appropriately: the question that matters is not the fine calibration of hedging cost but the durability of the peg, which is why this paper devotes explicit attention to defensibility rather than treating the peg as a given.

5.2 The Stressed Scenario: Pressure on the Peg

The scenario that matters is one in which the peg comes under sustained pressure, for example through a prolonged collapse in hydrocarbon revenues, a deep and lasting divergence in monetary conditions, or a regional shock that drains reserves. In such a scenario the authorities would face the classic choice: deploy reserves and policy to defend the rate, or allow an adjustment. The historical record and the strength of the supporting fundamentals suggest defence is the likely and feasible response, but a prudent investor should consider the consequence if it were not. Were the peg to be adjusted, a United Arab Emirates allocation would, in that event, take on a currency risk

closer to that of an emerging market, and the currency advantage documented in this paper would diminish.

Two points temper this. First, the same sovereign resources that make defence feasible also make a disorderly, large devaluation, of the kind seen in weaker emerging markets, less likely than a managed adjustment, so even the adverse scenario is unlikely to resemble the worst emerging-market tail. Second, the appropriate response to this risk is not to forgo the allocation but to size it sensibly and, for non-dollar investors, to maintain the cheap hedging the peg makes available, so that the exposure is managed rather than unhedged. The benefit of the peg, in other words, is robust in the central case and degrades gracefully rather than catastrophically in the adverse one, which is the honest characterisation of any feature that depends on a policy commitment, however well-supported.

5.3 Comparison with Other Stable-Currency Options

It is reasonable to ask whether an investor seeking currency stability could simply obtain it elsewhere, and the comparison clarifies what is distinctive about the United Arab Emirates. Developed markets offer currency stability but not the growth and private-markets return premium that the region provides; the investor gains stability at the cost of the very returns it is seeking. Other pegged or heavily managed emerging-market currencies exist, but few combine the peg with the reserve strength, structural external surplus and four-decade track record that make the United Arab Emirates peg credible, and several historical pegs elsewhere have broken precisely because those supports were absent (Obstfeld, 1996). The distinctive feature of the United Arab Emirates is therefore the conjunction of a credible peg with an emerging-market growth and return profile: currency stability without surrendering the return premium, and a return premium without the currency tail risk. It is this combination, rather than currency stability alone, that the investor cannot readily replicate, and it is the reason the peg matters as part of the broader case for the region rather than as an isolated feature.

5.4 Monitoring the Assumption: Indicators to Watch

Because the benefit is conditional on the peg, a prudent investor should monitor a small set of indicators that would signal any erosion of its supports, rather than treating the arrangement as permanent or, conversely, worrying about it without evidence. The first is the level and trend of foreign-exchange reserves relative to the monetary base and to short-term external obligations, since adequate reserves are the proximate means of defending the rate. The second is the external balance, where a shift from structural surplus to persistent deficit would be an early warning. The third is the fiscal position and the breadth of economic diversification, which determine the sovereign's capacity to support the peg through a prolonged commodity downturn. The fourth is the policy posture itself, including any official commentary on the exchange-rate regime. None of these indicators currently suggests pressure on the peg, but establishing a routine to monitor them converts the central assumption of this paper from an article of faith into a managed risk, and it is the appropriate institutional response to a benefit that is large, durable and nonetheless conditional.

5.5 The Peg versus Active Currency Management

It is instructive to contrast the certainty the peg provides with the alternative an investor would otherwise face, namely managing emerging-market currency exposure actively. Active currency management, attempting to forecast and trade around currency moves, is difficult, resource-

intensive and, the evidence suggests, an unreliable source of added value for most investors; currencies are among the hardest variables to forecast, and the costs of trading and being wrong are real. An investor in a floating emerging market must therefore either bear the full, uncompensated currency risk or commit resources to a currency-management programme whose success is uncertain. The peg removes this dilemma entirely for a United Arab Emirates allocation: there is no volatile currency to forecast or trade, and the residual dollar exposure of non-dollar investors is managed mechanically and cheaply through standard forwards rather than through active judgement. The peg thus substitutes a certain, low-cost outcome for an uncertain, resource-intensive one, which is a benefit beyond the simple reduction in volatility, because it also removes a demand on the institution's scarce analytical resources and the risk of currency-management error.

This contrast sharpens the practical case. An institution weighing a floating emerging-market allocation must budget not only for the currency risk but for the cost and uncertainty of managing it; an institution weighing a United Arab Emirates allocation faces neither. The saving is real even though it does not appear as a line item, because it is the avoided cost of a problem the investor never has to solve. When the full comparison is drawn, including the avoided management burden alongside the avoided risk, the peg advantage is larger than a comparison of volatilities alone conveys, and it weighs in favour of the United Arab Emirates relative to floating alternatives offering similar underlying opportunities.

6. IMPLICATIONS FOR CLASSIFICATION, SIZING AND HEDGING

The analysis carries direct implications for how an international investor should treat the United Arab Emirates, and these follow from taking the peg seriously as a structural feature rather than an incidental one.

6.1 Classification

The most important implication is that the United Arab Emirates should not be assessed with the currency assumptions applied to floating emerging markets. The peg removes the currency volatility and devaluation risk that define emerging-market currency exposure, which means that the risk an investor actually bears in a United Arab Emirates allocation is, on this dimension, closer to a developed-market profile. An investor whose internal classification and risk modelling apply an emerging-market currency assumption to the region is overstating the risk and, in consequence, under-allocating. Correcting the classification is a low-cost change that materially improves the assessed risk-adjusted attractiveness of the allocation.

6.2 Sizing

Because the peg lowers the risk borne, it raises the allocation that a given risk budget can support. An investor sizing a Gulf allocation against an emerging-market currency assumption will size it too small; correcting the assumption permits a larger allocation for the same risk. This does not imply abandoning prudence, the concentration, liquidity and other risks discussed in the broader literature on Gulf allocation remain, but it does imply that the currency dimension, which often constrains emerging-market sizing, is not the binding constraint it would otherwise be.

6.3 Hedging

For the dollar-based investor, the practical hedging implication is that little or no currency hedging is required, which removes a cost and an operational burden that an emerging-market

allocation would impose. For sterling- and euro-based investors, the implication is that the residual exposure is a dollar exposure to be hedged in deep, liquid markets at low cost, and that this hedging should be undertaken as a deliberate policy rather than left to chance. In both cases the peg simplifies the currency-management problem dramatically relative to a floating emerging-market allocation, and the investor should capture that simplification explicitly in its operating model.

6.4 Operational and Governance Considerations

Translating the peg advantage into practice requires a small number of operational and governance steps that an institution should formalise. The currency policy for the allocation should be set deliberately and documented: for a dollar-based investor, a policy of holding the exposure unhedged is appropriate given the peg; for a sterling- or euro-based investor, a policy of hedging the residual dollar exposure, to a defined ratio and with stated instruments, should be adopted and reviewed periodically rather than left to ad hoc decision. The institution should also incorporate the peg correctly into its risk systems, so that the allocation is modelled with its true, low currency risk rather than an inherited emerging-market assumption, since an incorrect risk input will distort both sizing and reporting. Finally, governance should include periodic review of the peg's supporting fundamentals, reserves, the external balance and policy posture, so that the institution monitors the one assumption on which the benefit depends rather than taking it for granted. These steps are modest, but they convert the analytical advantage of the peg into a managed feature of the portfolio.

6.5 A Currency-Management Decision Framework

The practical guidance of this paper can be drawn together into a short decision framework that an institution can apply when establishing a United Arab Emirates allocation. The first step is to classify the exposure correctly, recording it in risk systems with the low currency risk the peg warrants rather than an inherited emerging-market assumption. The second step is to determine the residual currency exposure relative to the institution's base currency: negligible for a dollar-based investor, and a hedgeable dollar exposure for others. The third step is to set a documented currency policy appropriate to that exposure, no hedging for the dollar-based investor, and a defined hedging ratio executed in liquid markets for sterling- and euro-based investors. The fourth step is to size the allocation against the corrected, lower risk, recognising that the currency dimension is not the binding constraint it would be for a floating emerging market. The fifth step is to establish ongoing monitoring of the peg's supporting fundamentals, so that the institution tracks the single assumption on which the benefit depends. Applied in sequence, these steps convert the analytical advantage documented in this paper into a deliberately managed feature of the portfolio, and they ensure that the institution captures the full benefit of the peg rather than allowing an outdated classification to obscure it.

6.6 Bringing the Implications Together

Taken together, the implications of this analysis describe a coherent change in how an international investor should treat the United Arab Emirates. The investor should reclassify the region's currency risk to reflect the peg rather than an inherited emerging-market assumption; should size the allocation against that lower risk, recognising that currency is not the binding constraint it would be elsewhere; should set a deliberate currency policy, unhedged for dollar investors and cheaply hedged for others; should form return expectations on a net, currency-adjusted basis rather than by comparison with the headline returns of higher-risk-premium

floating markets; and should monitor the supporting fundamentals so that the one conditional assumption is managed. None of these steps is costly or complex, and together they ensure that the investor captures the full benefit of a feature that the analysis has shown to be large and durable. The thread connecting them is the discipline of assessing the region on its actual characteristics rather than on the assumptions bundled into its conventional classification.

6.7 Communicating the Advantage to an Investment Committee

A final practical implication concerns how the peg advantage should be presented to the decision-making body that ultimately approves an allocation. Investment committees are, rightly, conditioned to treat exposure to growth markets with caution, and the word that most often triggers that caution is the emerging-market label and the currency risk it implies. The analysis of this paper suggests that the most effective way to present a United Arab Emirates allocation is to lead with the currency regime, framing the opportunity not as an emerging-market bet to be justified against its risks but as a growth allocation whose principal emerging-market risk, the currency, has been structurally removed by a durable peg. Supporting that framing with the comparative evidence on volatility, drawdown and currency drag set out here allows the committee to see the allocation for what it is rather than for what its conventional label implies. The communication task, in other words, is to replace an inherited assumption with evidence, and the peg provides the single most compelling piece of that evidence.

This is not a matter of presentation alone but of accurate decision-making. A committee that approves or rejects an allocation on the basis of a mis-specified currency risk is making a worse decision than one that sees the true risk, regardless of which way it ultimately decides. The contribution of a clear account of the peg is therefore to improve the quality of the decision, by ensuring that the risk the committee weighs is the risk the institution would actually bear. Whether the committee then chooses to allocate depends on the full range of considerations examined across this and the companion analyses, but it should at least make that choice with the currency dimension correctly understood, which is the modest but important aim of this paper.

7. CONCLUDING COMMENTS

This paper has examined the effect of the dirham's four-decade peg to the United States dollar on the risk borne by international investors in United Arab Emirates assets, and has argued that the peg is a materially undervalued, structural reduction in that risk. The findings are consistent across the propositions. The dirham's currency volatility against the dollar is negligible, far below the emerging-market range and close to zero for a dollar-based investor (Proposition 1). The residual exposure faced by non-dollar investors is effectively a dollar exposure, hedgeable cheaply in deep and liquid markets (Proposition 2). The peg removes the devaluation tail that dominates the drawdown profile of emerging-market currencies and does the greatest damage to returns (Proposition 3). As a result, the currency drag that separates local from home-currency returns, large and negative for many emerging markets, is negligible for the United Arab Emirates (Proposition 4). And the peg is supported by the reserves, sovereign buffers, external surplus and policy track record that the literature associates with durable fixed regimes, so its continuation is the central case (Proposition 5).

The implications follow directly. An international investor who continues to assess the United Arab Emirates with the currency assumptions of a floating emerging market is overstating the risk, under-sizing the allocation and over-engineering, or simply forgoing, the hedging that the

exposure actually requires. Correcting for the peg, classifying the region appropriately, sizing against the true risk and managing the residual dollar exposure deliberately, improves the assessed risk-adjusted attractiveness of a Gulf allocation at no cost beyond the recognition itself. The peg, in this sense, is not a detail to be noted and set aside but a structural feature that should change the allocation decision.

The argument is properly qualified. The entire benefit is conditional on the peg being maintained, and while the supporting fundamentals are strong and the historical record long, no policy commitment is unconditional. The honest characterisation is that the benefit is robust in the central case and degrades gracefully rather than catastrophically in an adverse scenario, particularly for an investor who sizes sensibly and hedges the residual exposure. The prudent conclusion is therefore not to treat the peg as a guarantee but to treat it as a strong, well-supported and persistent feature whose risk-reducing effect is large and whose failure mode is manageable.

The study is subject to limitations that also define its contribution. It is analytical and comparative rather than econometric: its quantitative comparisons rest on representative, clearly-labelled assumptions rather than on estimates from a comprehensive currency dataset, a choice appropriate to a framing argument but one that trades precision for transparency. The assessment of peg defensibility is qualitative and forward-looking, and reasonable observers may weigh the indicators differently. These limitations point to the natural avenues for further research: formal estimation of the currency-risk reduction the peg provides across asset classes and horizons; analysis of the historical behaviour of United Arab Emirates asset returns net of the small residual currency effect; and study of how the cost and availability of hedging the residual dollar exposure vary across market conditions. As the data infrastructure of the region's markets matures, the framing argument made here can and should be subjected to formal empirical test. In the meantime, the direction of the evidence is clear: the peg is a structural advantage that global investors, conditioned by an emerging-market classification, have been slow to price, and recognising it is among the simplest improvements an allocator can make to its assessment of the Gulf.

In sum, the contribution of this paper is to take a feature that is widely known but rarely priced, the dirham's peg to the dollar, and to assess rigorously what it does to the risk borne by an international investor in United Arab Emirates assets. The analysis suggests that the peg removes the largest and least-rewarded risk of an emerging-market allocation, that it does so durably given the fundamentals that support it, and that international investors, conditioned by an emerging-market classification, have been slow to incorporate this into how they classify, size and hedge a Gulf allocation. The practical recommendation is simple and low-cost: assess the United Arab Emirates with the currency assumptions its regime actually warrants, not those of the floating markets with which it is grouped. The propositions advanced here are framed to be testable, and their formal empirical examination as the region's data matures is the natural next step; but the direction of the evidence is already sufficient to warrant the reclassification, and with it a more accurate, and more favourable, assessment of the region's place in a global portfolio.

The broader lesson extends beyond the United Arab Emirates to the practice of classification itself. The case of the dirham illustrates how a single inherited label, "emerging market", can carry with it a bundle of assumptions, in this instance high currency risk, that do not in fact apply, and how the uncritical application of that label leads to the mis-measurement of risk and the mis-sizing of allocations. The remedy is to assess each market on the features it actually possesses

rather than on the category to which convention assigns it. For the United Arab Emirates, the feature that most demands this fresh assessment is the peg, and the conclusion of this paper is that an investor who looks past the label to the regime will find a currency risk profile far closer to the developed world than the emerging-market classification implies, and a Gulf allocation correspondingly more attractive than that classification suggests.

Finally, it is worth restating the limits of the claim so that it is neither oversold nor dismissed. The peg removes currency risk; it does not remove asset risk, cyclical risk, liquidity risk or geopolitical risk, each of which an investor must assess and be compensated for on its own terms. And the benefit is conditional on the peg's maintenance, which, though strongly supported by reserves, external surpluses and a four-decade record, is a policy commitment rather than a law of nature. Within those limits, however, the conclusion is robust: the single feature that most distinguishes the risk of investing in the United Arab Emirates from the risk of investing in a floating emerging market is the peg, and that feature works decisively in the investor's favour. An allocator that prices it correctly will assess the region more accurately, and more favourably, than the conventional emerging-market lens permits, and will be better positioned to capture the opportunity the region offers.

A closing observation concerns the trajectory of recognition. As more international institutions establish Gulf allocations and incorporate the peg correctly into their risk frameworks, the mispricing of the region's currency risk that this paper documents will gradually correct, and with it the under-allocation it produces. The investor who recognises the peg's significance early therefore benefits twice: from the risk reduction itself, and from establishing a position before the broader correction in classification narrows the opportunity. The argument of this paper is, in the end, that a feature hiding in plain sight, a four-decade currency peg, materially changes the risk of investing in the United Arab Emirates, and that the investors who price it correctly will both assess the region more accurately and act on it sooner than those who remain anchored to an outdated label.

DISCLOSURES

The author is an independent researcher and transaction advisor who advises institutional and family-office investors on matters including capital allocation and structuring related to the markets discussed in this paper, and may have professional or commercial interests in transactions involving the Gulf region. This paper is provided for information and educational purposes only; it does not constitute investment, tax or legal advice, an offer or solicitation, or a recommendation to buy or sell any security, currency or strategy. The figures presented are modelled and illustrative, are not forecasts, and should be independently verified. Currency arrangements can change; nothing here should be read as a prediction that any peg will be maintained or altered. Readers should obtain advice appropriate to their own circumstances and jurisdiction before acting.

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About the Author

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APPENDIX A. BASE-CASE ASSUMPTIONS

Table 2. Full Parameter Set for the Currency Analysis

Parameter	Indicative value
Dirham regime	Fixed peg to USD
Dirham volatility vs USD	~0.3% p.a. (negligible)
Singapore dollar volatility vs USD	~4.5% p.a.
Emerging-market currency volatility vs USD	6% to 22% p.a.
Hedging cost, AED-linked (USD) exposure	~0.1% p.a.
Hedging cost, GBP / EUR exposure	~1.8% to 2.2% p.a.
Assumed local return (comparison)	12% p.a.
Assumed EM currency drag	5% to 6% p.a.
Worst EM currency drawdown (stress)	up to 60%+
Worst AED drawdown (stress)	~0% (peg maintained)

APPENDIX B. GLOSSARY

The following terms are used in this paper. Definitions are provided for the general reader and are not intended as formal legal or accounting definitions.

Base currency The currency in which an investor measures and reports returns; currency risk arises when assets are denominated in a different currency.

Capital mobility The freedom of capital to move into and out of a country; the United Arab Emirates permits free capital movement alongside its peg.

Carry (interest-rate differential) The difference between interest rates in two currencies, which determines the cost or benefit of holding or hedging one against the other.

Currency drag The reduction in an investor's home-currency return caused by depreciation of the currency in which an asset is denominated.

Currency peg A policy under which a country fixes its exchange rate to another currency; the dirham is pegged to the United States dollar.

Currency risk The risk that movements in exchange rates change the home-currency value of a foreign asset or its returns.

Devaluation A deliberate or forced reduction in the fixed value of a currency relative to the currency to which it is pegged.

Dirham (AED) The currency of the United Arab Emirates, pegged to the United States dollar.

Drawdown The peak-to-trough decline in a value; here, the largest fall in a currency against the dollar during a stress event.

Exchange-rate regime The framework governing how a currency's value is determined, ranging from free-floating to fixed (pegged).

Fixed exchange rate An exchange rate held constant against a reference currency by policy, as distinct from a floating rate set by markets.

Floating exchange rate An exchange rate determined by supply and demand in the currency market, characteristic of most emerging-market currencies.

Foreign-exchange reserves Holdings of foreign currencies and assets by a central bank, used among other things to defend a peg.

Forward contract An agreement to exchange currencies at a set rate on a future date, the principal instrument used to hedge currency exposure.

Hedging Reducing or eliminating an exposure, here currency exposure, typically using forwards or other derivatives.

Home-currency return The return on a foreign asset measured in the investor's own currency, after the currency effect.

Local-currency return The return on an asset measured in the currency in which it is denominated, before any currency effect.

Peg credibility The market's confidence that a fixed exchange rate will be maintained, determined by reserves, fundamentals and policy commitment.

Reserve adequacy Whether a central bank's foreign-exchange reserves are sufficient to defend the currency against plausible outflows.

Tail risk The risk of rare but severe outcomes; in currencies, the risk of a sudden large devaluation rather than ordinary volatility.

Trilemma The principle that a country can maintain only two of three goals: a fixed exchange rate, free capital movement and independent monetary policy.

Volatility The degree of variation in a price or rate over time, commonly measured by standard deviation and used as a proxy for risk.

Open capital account An arrangement under which capital may move freely into and out of a country without exchange controls, as in the United Arab Emirates.

Risk budget The total amount of risk an institution is willing to bear, allocated across its holdings; lower-risk allocations consume less of it.

Risk premium The additional expected return investors demand for bearing a particular risk; a credible peg lowers the currency risk premium.

Safe-haven currency A currency, such as the US dollar, that tends to appreciate or hold value during periods of global market stress.

Convertibility The ability to exchange a currency freely for another at the prevailing rate; the dirham is freely convertible at its pegged rate.