KAMCO Research

GCC Monetary Union (GMU)

Are GCC Countries Ready For A Monetary Union ?

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The creation of a monetary union has been a primary objective among Gulf Cooperation Council (GCC) members since the early 1980s and significant progress has already been made in regional economic integration. The GCC states have unrestricted intra-regional mobility of goods, labor, and capital; regulation of the banking sectors is being harmonized; and in 2008 the countries established a common market.

A monetary union is where two or more countries share the same currency. It entails multiple countries giving up control over the supply of money to a central authority. Adjusting the money supply is a common tool for managing overall economic activity in any country, and changes in the money supply also affect the financing of government budgets. In theory, giving up control of a national money supply introduces new limitations on a country's economic policies, but in the case of most of the GCC countries, vast oil reserves and oil exports led economies reduce the effect of these limitations.

Convergence Criteria

Most of the convergence criteria for entry into the monetary union have already been achieved. The GCC countries are probably the most homogeneous among the unions, sharing a common history, language, and culture. They are mainly oil exporters (with the exception of Bahrain), are very open to trade and imported labor, have very flexible labor markets, and have complete factor mobility (ease of movement of labor and capital) within the group. Overall the GCC meets the generally accepted criteria for a single currency among its members, namely proximity (geographically), size, fluctuations of output (mainly oil), trade structure (export based), and inflation performance.

A set of five convergence criteria similar to those used in the run-up to the European Monetary Union, has been agreed on in principle. Although they are not preconditions for entry, by the end of 2008 the GCC countries had met almost all of the convergence criteria. The criteria are as follows:

1. Budget deficit lower than 3% of Nominal GDP, or 5% when oil prices are weak;
2. Public debt to GDP ratio lower than 60%;
3. Foreign Exchange Reserves in excess of four months imports;
4. Interest Rates not higher than 2% above the average of the lowest three countries rates;
5. Inflation not higher than 2% above the Average rate of the six states.

The exception was inflation, reflecting the higher inflation rates in Qatar, Kuwait and the UAE over the 2 years prior to the crisis. But recently these rates have sharply dropped on the back of weaker demand, consumer spending and property markets in the post global financial crisis period with the exception of Saudi Arabia and Oman where food prices have exerted a great deal of pressure and kept the price index at higher rates of 5.35% and 4.7% for 2010, respectively. But even in normal times, this inflation would not persist. In fact, the high inflation in these fast-growing economies is due to supply constraints arising from the rapid pace of implementing large spending programs and construction projects, and these pressures are expected to ease soon.

Table 1. GCC Countries Compliance with Convergence Criteria, December 2010

Country	Budget deficit	Public debt	FX Reserves	Interest Rates	Inflation
Bahrain	X	✓	X	✓	✓
Kuwait	✓	✓	✓	✓	✓
Oman	✓	✓	✓	✓	X
Qatar	✓	✓	✓	X	✓
Saudi Arabia	✓	✓	✓	✓	X
UAE	✓	✓	X	X	✓

X: does not meet specified criteria
Source: KAMCO Research, World Bank, IMF & GCC Central Banks

The recent crisis has forced GCC countries, along with many other countries across the world, to lower their discount rates in order to stimulate the stagnant credit markets and stimulate economic growth. This has caused the benchmark for the discount rate (average of the lowest three countries rates) to drop exposing Qatar and the UAE as having higher than benchmark rates. This incompliance is due to temporary conditions and is expected to start scaling upwards in tandem with the regional recovery in credit markets. In addition, increased government spending has resulted in an increase in government projected deficits over the next few years but exposing only Bahrain with an estimated budget deficit of 5.4% of the country's GDP.

Foreign exchange reserves are used by central banks to stabilize the value of the domestic currency through purchasing of the same. It is an important indicator of the ability of a country to repay foreign debt and for currency defense, and is used to determine credit ratings of nations. The incompliance by Bahrain and UAE in considered short term, especially the UAE, and does not possess great risk since the GCC plans to keep a peg on its proposed single currency.

The GCC monetary union has so far faced its share of setbacks including Oman and UAE announcements that it would not join the union along with Kuwait's announcement during May 2007 that it was changing its exclusive peg to the US dollar to an undisclosed peg to a currency basket, although it reaffirmed its commitment to join the GCC monetary union. Other key issues that need to be addressed for a successful launch of the union include:

1. In terms of monetary policy, there is a need for an institutional and governance framework to ensure smooth, transparent and effective monetary decisions;
2. GCC states will need to invest in building its statistical capacity in order to provide comparable, harmonized and timely economic and financial data;
3. Other areas that need investments are the development of financial infrastructure, including legal and regulatory platform.

Union Pros and Cons

The adoption of the GMU and single currency brings in a great deal of benefits to the single economies and the union as a whole. First, the elimination of transaction and accounting costs that are associated with bid-ask spreads and commission on foreign exchange transactions. Another benefit would be the removal of foreign exchange risk, which is considered a major obstacle to trade and cross border lending for any two economies; for the case of the GMU, this does not pose as a great benefit as it might in other unions since most of the currencies are pegged to the US dollar. Other benefits may include:

- **Bargaining power:** after establishing a single currency, the GMU will have an additional incentive to pursue their negotiation with other monetary blocks and form a stronger bargaining power;
- **More intra-trade:** given that all GCC member states have plans to diversify their economies and further develop the private sector along with the fact that the single currency would make GCC intra-trading cheaper than other alternatives, the GMU member countries are more likely to trade with each other. Thus, increasing synchronization of business cycles;
- **Economies of scale:** with more cross border trading, producers are likely to gain economies of scale along with the ease of price comparison brought by the single currency;
- **More potential investments:** The GMU will make the GCC region economic prospects more promising for both domestic and foreign investors, by lowering search costs to find investment opportunities, administrative procedures and offering a bigger market. Another important factor, is the prospect for bringing GCC national funds held abroad back for investment in local economies;
- **More integration:** the integration of financial markets in the GCC countries, coupled with its positive effect at the level of monetary and fiscal policies will enhance transparency and financial discipline at the regional level, a necessary condition for financial stability in the region. These are all factors that help attract more investment from national, regional, and international investors to the GCC countries;
- **More disciplined economic policy:** It also promises to offer more disciplined economic policy management by having members adopt appropriate policy measures that take the whole union into consideration.

But, at what cost? Besides the costs of forming a union, GMU member states will have to surrender its exchange rate and monetary policy instruments to a centralized union central bank. This is derived from the fact that when a member country relinquishes its national currency, it also relinquishes its ability to conduct a monetary policy. Under a monetary union, national central banks are no longer allowed to unilaterally take the initiative of altering exchange rate of the single currency or change the interest rate. Decisions of this type should be the responsibility of the newly established union-wide central bank. Such a cost however would not be significant in the case of the GMU since monetary policy already has a narrow room for maneuvering under the current pegged exchange rate system.

To Peg or Not to Peg?

In establishing a monetary union, however, the GCC countries must decide on the exchange rate regime for the single currency. The countries' use of a US dollar peg as an external anchor for monetary policy has so far served them well, but rising inflation in recent years has raised the question of whether the dollar peg remains the best policy. The conventional view on the choice of exchange rate regime has been that exchange rate flexibility allows for macroeconomic and financial stability in the face of real domestic shocks or foreign nominal shocks. Ideally, the exchange rate regime chosen should yield external stability, internal stability (low inflation), balance sheet stability, international competitiveness, credibility of monetary policy, and low transaction costs.

External stability is defined as a balance of payments position that is not likely to give rise to disruptive adjustments in exchange rates. A balance of payments position consistent with external stability is one in which both the underlying current account is broadly in line with its equilibrium level and the capital and financial account position does not create risks of abrupt shifts in capital flows. On the other hand, **balance sheet stability** deals with the impact of exchange rate volatility on the net open position of the financial and public sectors. **International competitiveness** of the non-oil tradable goods sector is related to how well the real exchange rate supports external trade, and changes in the nominal exchange rate can be an important indicator of the credibility of the domestic monetary policy stance. Similarly, exchange rate volatility can raise transaction costs in international trade and finance by increasing uncertainty and information needs. In applying these criteria, tradeoffs are usually necessary and political-economy considerations in the choice of regime may become relevant. Also, policy management considerations may dictate keeping an existing regime if no substantial gain is to be achieved by switching from one arrangement to another, and if the change would involve significant political or adjustment costs.

GCC countries have pursued economic policies consistent with exchange rate pegs. For instance, they have implemented appropriate fiscal policies and have flexible labor and product markets. GCC members have also accumulated significant foreign exchange reserves, underpinning the credibility of the peg and discouraging speculation against their currencies. All in all, from the standpoint of macroeconomic stability, the dollar peg has worked well in these countries, keeping inflation relatively low and strengthening confidence in the currencies and in the economies more generally.

Alternative Exchange Rate Regimes for the GMU

Given that inflation is an important area where control is still needed in terms of convergence criteria, two main arguments have been used to support alternative exchange rate regimes rather than the US dollar peg regime for the GMU. The first is that GCC countries can pursue domestic goals of inflation and output better if they had monetary policy independence. The second argument is that imported inflation, owing to a sustained depreciation of the US dollar, could be avoided by abandoning the US dollar peg regime. These arguments have not had sufficient merit in the past owing to the fact that, despite a significant depreciation of the US dollar, inflation in most

GCC countries have been subdued except for 2007-2008 and is currently stable at single digit rates. Alternatives for exchange rate regimes for the GMU include:

I. US dollar peg;
II. Managed floating;
III. Basket peg;
IV. Pegging to the export price of oil.

Table 2. GCC Member States Inflation Rates (2006 - 2011f)

(Percent)	2006	2007	2008	2009	2010	2011 f
Bahrain	2.04	3.25	3.53	2.79	2.6	2.50
Kuwait	3.09	5.47	10.62	3.95	3.8	3.59
Oman	3.44	5.89	12.61	3.54	4.7	3.50
Qatar	11.83	13.76	15.05	(4.87)	(2.4)	3.02
Saudi Arabia	2.31	4.11	9.87	5.06	5.4	5.30
United Arab Emirates	9.29	11.13	12.26	1.21	1.7	2.45
GCC Region	**4.3**	**6.3**	**10.8**	**3.2**	**4.2**	**4.2**

Source: KAMCO Research, GCC Central Banks & IMF

I. US Dollar Peg

Even though the share of trade between the GCC and the United States is comparatively low, a good case can be made for the GMU to continue pegging to the green back since almost all exports (primarily oil and gas) and a very high proportion of the external assets are US dollar denominated. A dollar peg ensures stability of income flows from abroad and stabilizes fluctuations in financial wealth. Although fluctuations in the value of the dollar against other reserve currencies could generate volatility in cross-rates between these currencies and the GCC currencies, the share of GCC non-oil exports is still relatively small, minimizing the impact of such exchange rate changes on external trade.

The dollar peg provides a strong and easily understood anchor for monetary policy. It is not possible to deviate too much from the US rate of inflation for an extended period of time. Yet, while inflation has been low in general, there have been significant differences between the GCC member states' inflation rates, which have led to diverging developments in their real effective exchange rates. One can argue that in this regard, price stability has to be supported by fiscal policy and by giving priority to implementing projects aimed at improving the economy's absorptive capacity. Furthermore, the familiarity of GCC authorities with this regime is an advantage to the current arrangement and keeping the single currency peg to the dollar would leave the public and policymakers on already familiar grounds. Other advantages for the system include:

- The regime simplifies trade and financial transactions, accounting and business planning;
- Easier monetary coordination among GMU member states;
- Exchange rate risk can be easily hedged.

II. Managed Floating

Managed floating is a system of floating exchange rates in which the government or the central bank intervenes to change the direction of the value of the currency through buying and selling of the currency. In most instances, the intervention aspect of a managed float system is meant to act as a buffer against an external economic shock before its effects become truly disruptive to the domestic economy. Letting the single GCC currency float against other currencies would have the advantage of allowing the GCC countries to use monetary policy to stabilize inflation and to promote the growth of the private non-oil economy by allowing the countries to absorb large adverse real shocks more easily than a fixed exchange rate regime. A more flexible exchange rate regime would also allow the countries to absorb large adverse real shocks more easily than a fixed exchange rate regime.

In light of the current structural characteristics of the GCC economies, however, it is questionable whether active monetary and exchange rate policies would achieve external stability. Furthermore, private sector investment and spending decisions depends on actual and projected government spending, limiting the role of financial markets and interest rates. Another issue remains in the choice of nominal anchor under the float where the two main criterion would be inflation targeting and monetary targeting. Inflation targeting requires a much more developed financial markets than it is currently in the GCC while monetary targeting requires a stable and predictable money demand function and the development of instruments and adequate forecasting ability to undertake efficient liquidity management. There are also risks associated with the managed floating regime, for example:

- Oil price swings can cause volatile exchange rates and eventually larger fluctuations in private sector output;
- Higher and more volatile inflation;
- Introduction of a new type of risk to international transactions;
- Complication of budgetary accounting and business planning;
- Insufficient financial markets would make hedging against exchange rate risk costly and probably impossible in the near term.

III. Basket peg

Pegging a currency to a 'Basket' of currencies, or Special Drawing Rights (SDR), could serve as a cautious move towards a more flexible exchange rate policy. With a basket peg, the main anchor properties of an exchange rate peg could be retained, while at the same time gaining some flexibility to react to negative effects of swings among the value of the major currencies. The volatility of the nominal effective exchange rate would be reduced, benefiting external trade and balance sheet stability. For example, a peg to the SDR would result in lower volatility of oil export receipts relative to the dollar peg.

Compared with fixing to a single currency, pegging to a basket of currencies has the disadvantage including:

- Traders will have to bear the exchange rate risk;
- It would be difficult and costly to hedge against exchange rate risk, especially in relatively underdeveloped financial markets;
- It reduces the microeconomic and informational benefits of maintaining fixed exchange rate for price comparisons and economic transactions;
- It tends to be less transparent and more difficult to explain to the public. The weights attached to the basket will have to be managed and lack of transparency could encourage speculative behavior, as the example of Kuwait shows.

On the other hand, pegging to a single major currency allows market participants to take advantage of instruments available for that major currency. What probably matters most is the extent of the higher exchange rate risk versus the reduced cost from lower exchange rate volatility.

IV. Pegging to the Export Price of Oil

Pegging the domestic currency to the export price of the main export product (PEP) has sometimes been contemplated for small open economies that are relatively specialized in the production and export of a particular mineral or agricultural commodity, which is oil in the case of the GMU. This approach is bound to decouple GMU's monetary policy from those that are oil importers through its automatic accommodation to terms of trade shocks while retaining credibility enhancing advantage of a nominal anchor.

There are several reasons why this type of regime would not be suitable for the GCC region, these reasons are as follow:

- The GMU would account for a significant part of total world output and exports of oil, hence, the small economy assumption is not applicable in this case;
- It is uncertain whether an automatic adjustment to terms-of-trade shocks would be effective under a PEP system where a decline in oil prices would result in a real depreciation. However, all adjustments would have to come through expanding non-oil exports or cutting imports due to constraints on oil production capacity and extraction limits, as well as the OPEC quota system. Furthermore, non-oil production is not independent from oil and gas production as non-oil exports also depend on hydrocarbon products for inputs;
- The PEP system would make import prices highly variable, as well as create significant volatility for other sectors of the economy where a consequence of high oil prices would be a real appreciation, which would raise the cost of other exports and dampen the diversification effort;

Conclusion

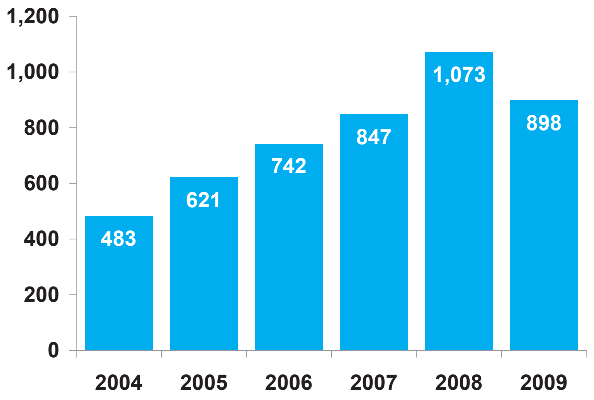
Given the longstanding peg to the US dollar by GCC currencies, and that it has provided a credible nominal anchor for monetary policy over these years, ensuring internal and external financial stability, the dollar peg seems to be the best option for, at least, the short term after the establishment of the GMU. During the run up to the union, the main challenge would be to keep inflation under control especially in an era of high government spending following the financial crisis and leading into a great phase of infrastructure development. This increased spending would mainly come from Qatar, after winning the bid to host Football World cup in 2022, Saudi Arabia, after its massive announced spending increase over the next five years, and Kuwait, which has vowed to turn the country into a financial and trading hub. Another challenge for keeping inflation subdued is the continued depreciation of the dollar against other major currencies.

Looking forward, the establishment of the GMU would require a harmonization of the financial market infrastructure, including regulatory and supervisory frameworks, clearing and settlement systems, standardization of financial contracts, as well as taxation and tariff agreements and labor policies.

Even though the US dollar peg seems like the best option for short term planning, it is important to keep the options open for the introduction of a more flexible exchange rate regime in the medium term. This conclusion comes from the fact that we do not expect to see a continuation of the depreciation of the US dollar nor do we see a diverging economic cycle relative to the United States. Furthermore, the decision for any exchange rate regime depends ultimately on the policy objectives and common preferences of the authorities involved.

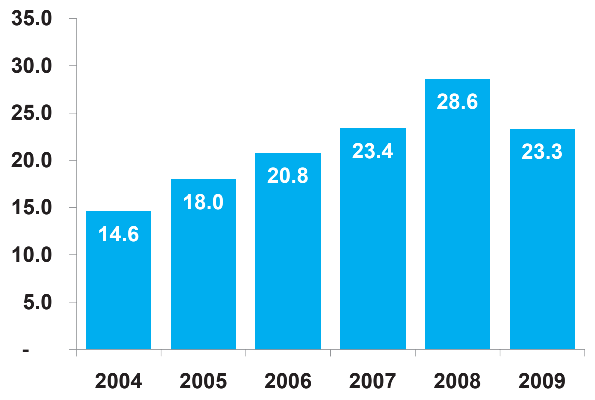
Appendix

GCC Historical Nominal GDP (USD bn)



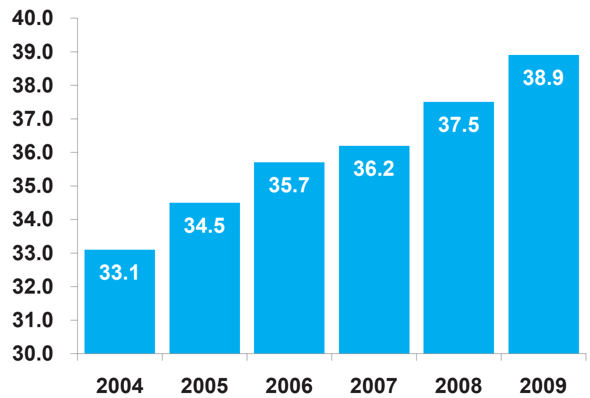
Source: KAMCO Research & GCC Statistics

GCC GDP Per Capital (000's USD)



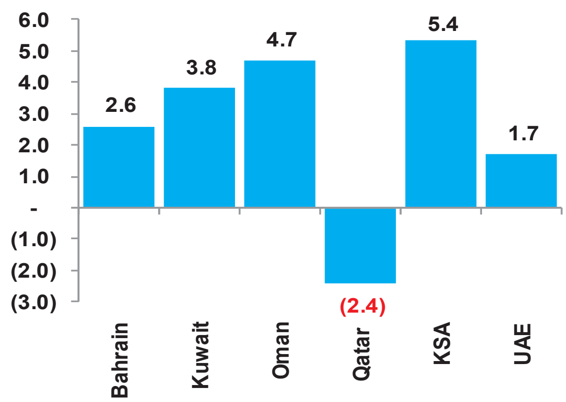
Source: KAMCO Research & GCC Statistics

GCC Population (mn)



Source: KAMCO Research & GCC Statistics

GCC Inflation 2010 (%)



Source: KAMCO Research & GCC Statistics

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