GULF COOPERATION COUNCIL MONETARY UNIFICATION

by

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ABSTRACT

In this report, I investigate the possibility of a monetary unification among the Arab States. The Gulf Cooperation Council (GCC) states that include Bahrain, Saudi Arabia, Qatar, UAE, Kuwait and Oman are coming together on the basis of common ethnicity, religion, culture, traditions, and monetary issues. This research will discuss different factors upon which the monetary unification and the birth of a new currency depend. For comparison to the Euro, I closely examined different factors such as inflation rates, exchange rates, trade, etc. over the past decade. As stated, this examination was done to see how these factors compare with those of the Euro region to determine if a similar monetary unification among the GCC states is possible. The target date for launching the new GCC currency was January 1, 2010; however that date has long passed. Although the above mentioned factors are favorable to currency unification of the GCC states, ample time is necessary to achieve such a herculean feat. After all, the Europeans did not achieve the unification of the Euro in one night. One hurdle to unification is that the GCC states still need to control the inflation rates in their own economies. Other economic factors, such as trade, have been favorable for all the GCC states, and all the states have been doing well in terms of the U.S. dollar (USD). Although unification may not have met the January 1, 2010 goal, the GCC will still be observing the economic factors and considering other possible scenarios. All the GCC countries vow to achieve this unification.

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CHAPER 1: INTRODUCTION

1.0 INTRODUCTION

The Arabian countries of UAE, Saudi Arabia, Bahrain, Kuwait, Qatar, the Republic of Yemen, and Oman, make up the Arabian Peninsula. The Gulf Cooperation Council (GCC) consists of these countries, except for Yemen. The introduction of a common currency was planned by the GCC states in 2001 to be in existence by 2010. The goal of unification or introducing of a common currency actually goes back to the 1980s, and this idea gained support after the success of a common currency in Europe (Benbouziane et al, 2010, p. 203).

1.1 HISTORY

In 1981, Saudi Arabia was the GCC's main force driving the idea of monetary unification. The main purpose behind establishing the GCC was to develop special relations among GCC members in areas such as trade, political system, investment, agriculture, security, industry, etc. The GCC was envisioned by the defense planning council for the regional common markets. The members of the GCC have a geographical proximity that allows them to adopt free-trade economic policies. Free trade among the GCC members began in 1983 when the tariffs on goods traded among them were eliminated. Through the 1980s and 1990s, the GCC worked to achieve common external tariffs for member countries. This common tariff was known as the GCC Custom Union (CU). GCC member countries reached an agreement in 2003, after the implementation of the CU in January 2003. This agreement led to the introduction of the GCC Common Market (CM) in January 2008 (Low & Salazar, 2011, p. 19).

1.2 OBJECTIVES

The primary objective in forming the GCC was the creation of a monetary union among the members. Another objective was to collectively confront member countries' security challenges. Examples of threats to the GCC members are the Iranians who are inspired by an Islamic activist, fundamentalists, and the Iran-Iraq war (Global Security, n.d.).

The supreme council of the GCC is the highest decision making entity and is populated by GCC heads of state who meet on an annual basis. The supreme council's decisions require unanimous approval to be implemented. The GCC members expect to have more foreign investment and intra-GCC trade because of the Common Market (CM). The CM agreement covers the establishment of public and private companies and deals with economic and investment services concerning the stock market. If the CM is followed by the planned monetary union, there is a likelihood that intra-regional trade will flow better. This trade flow should attract foreign investment to the region. The formation of the CM has benefited the GCC through high energy prices. Government revenues, the surplus current account, foreign asset accumulation, and a large boom in investment clearly reflect the positive impacts of the CM. The economic outlook seems quite favorable for these countries (Low and Salazar, 2011, p. 23).

The GCC is expected to earn 5 trillion to 9 trillion USD between 2007 and 2020 if the price of oil is above 50 USD per barrel. These expected earnings are more than double the earnings of the past 14 years (1993-2007). In 2008, the total net foreign assets of the GCC exceeded 2 trillion USD. As expected, this has resulted in a great interest by investors, regulators, and policy makers in the region (Streumer et al, 2008, p. 125).

1.2.1 Costs and Benefits of a Monetary Union

The unification of a currency in any nation comes with costs and benefits. Adopting a common currency requires each individual country to abandon its own monetary policy. Currency unification became a goal because of the real and anticipated benefits expected by the uniting nations. The benefits are discussed below (Alkholifey & Alreshan, 2010, p. 18).

1. One significant cost of trading has to do with bid-ask spreads and commissions on foreign exchange transactions; hence, unification would eliminate the transaction and accounting costs. Direct savings in transactions after adopting a single currency are probably larger for small and open economies with unsophisticated financial markets. Higher outputs and consumption gains might follow lower transaction costs.
2. Foreign exchange risk is a major obstacle to trade and cross border lending. Its removal would provide great opportunities to further expand the business between the countries. This would tend to intensify competition and increase allocative efficiency in small firms. If the exchange rate volatility is reduced to zero, then trade will be positively affected. With a common currency, the impact on trade will be even larger than the elimination of exchange rate volatility alone. Zero exchange rate volatility would be possible through a fixed exchange rate arrangement.
3. International price comparison would be much easier with the help of a more transparent pricing system.
4. More credible monetary policy can be gained by adopting the strongest exchange rate obligation.
5. The arrangements of monetary unions are less susceptible to speculative attacks.

Looking closely, one can see that there is homogeneity among the GCC countries in terms of sharing a common history, unions, culture, and language. The GCC countries, with the exception of Bahrain, share several common factors. They are exporters of oil, importers of labor, and open to trade. Except Bahrain, the GCC countries possess the adjustment of nominal wages with flexible labor markets and have full convertibility. It can be said that the requirements to achieve a common currency have already been fulfilled by the GCC states through the CM. A lot of effort has been put into fulfilling the GCC monetary policy, which has been very successful. Unrestricted intraregional mobility of goods, capital, and labor have already been virtually achieved by the GCC countries. For monetary unification, the GCC still needs to harmonize the prudential regulation and involve the banking sector's sharp eyes and supervision (Khan, 2008, p. 2).

A single GCC currency should encourage trade and financial integration as well as increase in the foreign investment. Even though it has been a decade since the GCC currencies have been de facto pegged to the US dollar, the question of "optimum currency area" still remains an unanswered question for the GCC states. The GCC has been provided the Monetary Union Agreement (MUA) draft by the European Central Bank (ECB) and the statutes of the Gulf Central Bank (GCB) and the Gulf Monetary Council (GMC). By the end of 2009, the GCC members and the GCC central banks established a monetary authority to prepare for the single currency and act as a transition body. The European Monetary Union agreed on the five criteria for convergence. Similar criteria have also been adopted by the GCC, in principal, and are as follows: interest rate, inflation, fiscal balance, reserves, and public debt (Table 1) (Khan, 2008, p. 3).

One of the structural characteristics of the GCC economies is the exchange rate regime. The government revenues, exports, and oil sector are extremely important to GDP. This GDP can be broken down in various ways. One way is to note three quarters of GDP is exports. Another is to note that government revenues equal three quarters of GDP, while another is to note that half of GDP comes from oil and gas. To further develop the non-oil private sector to enhance employment opportunities for the national labor force, the GCC needs to diversify their economies; this is a huge challenge and obstacle for the GCC states because the labor force is rapidly growing. At this point, the GCC must determine which exchange rate regime is most suitable to diversify their economies (Khan, 3008, p. 3-4).

There are currently two key dimensions of the currency regime in the GCC members: the internal exchange rate and the external exchange rate. The internal exchange rate is the exchange rate regime choice that concerns the GCC members in relation to the other members. The external exchange rate is the currency regime that concerns the GCC as a whole in relation to the rest of world. In general, the two cannot be specified independently. If each member of the GCC has a well defined regime for its own currency vis-à-vis some external currency or basket of currencies, this will determine a full "internal" relationship among the external values of the GCC's national currencies (Buiter, 2006, p. 1).

In addition, even if the GCC countries adopt a common currency, the management of that common currency on the basis of its external values is a major issue. As the GCC considers a monetary unification, it is facing some key issues. These issues are not just economic and technical in nature but are also political. Mastery of financial, economic, and technical matters is essential, as is a deep understanding of the political and historical perspective. The dominance of

the GCC countries in oil and gas production gives them the unique structural economic characteristic of needing diversification into tradable services. This would also require overcoming challenges in terms of financial, fiscal, exchange rate, and monetary management. Since the goal of the GCC states is one currency, the exchange rate regime must be capable of accommodating both cross-sectional heterogeneity and profound structural change over time. The political prerequisites for the sustainability of a currency for the GCC can be rewarding, but only if implementing an exchange rate regime is met. A unified currency is not an easy option and can end in drastic results if not taken seriously (Buiter, 2006, p. 3).

1.3 PREVIOUS UNIFICATION OF CURRENCIES

1.3.1 EU

Macroeconomic stability was one of the major objectives of the EU unification as well as the convergence process preceding it. Prior to the launching of the Euro, there was an impressive degree of budget balancing achieved. The economic factors improved significantly; between 1993 and 1998, the average financial deficit fell more than 5 percent of GDP. Another factor that can be the worst possible enemy of any country is inflation; inflation too significantly decreased. The average reduction in 1998 was over 4 percent, and inflation fell from as high as 10 percent in some countries to 1.5 percent (Almunia, 2006, p. 4).

The introduction of the Euro went well for its countries. The existence of the Euro, at least for the first seven years, turned out to be remarkably stable, especially as defined by the ECB. Some countries experienced a significant compression of short-term interest rates and a dramatic fall in the long term rates well after the introduction of the Euro. Also, the public debt

became much lighter as a result of the creation of the Euro. The strategy prepared by the ECB's financial sector is highly credible given the proven results (Table 12). Without any track record, the ECB started out as a central bank; the aforementioned achievements show that the ECB was a major success (Almunia, 2006, p. 5; Jygert, 2008, p. 36).

The elimination of exchange rate risk was the second key achievement of the European Monetary Union (EMU) in terms of the Euro. One of the major reasons for creating a unified currency, the Euro, was to reduce exchange rate risk. Elimination of the intra EMU exchange rate changes resulted in a reduction of transaction costs of cross-border activities. This automatically resulted in stronger trade and foreign investment. Trade among the EMU increased significantly after the introduction of the Euro in 1998; the amount of trade between EMU members and other members of the EU is less than the amount of trade among EMU members themselves. For the EMU, the Euro worked wonders; it took EMU countries to the top, and the Euro proved to be highly competitive with the US dollar. The introduction of a unified GCC currency may or may not have the same impact. However, the GCC needs to carefully analyze their economic, inflation, fiscal, and monetary factors if they wish the unification of the GCC currencies to bring them similar benefits (Almunia, 2006, p. 5).

CHAPTER 2: CHARACTERISTICS OF the GCC

2.0 MAIN ECONOMICS INDICATORS

The main economic indicators of the GCC are displayed in Table 2. In 2005, the GCC members as a whole had a GDP, based on purchasing power parity, of about 572 billion USD; this is roughly equal to one third of the GDP of France. The biggest economy among the six members is Saudi Arabia. Their GDP of 337 billion USD in 2005 made up 59 percent of the GDP of the whole block. The second largest economy is UAE with 19 percent of the total GDP of the six members. Bahrain has the smallest economy, comprising only 2.7 percent of the whole. The regions of Bahrain and Saudi Arabia have annual growth rates of 7 and 6 percent, respectively. About 35 million inhabitants were in the GCC area in 2004. Saudi Arabia had almost 68 percent of the population, roughly 24 million inhabitants. It is common knowledge that the GCC economies are oil dependent. The nominal GDP share of the petroleum sector in Qatar is 62.2 percent. In Saudi Arabia, 47.8 percent of the GDP is from the petroleum sector. The petroleum sector contributes 47.6 percent and 23.2 percent to the GDP of Kuwait and Bahrain, respectively (Hebous, 2006, p. 1-2).

In 2005, the weighted average GDP per capita of the GCC countries was 17,374 USD. Among the members, Qatar has the highest per capita GDP of 29,606 USD; this exceeds the average per capita GDP of Euro member countries of 28,702 USD. In terms of oil production, Saudi Arabia is the leader. However, despite this honor, Saudi Arabia has the lowest per capita GDP among the GCC members. It has a per capita GDP of 14,592 USD resulting in a difference of approximately 15,000 USD between the top and bottom GCC states. For the Euro member

countries, Luxembourg had the highest GDP per capita, and Portugal had the lowest. The difference of 47,500 USD is relatively large in comparison to the GCC difference (Hebous, 2006, p. 2).

2.1 BUSINESS CYCLE

The business cycles of the GCC countries are highly correlated due to their dependence on oil and oil activities. Higher oil prices lead to higher GDP for GCC countries (Figure 7). As shown in Figure 1, the deviation of the GDP from the Hodrick-Prescott trend is calculated for the GCC members, and it can be seen in the output gap. Note that Kuwait is excluded in the 1990-1991 Gulf War period. After unification, an individual GCC state would no longer be allowed to trade with its old currency, nor be able to use national monetary policies, since the currencies of the GCC states would be converted into one with a monetary policy that is performed by a union-level central bank. Analysis of the theory of the Optimum Currency Area shows this is particularly costly for a GCC member in the case of asymmetric shocks at the national level when exchange rate policy may be required. However, the likelihood of the occurrence of an asymmetric shock is small for the GCC states. Hence when forming the GCC monetary union, it is less costly to abandon the ability to follow the national policy according to the theory of the Optimum Currency Area. If the dependence on oil activities and oil itself can be reduced, the correlation between the GCC states' business cycles can be reduced (Hebous, 2006, p. 3).

CHAPTER 3: TRADE

3.0 TRADE

The fact that the GCC economies are open to international trade can be measured by the degree of openness, as defined by the ratio of exports plus imports to GDP. Table 3 shows that this ratio ranges from 73.6 in Saudi Arabia to 147 in Bahrain. In the 2004 list of the world exporters from the World Trade Organization (WTO), Saudi Arabia was ranked number 19. All GCC states are WTO members. Oil and oil products, including natural gas, are the primary exports of all GCC members. For Kuwait and Qatar, the share of oil products is 92 percent, and the share of gas products is 90 percent. Table 3 also shows that UAE has the smallest share of 35.8 percent (Hebous, 2006, p. 4).

Table 4 shows that Asia is the main export destination for all the GCC members. About 28.5 percent of the GCC‘s exports are purchased by Japan and South Korea. This share would reach 46.6 percent if China and India are added.

Table 5 shows the import side for the GCC; Asia and the EU are major partners of the GCC members. The EU is relied on heavily as the main source of imports for Kuwait, Oman, and Qatar, while the UAE relies on Asia as a major source of imports. The second biggest partner of the UAE is the EU. Investments in the GCC have been exceeded by the savings of these states. Over the last decade, this is an indication that all members exhibit trade surpluses with reference to their current accounts (Hebous, 2006, p. 4).

The intensity of the trade among the GCC members will determine the benefit from a monetary union; this is especially true if transaction costs are lowered. By introducing a unified currency, bilateral trade effects are also positive. Although the trade between GCC members is small, there has been a successful free trade area since 1983. Tables 4 and 5 illustrate the trade patterns between these areas. Generally, Table 5 shows small import shares for the GCC countries. Bahrain's import figure of 37.7 percent makes it an exception from the other GCC states. Since GCC states are similar in terms of their endowment, the small intrastate trade volume is not surprising at all. However, the intrastate trade ratios of non-oil exports are much larger in comparison to the overall intrastate export ratios (Table 6) (Hebous, 2006, p. 5).

In the last two decades, the GCC intra trade has increased. Figure 2 shows that, in 2003, Saudi Arabia's exports to GCC states were 6 billion USD. This is 25 million riyal in its own currency as compared to 5 million riyal in 1984. The main trade areas in the gulf are Bahrain and UAE. As compared to 2004, UAE had a very small share of the trade with Saudi Arabia in 1984 (Hebous, 2006, p. 5).

CHAPTER 4: MONETARY COMPONENTS

4.0 EXCHANGE RATE

Until 2001, the Qatar riyal, the UAE dirham, the Bahraini dinar, and the Saudi Arabian riyal, fluctuated around the value of the special drawing rights (SDR). The Omani riyal and the Kuwaiti dinar were not tied to the SDR. The Omani riyal, since 1973, has been officially pegged to the USD; the Kuwaiti dinar is determined from a weighted basket of currencies (Hebous, 2006, p. 7)

For the last two decades, however, all the currencies, except the Kuwaiti dinar, have in practice a de facto fixed exchange rate relative to the US (Figure 3). The Qatar riyal and Bahraini dinar have been pegged to the USD with rates of 0.37 and 3.64 per USD, respectively, since 1980. Similarly, the Saudi riyal has been fixed at a rate of 3.75 per USD since 1986, and the UAE dirham has been fixed at a rate of 3.67 per USD since 1981. After the Gulf War in 1991, the Kuwaiti dinar has been fairly stable in relation to the USD. The GCC introduced a de jure peg in 2001 as a step towards a complete monetary union. Currently, the GCC currencies have a fixed exchange rate relative to the USD, as stated in a formal agreement. The agreement in practice did not require major modification by the national authorities due to the existing stability of the GCC (Hebous, 2006, p. 7-8).

Table 7 shows nominal exchange rates that are collected by the IMF. The data depends on annual exchange rate. In the long run, the real exchange rates are unlikely to be affected by the nominal exchange rates and the differences that might arise because of adopting a common currency should not be corrected by using the money (price and quantity). Most of GCC

currencies have shown low to moderate differences in exchange rates due to the fixed exchange rate in GCC currencies (Merza & Cader, 2009, p. 196).

The open international capital flows and the fixed exchange rate present a problem that is known as the principle of the impossible trinity. Under this principle, a fixed exchange rate, full capital mobility, and monetary policy independence cannot be maintained simultaneously. The GCC must consider two important points in order to choose the future exchange rate regime. To keep inflation in check, as well as work against the high volatility in the price of oil, the fixed exchange rate works well. This may be due to the fact that the key GCC export products are usually in the USD rather than the local currency. The GCC's goal of diversification must also be considered in selecting the future exchange rate regime. Given this goal, the non-oil sector may become a more important component in the regime decision. This is especially true for Oman and Bahrain whose oil reserves are declining. Establishing a common currency that is still pegged to the USD would show no significant change in the exchange rate (Hebous, 2006, p. 8).

There are different preferences among economists about the exchange regime. Some of them advocate pegging a common currency to a basket of currencies. One of these economists is Abed who in 2003 considered a basket of currencies consisting of the USD and the Euro. Abed suggested the Euro would have more weight than the dollar. This suggestion would allow for a more flexible exchange rate regime. In 1999, Frankel found that the GCC would be driven towards a hard peg of the exchange rate for a new common currency for several reasons. The GCC central bankers are familiar with the policies of a hard peg regime. They have understood the application of it for years, and they have performed well with this type of regime. A hard peg is defined as matching the fixed exchange rate to a hard currency, and holding enough reserves

to support the peg. A hard peg would not only insulate the new currency from probable external shocks, but it would also instill confidence from other countries in the currency. Because the Middle East is subject to political instability, an external anchor might be an important, or perhaps crucial, step for the sake of the stability of the new currency (as cited in Hebous, 2006, p. 8; Calvo, 2000, p. 4).

An external anchor, at the highest level of analysis, is defined as a process in which national political systems are subject to pressures, variably dense external linkages, and stimuli affecting the conditions of democracy. The discussion of an external anchor brings up the question of should the anchor be a hard or be a soft peg which allows the exchange rate to fluctuate relative to a desired bracket. This leads to the question of whether a soft peg is easier said than done. Is a soft peg so complicated that it is virtually impossible for the GCC to use? Right now, the GCC states are generally polarized at the two extremes, i.e., hard peg and floating peg. In addition, the GCC would need to determine which external currency to use as the peg: the USD, the Euro, or the dollar basket itself. Determining whether to have a fixed or floating exchange rate is a key issue when discussing the exchange rate regime of a uniform currency. The other major oil exporting countries, such as Norway and Venezuela, face a situation that is similar to that of the GCC. These countries have established independent floating exchange rate arrangements. Iran is another example of a country whose main export is oil, and Iran switched in 2002 to a floating exchange rate system (as cited in Hebous, 2006, p. 9; Baracani, 2007, p. 6).

4.1 INTEREST RATE

The GCC states' interest rates and the US federal funds rate on three months deposits are plotted in Figure 6. This figure shows that the GCC states' interest rates generally moved together over the last two decades. Until 1990, there was a fixed interest rate for Qatar. Later, it fluctuated along with the interest rates of other GCC countries. Figure 6 also shows that the GCC interest rates closely followed the movements of the US interest rate. The interest rates of Saudi Arabia and Bahrain almost mimic that of the US. In the GCC areas, the rate difference is quite small; consequently, massive convergence is not needed (Hebous, 2006, p. 11).

4.2 INFLATION

The inflation rate of the GCC has been relatively low in the last decade; however, the inflation faced by the individual members varied. Figure 4 shows the weighted average GCC inflation rate between 1985 and 2005. Between 1996 and 2005, the inflation rate was below 2 percent. In 2005, it rose to 2.25 percent. The inflation rates spiked during 1991 and 1995. The fixed exchange rates brought these spikes under control. In the last 20 years, the inflation rates have had a tendency to be volatile. As shown in Figure 5, the GCC states experienced high inflation rates on a temporary basis due to country-specific events. However, after several periods of upward pressure, the countries were able to control the inflation. In 1991, the period right after the Gulf war, inflation rate of Kuwait was almost 9.8 percent. The inflation rate in Kuwait has declined over time. Qatar's inflation rate of 6.8 percent in 2004 was the highest rate of inflation recorded among the GCC members. According to Qatar central bank, the inflationary pressure in the country was due to two factors. There was a boom in the reconstruction sector,

and there was a significant increase in rents because many buildings were modernized and rebuilt (Hebous, 2006, p. 9-10).

The inflation rate in Qatar dropped to 3 percent in 2005. However, the UAE experienced a sharp increase up to 6 percent in the same year. Negative rates were observed in Saudi Arabia from time to time. For the last 15 years, except 1991 and 1995, Saudi Arabia was one of the countries that had very low inflation rates. After seeing the volatility of the inflation rates shown in Figure 5, one might question the attitude of the GCC countries toward price stability. One might ask who is in charge of this purse. The answer is the common independent central bank. Before the GCC institutes a uniform currency, member countries need to decide if the central bank is going to be a single, union-level institution or if the central bank will be an association of the existing national central banks of the GCC member countries. Currently, the GCC national central banks are independent of one another. For example, it is prohibited by law to finance the government deficit through the central bank in Saudi Arabia, but it is allowed in other GCC states. Whether the GCC states will choose a coordination form between the national central banks or agree on establishing a union-level institution is yet to be decided (Hebous, 2006, p. 10-11).

According to the IMF, the inflation rate in the GCC was supposed to rise to about 7 percent in 2008, which is higher than the earlier forecast of 6 percent. According to Gene Leon, the deputy chief of IMF for the Middle East, the average expected inflationary rate in 2008 was 7 percent. In 2008, the forecast of the overall inflation rate in the six GCC states was 6 percent. The IMF expected inflation in Qatar to be around 12 percent, whereas UAE would have an 8 percent rate in 2007. Information provided by Leon showed that the inflation rate in Saudi

Arabia actually surged to around 14 percent in 2007. The IMF expected inflation rates of 10 percent and 6.4 percent for Qatar and the UAE, respectively. Real consumer prices rose by about 11 percent in the UAE. In Saudi Arabia, inflation rose by more than 4.1 percent in 2007. This is important because Saudi Arabia, the largest economy in the Middle East, was battling inflation of more than seven percent in 2008. This anomaly is noteworthy because historically Saudi Arabia has had one of the lowest inflation rates when compared to the other GCC states. Inflation increased by approximately 5.5 percent in 2007 in Oman; this is four or five percent more than expected by the IMF. This surge was more than experienced by either Bahrain or Kuwait. The GCC economies have been enjoying impressive growth rates because of the surge in oil revenues, but this also has left them awash with cash (The Peninsula Qatar, 2008).

According to Leon, the Gulf governments must contain current expenditures to control inflation. In addition, capital investment, which plays an important role in containing inflation, can be reduced. External factors are also fuelling the GCC inflation. Capital equipment prices, food prices, and raw material prices are rising largely due to the depreciation of the USD. Because the GCC currencies, except the Kuwaiti dinar, are pegged to the USD, this depreciation affects the inflation rate. Leon is convinced that de-pegging with green money would have a limited effect in the long term on the GCC currencies, even with a revaluation of those currencies in relation to the dollar. However, there are many effective methods and procedures to solve this kind of problem (The Peninsula Qatar, 2008).

Kuwait has planned to tighten consumer lending according to KUNA (Kuwait News Agency). From March 30th forward, fresh loans will be limited to monthly interest and repayment installments equivalent to no more than 40 percent of a person's salary; this limit had

been 50 percent. The limit on the pension dependent is 30 percent. According to KUNA, the Kuwait Economic Society chairperson, Rola Dashti, said that this change would help ease inflation to some extent. A recent addition of a wage hike for government workers was hindering the process of tackling inflation. In 2007, the inflation rate in Kuwait remained close to a record high in November at 6.7 percent on rent and food costs. Kuwait is the only GCC state that has stopped pegging its currency to the USD. According to the general manager of Al Joman Centre of Economic Consultancy, Naseer Al Nafisi, the central bank is trying to curb credit and limit bank violations, which may limit banks' profit growth (The Peninsula Qatar, 2008).

CHAPTER 5: FISCAL SIDE

5.0 DEFICIT

There are three important budgetary issues in the GCC states. Oil and the activities related to it are the major source of revenues for the government for all of the GCC states (Table 8). Thus, the government revenues move pro-cyclically with the total revenues, so ultimately revenues move with the oil sector revenues, as shown in Figure 8. Oil sector revenues are represented by the dashed lines, and government revenues are represented by the thick lines. The oil sector revenues are clearly the major source of the total government revenues, as indicated by the small distances between the two curves (Hebous, 2006, p. 12).

Second, in 1990, all the GCC members experienced budget deficits, but by 2002 all members had budget surpluses since the oil prices increased by 2002 (Figure 7). In 2004, the UAE achieved a balanced budget (Figure 8). The third aspect is that, as previously stated, the budget status is largely dependent on oil revenues. Because of this situation, the final budget point to highlight is the fact that the revenues from oil activities are exhaustible due to the depletable nature of oil. Oil reserves have the following expected depletion dates: Saudi Arabia, 2110; Bahrain, 2011; UAE, 2110; Oman, 2022; Kuwait, 2121; and Qatar, 2049. These dates indicate that the governments of all the GCC members need to find alternative revenue sources in the long run. If Bahrain does not find a substitute for oil activities quickly, then it will certainly be in a bind because currently it is very much dependent on oil for its activities. The same can be said for Oman. Thus, regarding budget issues, both Bahrain and Oman are in the

same boat; both countries need to find alternative revenue sources quickly, or they will be facing budget crises (Hebous, 2006, p. 12).

5.1 DEBT

Table 9 shows the debt-GDP ratios of the GCC states. The ratios in 2006 are relatively small for all GCC members compared to the ratios of 1998 to 2002. The UAE has the lowest debt ratio, while Saudi Arabia has the highest ratio among the GCC states. Comparing the averages of 1998-2002 to 2006, we note that these ratios have decreased for all the states. This indicates clearly that these states have done a good job in keeping the debt ratios fairly small. The trend of reducing the debt ratio was expected to continue through 2006 (Hebous, 2006, p. 13).

5.2 CONVERGENCE

The GCC members agreed on convergence criteria that were similar to the criteria used by the EU for its own monetary unification. The GCC convergence criteria are as follows.

1. Budget deficit lower than 3 percent of GDP;
2. Public debt-to-GDP lower than 60 percent;
3. Currency reserves in excess of at least four months of imports;
4. The interest rate should not exceed the average of the lowest three countries interest rate by more than 2 percent.
5. The inflation rate should not exceed 2 percent above the average rate of the GCC members (Hebous 2006, p. 13).

There are no theoretical reasons for using an exact replica of the EU criteria or for using different criteria; thus, it is not an issue. Consequently, the GCC selection criteria for entering the union will probably not be based on the convergence criteria. Hopefully, these criteria will at least serve a policy guide. Currently, in financial terms, the GCC countries have successfully achieved budget surpluses since all the GCC members have met the budget deficit criterion. Nonetheless, one caveat must be made here; these surpluses occurred in periods of high expansion of oil revenues. As is known, higher oil prices cause higher GDP values and higher revenues. Given the dependence of the GCC states on oil revenues, this time period may be creating a misleading picture. This picture potentially portrays a better fiscal policy stance than truly exists. Some evidence supporting this point is available (Hebous, 2006, p. 14).

In 2004, all the GCC states, except Saudi Arabia, satisfy the debt criterion. However, by 2005, Saudi Arabia reduced its debt ratio, so it also satisfied the condition (Table 1). The GCC states generally retain high foreign reserves. For instance, in 2004, all the GCC states, except for Bahrain, held reserves that were at least 4 months worth of imports (Table 10). If the reserve requirement was increased to six months worth of imports, then Bahrain would violate that requirement (Hebous, 2006, p. 14).

No major convergence steps are required to comply with the monetary criteria. The European Monetary system required that the Euro was introduced to bilateral parties. This step is unnecessary for the GCC because of the existing fixed peg to the USD. All GCC states have met the interest rate criterion. However careful attention and actions are required by the individual states regarding inflation volatility. In 2005, Qatar had the highest inflation rate of 6.8 percent, and the UAE had the lowest at 4.6 percent; Bahrain fell in the middle with a rate of 4.9 percent.

The weighted average of all of the GCC states was 2.25 percent. All of the inflation rates discussed have exceeded the weighted average by more than 2 percent. Qatar had a difference of 4.55 percent; the UAE was the closest to 2 percent but was still at 2.35 percent over the weighted average. Table 1 summarizes the convergence criteria and shows which criterion are being fulfilled or violated by each of the GCC countries as of 2006. These data show that inflation is the biggest hurdle to convergence. Other than the presence of excess inflation, the GCC states have achieved a noteworthy degree of convergence (Hebous, 2006, p. 15).

5.3 DIVERSIFICATION AND OTHER ISSUES

Currently the GCC states, without a doubt, are facing a major challenge. That challenge is the maintenance of the non-oil sector and the diversification of all of the economies. Table 11 shows that export diversification for all GCC members has been limited. In order to support areas such as privatization, direct foreign investment, infrastructure development, tourism, and establishing financial centers, the GCC states must direct their actions towards these sectors. Bahrain and the UAE are relatively less dependent on oil. Large projects are being implemented in Dubai to promote more tourism as well as the leading businesses in the UAE. Bahrain has further enhanced its economy with the aid of Islamic banking and tourism. The manufacturing industry is being supported by not only Saudi Arabia but also other GCC members (Nechi, 2010, p. 164; Hebous, 2006, p. 16).

Reforms in the labor market and the creation of new jobs are related to diversification and the enhancement of non-oil activities. In 2004, there were 35 million inhabitants in the GCC states, up from just 13.76 million in 1980. This dramatic increase highlights the fact that there is

high population growth in these states. All the GCC economies rely on mostly immigrant human capital due to existence of the large public sector that requires more labor. However, the public sector currently is not able to absorb the oversupply of labor since the nationals have a strong preference to work in the public sector. To a certain extent, this issue does not include free movement of labor for multiple reasons. One of these reasons is that expectations are low. Another reason is that the educational basis of the general GCC nationals is similar. Diversification is an immediate need and not just mandatory in the long run for those states with declining oil reserves (Hebous, 2006, p. 16).

CHAPTER 6: CONCLUSION

6.0 ENLARGEMENT

The potential enlargement of the future common currency and the monetary union is not on the GCC states' agenda now since they need more time to experience the results of the unification. However, this is an idea to expand the block in such a strategic way that it would include the whole Arabian Peninsula; this is a herculean task. Mere words will not be enough to achieve such a goal. If Yemen joins this group for the purpose of monetary unification, then it would make the monetary union much stronger. Yemen alone has a per capita GDP worth 500 USD. This would make a huge difference among the GCC members. On the other hand, a study by Chami et al. shows a positive effect due to this enlargement. The driving force of enlargement to include the other Arabic countries does not exist yet, but it is in the political process (as cited in Hebous, 2006, p. 16).

6.1 COSTS AND BENEFITS OF A GULF MONETARY UNION

The costs and benefits of having a single currency are hard to quantify in economic terms for a group of countries. However, there are some promising benefits, such as increased bargaining power and more intra-GCC trade. The GCC members will have an intrinsic incentive to widen their collective bargaining power, giving them a stronger bargaining position. This would pave the way towards more access to the markets of industrial countries in a less discriminatory way. Trade would be much cheaper between countries with a unified currency. Thus, more intrastate trade is expected with the introduction of a new Gulf currency. Increased

intrastate trade should lead to further synchronization of business cycles, which will facilitate the formulation of a union-wide monetary policy. The costs of a gulf monetary union are that when a country abandons its own currency, it abandons its monetary autonomy (Alkholifey & Alreshan, 2010, p. 22-23).

6.2 CONCLUSION

After analyzing the economic, trade, and exchange rate conditions of the GCC, it can be concluded that while it is not overwhelming, there is an economic case for the GCC monetary union. The deadline for the achievement of a single currency by 1st January 2010 has long ago passed, and there seems to be no further plans in motion to achieve this unification.

The lack of economic integration among the GCC members is striking. Apart from Saudi Arabia, the small size of the GCC member countries would seem to be conducive to the unification of the currency. The economic arguments might not support the monetary unification in the short run. However, in the long run, these very same factors would become strong support for unification; mutual benefits would be reaped over time. In addition to this observation, Saudi Arabia has established a leadership role in this monetary union, and this means that the program will not be left alone or allowed to die down.

Tables

Table 1 *GCC countries: Compliance with the convergence criteria, end-2006*

GCC countries: Compliance with the convergence criteria, end-2006					
Country	**Budget deficit lower than 3 percent of GDP, or 5 percent when oil prices are weak**	**Public debt to GDP ratio lower than 60 percent**	**Foreign exchange reserves in excess of four months' imports**	**Interest rates not higher than two percentage points above the average of the lowest three countries' rates**	**Inflation not higher than 2 percent above the average rate of the six states**
Bahrain	Y	Y	N	Y	Y
Kuwait	Y	Y	Y	Y	Y
Oman	Y	Y	Y	Y	Y
Qatar	Y	Y	Y	Y	N
Saudi Arabia	Y	Y	Y	Y	Y
UAE	Y	Y	Y	Y	N

Source for table: Khan, 2008.

Y= criteria has been met

N= criteria has not been met

Table 2 *Main economic indicators in the GCC states*

Country	GDP (US$ Bill)	GDP share in the GCC GDP (percent)	GDP annual growth (percent)	GDP per capita (US$)	Petroleum activities[a] / nominal GDP	Inhabitants[b] (Mill)
Bahrain	15,796	2.76	7.1	19748	23.2	0.72
Kuwait	44,675	7.81	3.2	16297.2	47.6	2.61
Oman	39,559	6.92	3.8	16299.6	42	2.53
Qatar	23,584	4.12	5.5	29606.6	62.2	0.78
Saudi Arabia	337,268	58.97	6	14592	47.8	23.95
UAE	111,027	19.41	5.6	23722.8	32.6	4.28
GCC	571,909	100	5.56[c]	17374.6[c]	44.34[c]	34.87

Source for table: Hebous, 2006.

[a] Including the gas sector.

[b] Figures on inhabitants are in 2004.

[c] Weighted average based on the GDP share.

Source for data: IMF, International Financial Statistics (2004), World Economic Outlook (September 2005), and the national central banks.

Table 3 *Trade indicators in the GCC state*

Country	Openness [a]	Petroleum activities [b]/ exports	WTO membership
Bahrain	146.9	76.5	1995
Kuwait	92.5	92.8	1995
Oman	93.6	68	2000
Qatar	84.7	90	1996
Saudi Arabia	73.6	88.36	2005
UAE	132.8	35.8	1996

Source for table: Hebous, 2006.

[a] Average 2001-2003, and 2004 for UAE and Qatar.

[b] Including gas; figures in 2004 except for Saudi Arabia in 2003.

Source for data: World Trade Organization and national central banks.

Table 4 *GCC's Trade with main partners, 2009*

GCC'S TRADE WITHIN MAIN PARTERNER (2009)											
The Major Import Partner				The Major Export Partner				The Major Trade Partner			
RK	**Partner**	**euro**	**%**	**RK**	**Partner**	**euro**	**%**	**RK**	**Partner**	**euro**	**%**
	countries	**223,535.10**	**100%**		**countries**	**296,856.70**	**100%**		**countries**	**520,391.80**	**100%**
1	EU27	63,064.70	28.20%	1	Japan	52,281	17.60%	1	EU27	83,393.80	16%
2	China	24,662.00	11%	2	S. Korea	32,453	10.90%	2	Japan	66,170.80	12.70%
3	U.S	23,215.20	10.40%	3	India	28,989.10	9.80%	3	India	50,175.10	9.60%
4	India	21,186.00	9.50%	4	China	23,669.10	8.00%	4	China	48,331.50	9.30%
5	Japan	13.889.8	6.20%	5	EU27	20,329.10	6.80%	5	U.S	43,245.50	8.30%
6	S. Korea	9,247.50	4.10%	6	U.S	20,030.40	6.70%	6	S. Korea	41,700.60	8%

Source for table: DG Trade.

Table 5 *Destination of the GCC imports, 2004*

	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	UAE
Asia	11.1	16.1	12.4	12.3	18.9	37.6
EU	27.5	37.2	29	45.5	31.1	33.1
Japan	7.3	12.8	16.7	5.1	9.7	1.4
USA	5.6	7.9	4.7	9.5	15.2	6
GCC	37.7	10.1	27.6	17.4	4.8	3.7
Others	10.8	15.9	9.6	10.2	20.3	18.2

Source for table: Hebous, 2006.

Source for data: IMF International Trade Direction.

Table 6 *Non-oil exports within the GCC states, 2004*

Exports to GCC/Non-oil exports	
Bahrain	37.4%
Kuwait	-
Oman	50.2%
Qatar	26.5%
Saudi Arabia	28.6%
UAE	13.1%

Source for table: Hebous, 2006.

Source for data: The national central banks.

Table 7 *Currency units per SDR, 2007*

	U.S. Dollar	Bahrain Dinar	Kuwaiti Dinar	Omani Rial	Qatar Riyal	Saudi Arabian Riyal	U.A.E. Dirham
Mean	1.404	0.528	0.421	0.540	5.111	5.261	5.156
Minimum	1.253	0.471	0.385	0.482	4.559	4.697	4.600
Maximum	1.524	0.573	0.445	0.586	5.548	5.716	5.598

Source for table: Merza & Cader, 2009.

Source for data: IMF publications 2007.

Table 8 *The share of oil revenue in total government revenues, 2004*

Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	UAE
72.6	88.5	68.9	64.3	84.1	77.6

Source for table: Hebous, 2006.

Source for data: The national central banks.

Table 9 *Debt-to-GDP ratios in the GCC states*

	1998-2002	2003	2004	2005	2006
Bahrain	29	37.1	28.6	24.8	23.5
Kuwait	43.6	27.6	20.4	14	11.9
Oman	27.4	16.4	15.4	11.1	9.5
Qatar	76.1	54.3	42.2	30.2	24.4
Saudi Arabia	96.7	82	65	42.7	27.3
UAE	5.5	6.6	8.4	6.6	2.8

Source for table: Hebous, 2006.

Source for data: IMF Regional Report, September 2005.

Table 10 *Foreign reserves and 4-Months imports in the GCC states, 2004*

	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	UAE
Reserves[a]	1.94	8.25	3.6	3.4	27.3	18.5
4-Months Imports[b]	2	3.64	2.65	1.8	13.6	18

Source for table: Hebous, 2006.

[a] Total reserves minus gold.

[b] Calculated as: annual imports*(1/3).

Source for data: IMF, international Financial Statistics, 2004, and the national central banks.

Table 11 *Exports Diversification Index for GCC countries*

Year	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	UAE	Average
1980	0.790	0.732	0.922	0.934	0.942	0.870	**0.865**
1995	0.767	0.831	0.709	0.835	0.860	0.691	**0.782**
2000	0.781	0.738	0.734	0.826	0.838	0.718	**0.773**
2007	0.818	0.825	0.684	0.814	0.780	0.637	**0.759**

Source for table: Nechi, 2010.

Source for data: UNCTD.

Table 12 *The 27 EU countries' performance on Maastricht criteria, 2006*

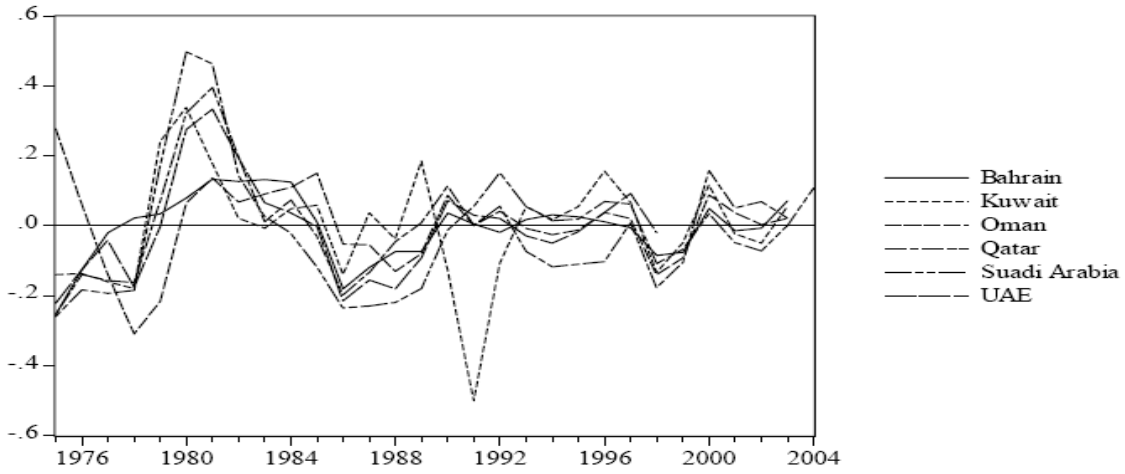
Maastricht criteria: The EU27 countries in 2006				
Country	Budget deficit (% of GDP)	Public debt (% of GDP)	Inflation (%)	Interest rate (%)
Austria	-1,1	62,2	1,7	3,8
Belgium	0,2	89,1	2,3	3,81
Germany	-1,7	67,9	1,8	3,76
Spain	1,8	39,9	3,6	3,78
Finland	3,9	39,1	1,3	3,78
France	-2,5	63,9	1,9	3,8
Greece	-2,6	104,6	3,3	4,07
Ireland	2,9	24,9	2,7	3,76
Italy	-4,4	106,8	2,2	4,05
Luxembourg	0,1	6,8	3	3,89
Netherlands	0,6	48,7	1,7	3,78
Portugal	-3,9	64,7	3	3,91
Slovenia	-1,4	27,8	2,5	3,85
Bulgaria	3,3	22,8	7,4	4,18
Cyprus	-1,5	65,3	2,2	4,13
Czech Republic	-2,9	30,4	2,1	3,78
Denmark	4,2	30,2	1,9	3,81
Estonia	3,8	4,1	4,4	4,3
Hungary	-9,2	66	6,6	7,12
Latvia	0,4	10	3,8	4,13
Lithuania	-0,3	18,2	4	4,08
Malta	-2,6	66,5	2,6	4,32
Poland	-3,9	47,8	1,3	5,23
Romania	-1,9	12,4	6,6	7,23
Slovakia	-3,4	30,7	4,3	4,41
Sweden	2,2	46,9	1,5	3,7
United Kingdom	-2,8	43,5	2,3	4,37
Reference value	-3	60	3,0	5,7

Source for table: Jygert, 2008.

Note: Shaded areas show fulfillment of the Maastricht criteria.

Figures

Figure 1 *Business cycles in the GCC states*[a]

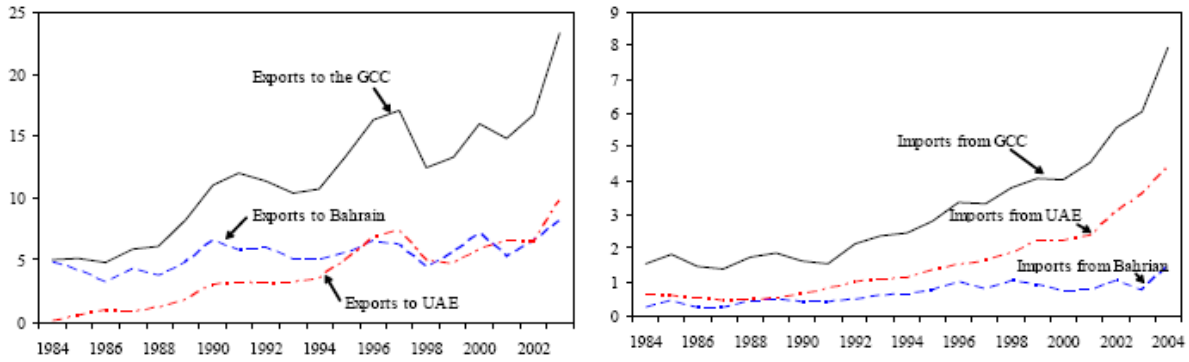


Source for figure: Hebous, 2006.

[a] Deviation from the Hodrick-Prescott trend.

Source for data: IMF, International Financial Statistics, 2004.

Figure 2 *Exports and imports of Saudi Arabia to and from the GCC members*[a]

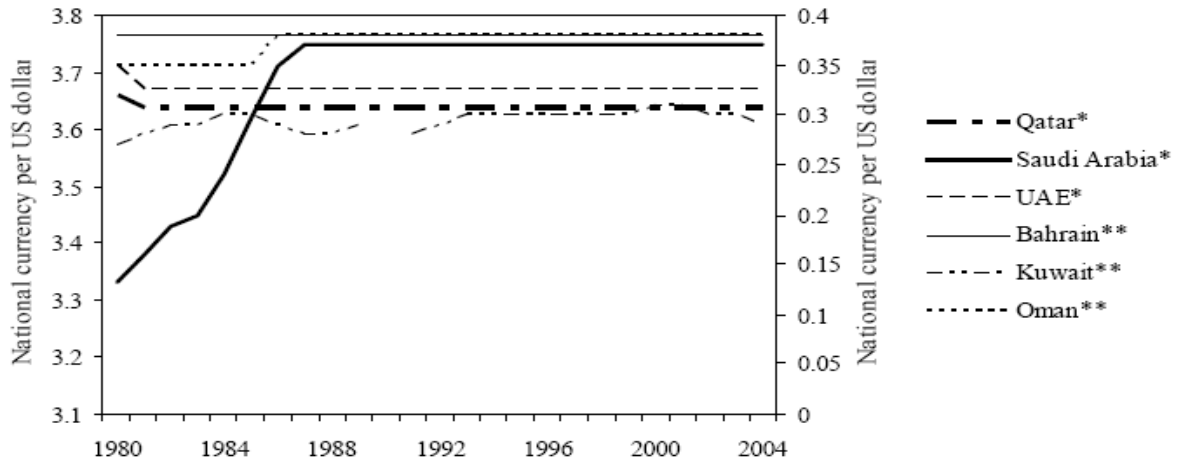


Source for figure: Hebous, 2006.

[a] Figures on the vertical axis are in billions of Saudi Arabia riyal.

Source for data: Central bank of Saudi Arabia.

Figure 3 *Exchange rates in the GCC states; national currency per USD*



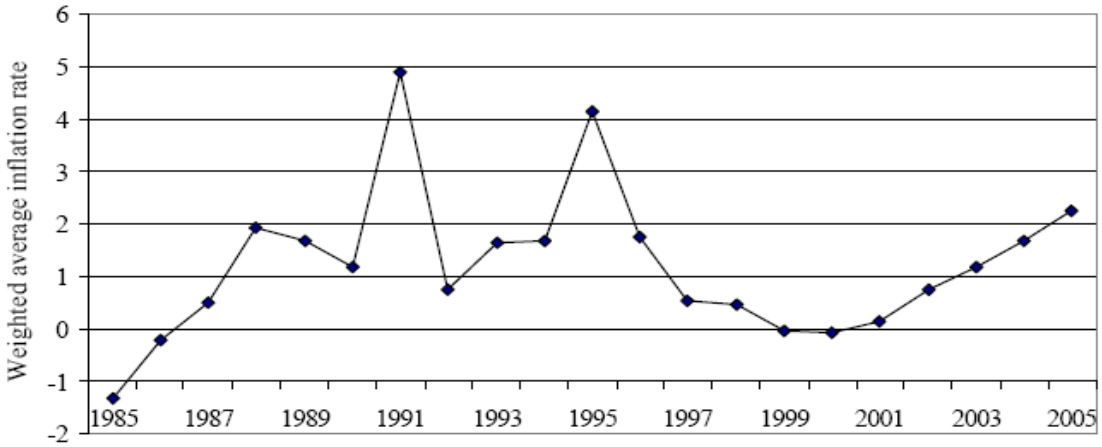
Source for figure: Hebous, 2006.

* Left-hand scale.

** Right-hand scale.

Source for data: IMF, International Financial Statistics, 2004.

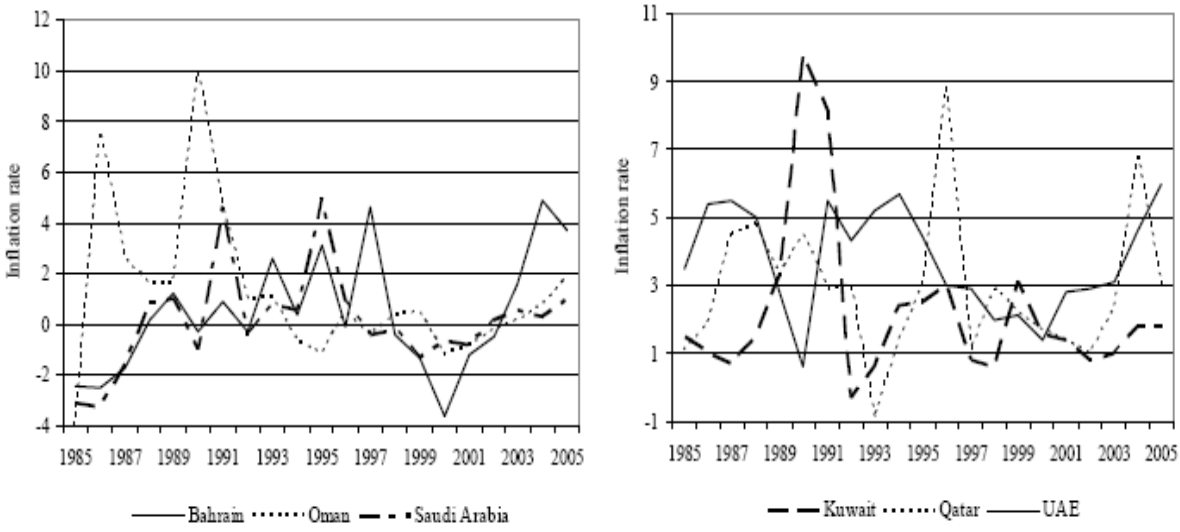
Figure 4 *Weighted average inflation rate for the GCC union*



Source for figure: Hebous, 2006.

Source for data: IMF, World Economic Outlook, September 2005.

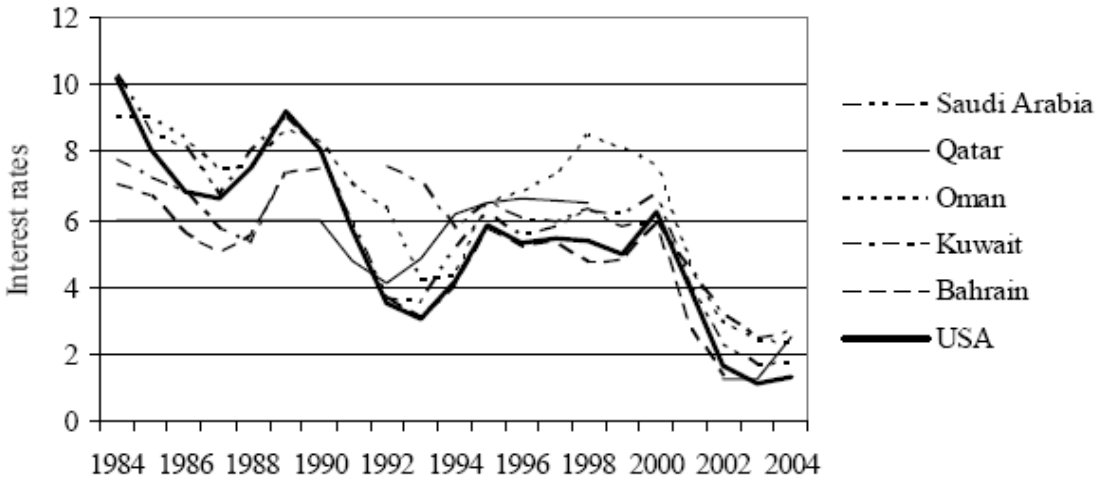
Figure 5 *Inflation rates of the GCC states*



Source for figure: Hebous, 2006.

Source for data: IMF, World Economic Outlook, September 2005.

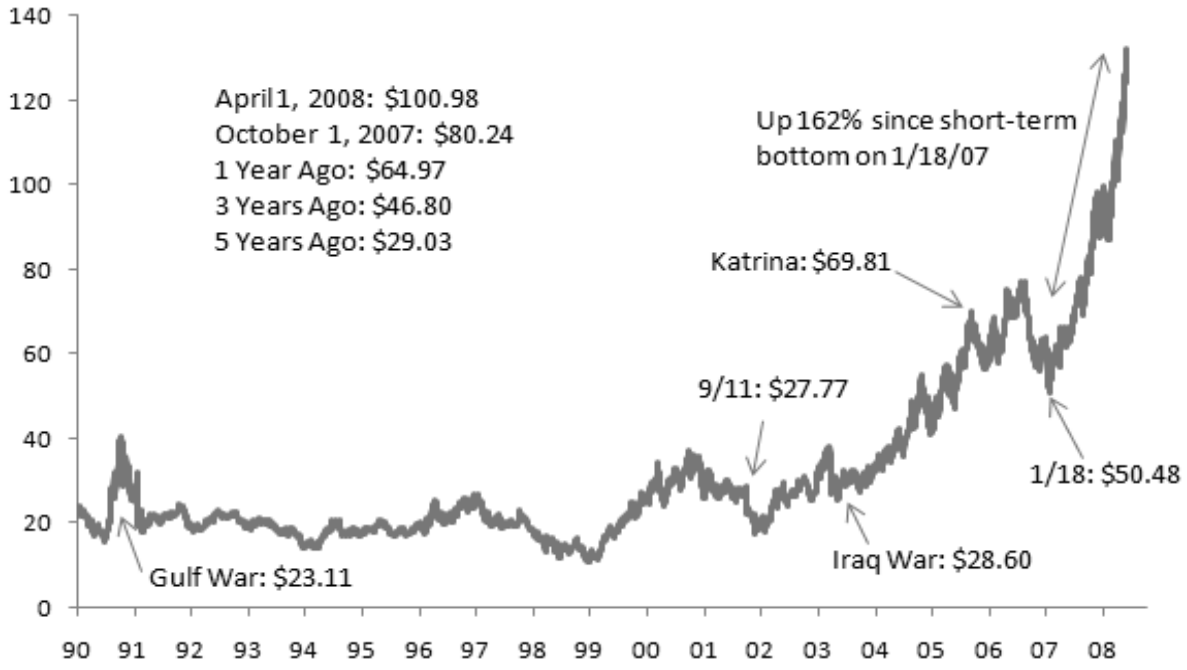
Figure 6 *Interest rates in the GCC states*



Source for figure: Hebous, 2006.

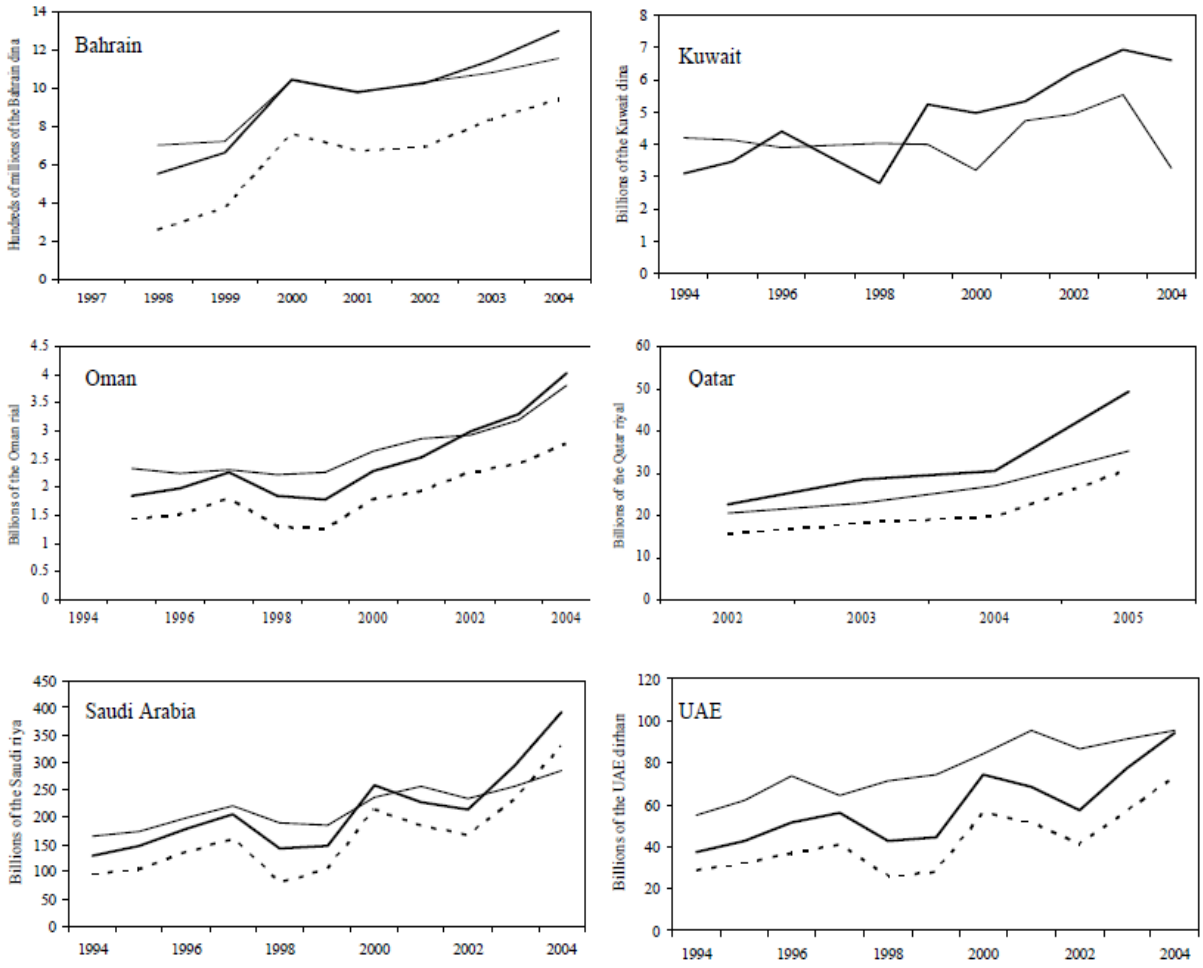
Source for data: IMF, International Financial Statistics, 2004, and national central banks.

Figure 7 *Oil Prices since 1990*



*Source for figure***:** Bespoke Investment Group.

Figure 8 *Public finance in the GCC states*



Source for figure: Hebous, 2006.

Source for data: The national central banks.

------- Oil sector revenues

——— Government revenues

——— Government expenditure

End notes

"A data-smoothing technique that is commonly applied to remove short-term fluctuations that are associated with the business cycle, thereby revealing long-term trends." (Hodrick Prescott filter)

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