Monetary Union in the Gulf

Prospects for a Single Currency in the Arabian Peninsula

Emilie J. Rutledge

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At a time of momentous shifts in the balance of world economic forces epitomized by the current oil price boom, the weakening US dollar and the global credit crunch, the meteoric rise of the Arabian Peninsula cannot be understated. Neither, therefore, can their planned monetary union. As key suppliers of the world's oil and gas the Gulf states have accumulated vast wealth: taken together their sovereign wealth funds are by far the world's largest and the influence of these funds is becoming increasingly apparent. This book provides a thorough analysis of the scheduled 2010 monetary union. Its findings are based on both primary research and a detailed empirical analysis of the region's economies spanning 1980–2006. It assesses the region against optimal currency area criteria, the European criteria, highlights outstanding preparations and considers the underlying economic and political factors that may aid or indeed delay the launch date. Critically this book argues that the present dollar-peg exchange rate regimes are no longer optimal. The future Gulf dinar is likely to seek a more independent path. The ramifications of this – a potential Islamic anchor currency and an alternative oil-invoicing currency – are also considered in some detail.

Emilie J. Rutledge is Assistant Professor of Economics at the United Arab Emirates National University. She regularly contributes articles and opinion pieces on GCC economic issues to the regional press. Previously she worked as an economist at the Gulf Research Center, a Dubai-based think tank.

Emilie J. Rutledge's new book, *Monetary Union in the Gulf: prospects for a single currency in the Arabian Peninsula* is the first systematic, book-length treatment of the case for and against monetary union among the members of the Gulf Cooperation Council. It redefines the field of exchange rate economics for the Gulf states and raises the debate to a new and higher level. The book is as excellent as it is timely. Each of the GCC members is engaged in an evaluation of the merits and demerits of the bilateral US dollar pegs that have been the dominant exchange rate regime of the region. Dr Rutledge presents the relevant economic theories clearly and marshals the empirical evidence convincingly. Her familiarity with and deep understanding of the region permit her to address not only the technical, financial and economic issues but also the political economy drivers of the choice of currency regime. **This book is destined to become a classic and is required reading for all those interested in exchange rate issues in resource-based economies, a category that is rather wider than the GCC.**

Willem H. Buiter (*Professor of European Political Economy, European Institute, London School of Economics and Political Science, UK*)

This book comes at a crucial and timely moment. Changes in the balance of global economic power, and the huge wealth being accumulated by Gulf states, mean that an effective Gulf Monetary Union would have far-reaching effects on the global economy. Rutledge's careful analysis of the prospects and requirements is exactly what is needed.

Professor Timothy Niblock (*Institute of Arabic and Islamic Studies, Exeter University, UK*)

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Contents

Figures

Tables

Foreword

The subject of Gulf Cooperation Council (GCC) monetary union has been much in the news in recent years, not least because having a target for the introduction of a single currency by 2010 looked extremely ambitious, if not unrealizable, despite the benefits that this might bring in terms of savings on transactions costs and the increased integration of Gulf capital markets. Oman's decision to opt out of the proposed monetary union and Kuwait's abandonment of the US dollar peg for its currency illustrated the fragility of the monetary union project and the difficulty of moving to closer integration even among countries with a common language, similar cultures and the same challenges of economic diversification and job creation for local citizens.

It is important to see beyond current business media headlines and have a deeper perspective of the underlying issues influencing policy choices. This is the value of this study by Dr Emilie Rutledge, the first exhaustive investigation of the challenges of GCC monetary union. As is fitting in any solid piece of academic research, relevant theories are examined, notably optimal currency area theory, originally applied to resource rich-Canada, but arguably also of relevance to the resource rich GCC. The classic preconditions for an optimal currency area do not appear to be met in the GCC however, as much stress was placed on factor mobility involving labour and capital, as well as a high proportion of intra-regional rather than extra-regional trade.

A critical feature of the Mundell model for an optimal currency area is the assumption that for monetary union to succeed participants should have similar Phillips curves, implying a common trade-off between unemployment and inflation. The original negative relationship has long broken down in Europe and North America, and in the GCC unemployment data is unreliable and not very meaningful as the problem of youth unemployment is structural rather than cyclical and caused more by supply than demand factors rendering monetary policy useless. Yet in the GCC this means that there are less likely to be losses from a pooling of monetary sovereignty regardless of differences in labour market conditions between member states, as short-term monetary expansions or loosening of monetary policy will not by itself increase employment opportunities for local nationals.

As the currencies of Saudi Arabia, Bahrain, Qatar and the UAE have long been pegged to the US dollar and there are no restrictions on financial transfers, the advantages and disadvantages of free capital mobility have already been realized. Monetary union will therefore arguably make little difference, and as in the Eurozone, separate national or even sub-national financial markets will continue to exist reflecting legal and regulatory differences. For portfolio investors there are likely to be gains from a single currency, however, as apart from in Saudi Arabia designing a diverse equity portfolio to reduce risk is problematic and even market risk is reduced by having multiple market exposure. At present there are no impairments to having a GCC-wide portfolio, and such funds already exist, but there are currency transaction costs which would be eliminated, and denomination in a common currency across markets facilitates stock performance comparisons.

Rutledge provides a detailed picture of the GCC economies over the period 1980–2006 and utilizes this to put forward a detailed cost/benefit analysis of the proposed GCC monetary union. Progress to date and outstanding preparations are also set out in considerable detail. She considers the need for institutional reform and fiscal convergence to be particularly important, terming this as the *European criteria*, and furthermore contends that for the GCC, *indirect benefits* (those occurring as a result of the process of forming a single currency) may bring more immediate benefits than do the *direct benefits* arising of the monetary union itself.

Semi-structured interviews and a region-wide business survey were carried out to ascertain the opinions of leading central bankers, policymakers and the business community regarding on the proposed monetary union. What is worth mentioning is that almost none stressed the gains from increased price transparency with a common currency, a factor which has proved of major significance in the Eurozone and which could also be important in the GCC given the extent of intra-regional travel by local nationals. Increased awareness by Saudi visitors of just how expensive Dubai actually is, for example, might result in some curtailment of price increases, if not reductions.

There have been press articles and editorials in the Gulf press blaming the currency peg with the US dollar for the surge in domestic inflation, with exchange rate policy becoming subject to increasing debate given the US dollars depreciation, most notably against the euro and sterling, in which a significant proportion of GCC imports are denominated. Yet abandonment of the dollar peg is unlikely in the near future, not least because oil, gas and petrochemical exports from the GCC are dollar denominated and the political relationship with the United States is valued by GCC governments in strategic terms, not least for security reasons. Furthermore, although an increasingly significant proportion of GCC imports originate in Asia, these are also US dollar denominated and they have increased relatively to euro-denominated imports. GCC exchange rate policies are therefore unlikely to change, unless Asian currencies are meaningfully uncoupled from the US dollar and appreciate significantly. The abandonment of oil price denomination in US dollars is also likely to be a precondition for exchange rate policy change, not least because even the Kuwait basket is US dollar heavy.

In the longer term such external changes are likely however, the issue being whether the GCC states have any strategy to deal with international currency crises. As clearly they don't, the value of Rutledge's study is that it draws attention to exchange rate issues and encourages debate. Monetary union by 2010 is certainly not realizable, but the currency debate in the GCC has only just begun and in the longer term the members will inevitably be currency price makers, not takers, with a new GCC currency perhaps the denominator for energy pricing of choice.

Professor Rodney Wilson
Durham University, UK

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Abbreviations

/b	per barrel of oil
AMF	Arab Monetary Fund
BRIC	Brazil, Russia, India and China
CPI	consumer price inflation
Cu. Ft/d	cubic feet per day
EMI	European Monetary Institute
EMU	European Monetary Union
ESCWA	Economic and Social Commission for Western Asia
EU	European Union
FDI	foreign direct investment
FTA	free trade agreement
FTZ	free trade zone
GCC	Gulf Cooperation Council
GDP	gross domestic product
IEA	International Energy Agency
IFS	International Financial Statistics
ILO	International Labour Organisation
IMF	International Monetary Fund
IOC	International Oil Company
IPO	initial public offering
KSA	(Kingdom of) Saudi Arabia
mbpd	million barrels per day
MENA	Middle East and North Africa
MU	monetary union
OCA	optimal currency area
OPEC	Organization of the Petroleum Exporting Countries
PPP	purchasing power parity
SAMA	Saudi Arabian Monetary Agency
SGP	Stability and Growth Pact
SME	small and medium sized enterprise
TIR	trade intensity ratio
UAE	United Arab Emirates
UN	United Nations

UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Program
US	United States (of America)
WDI	world development indicator
WTO	World Trade Organization

1 Introduction

In 1980 six states on the Arabian Peninsula (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates) formed the Gulf Cooperation Council (GCC). For 20 years the impact of this event barely registered on the world's media antennae. But since the beginning of the twenty-first century these states have been making the headlines with increasing frequency and not only because of their geographic proximity to Iraq and Iran or their position as the world's key supplier of oil and gas. A string of high-profile overseas acquisitions – including P&O and Madame Tussaud's – and the region's unprecedented construction boom have also contributed to a worldwide perception that some kind of tectonic shift is taking place in the world's economic and strategic geography. And while Western observers look on with a mixture of admiration, disdainful hauteur and not a little anxiety, such 'excesses' as the Emirate of Dubai's man-made palm tree-shaped islands, the world's tallest building and ski-slopes in the desert, nevertheless add further conviction to the view that 'something of massive proportions' is happening in the Arabian Peninsula.

It is therefore in this context that the growing role of the Gulf's political organization – the GCC, and, in particular, its major 'project' the adoption of a single currency, must be understood and evaluated. Indeed, one could go further. At a time of momentous shifts in the balance of world economic forces epitomized by the precipitate fall in the US dollar and the global credit crunch; the meteoric rise of the Arabian Peninsula to which we have alluded cannot be understated. The pivotal position GCC sovereign currencies have vis-à-vis the value of the US dollar is becoming increasingly apparent.

Five of the six GCC states have maintained dollar pegs for most of this book's period of study: 1980–2006; and the dollar is undoubtedly a key component of Kuwait's basket peg. Their oil is invoiced in dollars and most of their surplus 'petrodollar' revenues have – until recently at least – been recycled back into US government-issued securities. However, when the *Gulf dinar*, as we shall term it, comes into existence, the consequences may be of critical importance to both the US and world economies. Not only would a Gulf dinar undoubtedly become the Middle East's and the Islamic world's most significant currency as well as the world's second most important common currency, it may also present the GCC states with an opportune moment to de-peg from the dollar.

Reprising the fundamental economic underpinning of that 'tectonic shift' in the Arabian Peninsula's geo-strategic position, let us remind ourselves of a few critical facts: The states comprising the GCC currently supply 23 per cent of the world's crude oil – a figure which is set to increase considerably in the coming decades. They also sit on 40 per cent of the world's proven oil reserves and nearly a quarter of the world's proven gas reserves. Unlike previous oil booms, these states are seemingly no longer content to simply export crude oil and recycle all of their windfall earnings back into the oil-importing industrialized economies. Instead they are using some of this surplus capital to expand their own refining and petrochemical capacities, enabling them to retain more of the 'value-added' value that has traditionally been added and collected by Western oil and petrochemical companies. The GCC is also forging new strategic alliances with Asia by investing billions of dollars in Chinese and Indian refineries and petrochemical plants – many are being designed specifically to handle Gulf crudes.

The second critical fact is the huge financial wealth (and possibly with it influence) amassed by the region's governments. With the huge increase in oil prices that has occurred since the beginning of the decade, the bloc's current account surpluses are growing at a rate similar to that of the US's current account deficit and are comparable in size to China's huge surplus. Between 2002 and 2006 the GCC amassed some $558 billion in net foreign assets and their stock of foreign assets is now estimated to be worth $1.6 trillion (IIF 2007). In 2007 their sovereign wealth funds bought significant stakes in a wide range of international banks and private equity firms including HSBC, Standard Chartered and the Carlyle Group. When the UAE's Abu Dhabi Investment Authority – rumoured to manage $900 billion worth of government funds – purchased a 4.9 per cent stake in Citibank for $7.5 billion, it marked the clearest sign yet that the Arabian Peninsula states are no longer content to place all of their surplus capital into US government securities. The implication of this for the dollar's dominant position and its role as the de facto oil-invoicing currency remains to be seen.

This book is intended to give an account of the GCC's longstanding goal of becoming a monetary union (MU). It will chart the history and key developments to date and consider its appropriateness, using both the optimal currency area (OCA) benchmark and more recent criteria drawing upon the European Monetary Union (EMU) experience – the latter we term the *European criteria*. It will look at the outstanding prerequisites and necessary policy reforms, arguing that political determination and commitment, rather than purely economic factors are slowing down the process. It will also assess the longer term prospects: will MU bring net benefits for all participating states? Is it conceivable that one day the Gulf dinar will be viewed a viable anchor currency for the Middle East or even the Islamic world and even possibly be used to invoice the region's oil sales? As we have already indicated, these are not just issues of interest to economists specializing in the Middle East, but also major questions of political and geo-strategic importance as we move into the second decade of the twenty-first century.

The present conjuncture

Although five of the six GCC states still officially plan to adopt a common currency by 1 January 2010 (Oman surprised many by unilaterally opting out in December 2006), the launch date may well end up being postponed for a number of years. This is because many of the prerequisite policy reforms, such as establishing a fully functioning common market, setting up a GCC central bank and meeting a set of fiscal and monetary convergence criteria, have yet to take place. However, the region's MU plans are likely to remain on the agenda, in part because of the perceived economic benefits but also because it represents the culmination of a longstanding ambition for deeper regional integration. Nevertheless, it must be acknowledged that in reality, an MU will never be entered into for economic reasons alone. Ultimately any decision will be borne out of political considerations and only achieved with concerted political will.

Arguably the GCC countries are now in an ideal fiscal position to move ahead with economic reform including the MU project as they have ample funds to soften any transitional costs. High oil prices since 2002 have resulted in a region-wide economic boom which has been the most pronounced throughout the period covered in this study (1980–2006). As an indicator of the huge increase in the Gulf's income during the last few years, in 2006 their collective current account surplus of $176 billion rivalled that of China's. All the more impressive when one considers the fact that the GCC has a population of just 35 million compared to China's 1.3 billion. Many energy analysts predict that current oil prices and levels of demand will be in place for a number of years so come; some even believe a 'price paradigm shift' has now taken place. A 2007 International Energy Agency report projected that global oil demand would increase by 2.2 per cent annually, climbing from 86.1 million barrels per day (mbpd) to reach 95.8mbpd by 2012.

Nevertheless, the 'feel-good factor' brought on by these huge oil price windfalls, seems if anything, to have reduced the urgency with which the MU project is being pursued. Indeed, it is worth noting that the Gulf's most unambiguous commitment to MU and regional economic integration – the signing of the new GCC Economic Agreement – was taken in 2001, at the tail-end of a protracted period of low oil prices, coupled with stagnating growth rates and, in many cases, declining per capita incomes. It would seem that the region's vast new wealth might be encouraging the view – at least among some members – that hydrocarbons alone can float their citizens into an endless future of economic wellbeing, avoiding the difficult economic and political reforms which are part and parcel of the MU project, not least the devolution of hitherto jealously guarded sovereign powers to supranational GCC institutions and the need for greater fiscal discipline and budget accountability.

But no matter how well-endowed with hydrocarbon resources, those resources are nevertheless finite and depleting and while there may be some conjunctural nonchalance about the current state of affairs there are still many statesmen, economists and opinion formers in the Gulf who recognize that economic diversification must remain an ultimate policy objective and that MU will be one of the essential factors in broadening the GCC's economic base.

The choice of model

Naturally, as with any such major policy endeavour, opinions on the economic utility of a GCC MU are mixed. On the one hand, it has been argued that there will be few advantages, as member economies already have stable exchange rates vis-à-vis one another and therefore, will not benefit substantially from conventional advantages of MU such as the elimination of exchange rate risk. As intra-GCC trade is considered low, a reduction in transaction costs will likewise, not provide significant gains. Jadresic (2002) for instance, concluded that 'the benefits do not seem too large ... neither do the costs'.

On the other hand, and as this book will point out, there are likely to be a range of advantages, both conventional MU ones and associated ones. Many of the latter can be characterized as indirect outcomes. We view these as significant *associated advantages* as they will benefit the general polity and society of the Gulf states (for example the implicit need for more transparency and budget accountability will enhance private sector confidence, the need for greater fiscal discipline should foster more balanced and sustainable growth). At the same time, we also acknowledge that those who benefit from the opaque status quo, may conceivably view what we term 'associated advantages' as not being advantageous and rather as 'costs' or 'obstacles'.

It should also be stated from the outset that the magnitude of any costs or benefits arising from a GCC MU will depend not only on a range of variables including the degree to which the Gulf states meet structural criteria and the degree of preparations made in the lead-up to MU but also on what type of MU the bloc decides to implement. At one end of the spectrum is the Eurozone, at the other is the Eastern Caribbean Currency Union (ECCU)[1] and the three French franc zones.[2]

Unlike the euro which is a free floating currency, the East Caribbean dollar has maintained a fixed peg to the US dollar since 1976. Eight Caribbean states share this currency and it is managed by a single institution – the East Caribbean Central Bank. The IMF (2007e) defines the ECCU as a 'quasi-currency board arrangement' and credits it with delivering both price and exchange rate stability and fostering a relatively deep and stable financial system. A currency board system is considered to add credibility to a fixed exchange rate regime (De Grauwe 2007).

The French franc zones' common currencies are similar to the East Caribbean dollar in that they also maintain a fixed peg to an anchor currency, in this case the euro, but the nature of the MU is different. Primarily France guarantees convertibility at a fixed rate into euros for these currencies, in return France has representation on the two regional central bank's executive boards and MU members are required to deposit 65 per cent of their exchange reserves with the French central bank (Healy 2003). Having a fully convertible currency is generally considered to increase FDI inflows and encourage private domestic investment (capital retention).

The question of whether a future Gulf dinar would remain loyal to the dollar peg, as alluded to at the outset of this introduction, or opt for an alternative form of exchange rate regime is a subject of enormous speculation in both the regional and international financial press. In a similar vein to the ambiguity that surrounds the MU project in general, GCC government officials and central bank governors have often given mixed signals on what the future regime is likely to be. Currently, the consensus view is that the new currency would initially stick with the status quo and alternatives such as a trade-weighted peg or a some form of free float would be considered at a later date.

Undoubtedly the launch of the euro in 1999, and its subsequent success, rekindled the GCC's interest in proceeding with their own MU plans. Indeed, at the 2001 GCC summit, at which members set out a clear timetable for achieving MU by 2010, King Abdullah of Saudi Arabia stated that the EMU was the 'model to follow' (Al-Saud 2002). The European Central Bank (ECB) has provided direct assistance to the GCC by providing a 'draft monetary agreement' for the GCC MU (Ameen 2006a). The ECB has also run a series of workshops with the GCC Secretariat's MU technical committee and the Payment Systems Committee while the former head of the IMF, Rodrigo Rato, has suggested that on their path towards a single currency the GCC should learn from European institutions such as Eurostat – a supranational data-gathering and statistical agency that helped assess EMU convergence prior to the euro's launch (Al-Mansouri and Dziobek 2006). Nevertheless, there may be features of EMU which are in some instances inappropriate and in others highly challenging for the Gulf states, as we shall see later in this book.

Regional monetary precedents and problems

There are some regional precedents to the planned GCC MU, which, in a similar vein to the ECCU and French franc zones, have a link to former colonial rule. Since the 1950s, with the exception of Saudi Arabia, which has had its own currency since Ottoman times, all of the present-day GCC states once used a common currency, the Indian rupee, reflecting the dominant role of Britain's Indian Empire in the Arabian Peninsula. Between 1959 and 1966 these states actually used their own distinct common currency known as the Gulf rupee, but pegged to the Indian currency.[3] However, after gaining independence in 1961, Kuwait replaced this with its own sovereign currency, the Kuwaiti dinar.

In the early 1960s several Gulf states sought to establish an independent MU. This culminated in 1965 with the signing of the Arabian Gulf Currency Agreement by Abu Dhabi, Bahrain, Dubai and Qatar. Under this agreement an MU was to be formed and a common currency would be introduced for general circulation. However, differences emerged during the implementation process and as a consequence, Qatar and Dubai decided to form their own MU and signed the Qatar–Dubai Currency Agreement in March 1966 (Symes 1997). The agreement provided for the introduction of a common currency and the establishment of a currency board to manage it.

In June 1966, India devalued its own currency and the Gulf rupee declined with it (Johri and Miller 2002). Most Gulf states did not feel a devaluation was appropriate for their economies and sought alternatives. During the transition away from the Gulf rupee all the Gulf states briefly used the Saudi riyal but eventually Qatar and most of the Emirates that now comprise the UAE agreed to start using their own recently agreed upon single currency, the Qatar and Dubai riyal. However, the Emirate of Abu Dhabi opted for the currency of the newly independent Bahrain, the Bahraini dinar. This left only Oman using the Gulf rupee and it continued to do so until 1970 when its own sovereign currency, the Omani rial, was introduced. The Qatar and Dubai riyal continued to circulate even after Qatar gained independence in 1971 and Dubai, also gaining independence, became a member of the UAE in the same year. It was not in fact until 1973 that the riyal ceased to be legal tender. It is also worth bearing in mind that the seven Emirates of the UAE, whose economies were, and are, by no means homogenous, all adopted the Emirati dirham without any documented monetary complications.

By the mid-1970s, with turbulent political, economic and military events rocking the whole Middle East, there was a renewed interest in MU among the Gulf states. In 1975, Kuwait's Central Bank commissioned Professor Robert Mundell – who established the foundations of the OCA theory – to assess the region's suitability for MU; at this time the plan was to include *only four* of what are now the six GCC states – Bahrain, Kuwait, Qatar and the UAE (Al-Hajji 1999). Nevertheless, soon after its formation in 1981, the GCC adopted the wide-ranging Unified Economic Agreement (GCC Secretariat General 1981) which set out a framework for full economic integration and stated that *all six* states would 'endeavor to establish a joint currency'.

The 2001 Economic Agreement and after

A shared culture, language, religion and resource dependence should theoretically make the relinquishing of sovereign currencies less politically contentious and emotive than was the case in the Eurozone countries prior to 1999. Yet, apart from the GCC states signing a free trade agreement (FTA) in 1983, there was little tangible progress until the December 2001 GCC summit where leaders re-energized their economic integration efforts. At the summit of 2001 a revised economic agreement was signed and although broadly based on the original 1981 economic agreement, the language was more specific. For instance, Article Four stipulated that all members would work towards a specific timetable in order to prepare for monetary unification (GCC Secretariat General 2001).

The 2001 Economic Agreement listed specific steps that would need to be taken in order to establish a GCC MU. They included fostering a high level of harmonization in all economic policy areas, particularly fiscal and monetary policy and setting economic convergence criteria related to monetary and fiscal stability. It was agreed that a customs union be established as soon as possible, convergence targets set in 2005, a common market completed by 2007 and for a GCC single currency to be launched by 2010 (GCC Secretariat General 2001).

The GCC Secretariat is the main supranational institution in the Gulf and is located in Saudi Arabia with a staff of several hundred. In 2002 the GCC Supreme Council set up a Monetary Unit at the Secretariat, however its role and influence are debatable – to date it has published no research papers or policy recommendations on the proposed MU which are in the public domain. It remains the case that most (provisional) decisions are made by the bloc's respective central bank governors who meet twice a year and report to the GCC Committee for Financial and Economic Cooperation.

Yet all binding decision making powers ultimately rest with the region's rulers. For instance in 2006, the UAE Central Bank governor, Sultan Al-Suwaidi, said that central bankers had reached agreement on several issues and passed these onto the Committee for Financial and Economic Cooperation. These issues included 'agreement on the framework of the proposed common monetary authority, or the GCC's central bank, and its relationship with the individual central banks, as well as payment systems and the suggested reserves'. Al-Suwaidi, added that the 'draft monetary agreement [was] based on the draft agreement that was provided by the European Central Bank' (Ameen 2006a). Yet to date, none of these decisions appears to have been officially endorsed and the GCC central bank is yet to be established.

The GCC agreed to officially peg their respective currencies to the dollar by 2003 in order to stabilize bilateral exchange rates in the lead-up to MU. For most this was essentially a cost-free move as they already had de facto pegs to the dollar, Kuwait alone had to modify its exchange rate regime from a basket peg but retained a band of adjustment of ±3.5 per cent.

In 2003, in what was considered a major achievement towards integration, the GCC began the first phase of setting up a customs union that harmonized external tariffs to five per cent and removed intra-regional ones. Yet the final stage of the customs union, scheduled for the end of 2005, has been complicated by the discord arising from Bahrain's decision (later followed by Oman) to 'go it alone' and sign a bilateral FTA with the US. It was agreed at the 2005 GCC summit that the interim period for the customs union would be extended until the end of 2007.

It was widely anticipated that the GCC would formally adopt a set of convergence criteria at the 2005 summit, not least because the bloc's central bank governors had reportedly agreed on the style of convergence criteria (along the lines of Europe's Maastricht criteria), but at the summit it was agreed that finance ministers needed more time to consider them. Yet according to officials at the GCC Monetary Union Unit ministers have since agreed upon a set of monetary and fiscal convergence criteria.

However, at the 2005 GCC summit leaders did agree to exempt most goods from tariffs and to allow Gulf nationals to conduct commercial activities across the bloc, most notably citizens full access to one another's bourses. Gulf nationals do not need passports to travel between GCC states and they are also allowed to own property and many types of business in neighbouring states. As this book goes to press, the GCC Secretariat announced on 1 January 2008 that a GCC common market had come into being. However, the Secretariat acknowledged that the common market is far from complete given that it may take many months, if not longer, to negotiate the harmonization of legislation across the bloc.

Although little progress on the path to MU has been made and scepticism in the regional press has grown, up until 2006, there had been no actual setbacks. This changed in 2006 when Oman opted out altogether. Although an MU without Oman is perfectly feasible economically speaking, it nevertheless dealt a political and psychological blow. The Omani government cited the general lack of progress that had thus far been made towards the GCC MU for its decision, but we contend that the growing controversy surrounding the utility of pegging to a weakening dollar and the divergence of opinions on the optimal future exchange rate policy for the future single currency is likely to have been another key factor. While Oman (and probably Bahrain) see advantages in a weak currency (as it makes their non-oil manufactured goods more internationally competitive), Kuwait clearly does not.

The second setback was Kuwait's decision in May 2007 to revert to its pre-2003 exchange rate regime, citing the need to tackle 'imported inflation' through a gradual currency revaluation. This move jeopardized one of the few monetary convergence areas the GCC had been meeting – stable bilateral exchange rates. While the dollar component of Kuwait's basket peg is thought to be substantial, the Kuwaiti dinar will inevitably fluctuate more now vis-à-vis the other currencies (in the five months following this move the Kuwaiti dinar had appreciated by five per cent against the dollar).

The third setback came in September 2007 when Saudi Arabia's central bank governor, Hamad Al-Sayyari, let it be known that GCC central banks had agreed to deal with their respective inflation problems separately (Augustine 2007a). The UAE central bank governor added further uncertainty by warning that the 2010 launch date may need to be put back to 2015. Nevertheless what regional central bankers say and the policy decisions actually taken by GCC leaders are not always in sync. In December 2007, the communiqué of the GCC summit stated that the leaders remained committed to the MU project and the scheduled launch date of 2010 and since September 2007 the monetary policies of the four pegged currencies have not diverged.

While it is our view, given the limited progress to date, that meeting the 2010 deadline now seems ambitious, as regional leaders have invested considerable political capital in the MU project it seems inconceivable that they will abandon it altogether. In addition, the wider geopolitical scene must be taken into consideration. The nations of the Arabian Peninsula lie on a fault line of Middle East tensions – tensions which are unlikely to evaporate in the foreseeable future. In the coming years they may well realize that greater unity of purpose is an essential prerequisite of their survival as both modern and monarchical Islamic states and that MU is a key means to achieving that objective.

Outline of the study

This book has two key objectives: firstly, to assess the appropriateness of MU for the GCC as an economic region and, secondly, to ascertain the costs and benefits, for the bloc as a whole (and where possible on a country-by-country basis). We will also outline some implications and prospects for the Gulf dinar. In addition primary evidence gathered from a GCC business survey on the subject and the views of regional experts expressed in interviews conducted by the author,[4] this book also uses extensive empirical analysis based on officially published regional datasets – where credible and consistent – and data collated by institutions such as the Arab Monetary Fund (AMF), the International Monetary Fund (IMF), the UN and the World Bank.

This book proceeds as follows: Chapter 2 will begin by providing a macroeconomic overview of the GCC and, where relevant, highlighting the similarities and differences between the member economies. It will focus in detail on the GCC's main economic characteristics, key economic policies and the bloc's performance over the period of study. It will then touch upon some of the challenges facing the region which may well become more pronounced in the coming years and will undoubtedly have a bearing on the MU project; in particular the extent of the GCC's continuing dependence on hydrocarbons and growing national unemployment levels are highlighted.

In Chapter 3 we undertake an assessment of the GCC as a Mundellian 'economic region' and test the bloc against the OCA criteria. According to OCA theory, groups of economies with high levels of intra-regional trade, factor market mobility, economic diversification and business cycle synchronization stand to benefit most from MU. We investigate both quantitatively and qualitatively, the extent to which GCC economies meet the core OCA criteria. This chapter also takes into consideration later empirical research which has concluded that even if a group of economies do not meet all of these criteria prior to forming MU, the process of unification itself may result in these criteria being met.

In Chapter 4 the GCC's progress towards MU is critically assessed. The experience of EMU has illustrated that a number of prerequisite policies and preparations are required in order to establish a stable and sustainable MU; we term these the *European criteria*. In particular, we assess the progress towards establishing a common market, building supranational institutions not least a regional central bank, meeting provisional convergence criteria and preparing the private sector. Finally in this chapter we analyze the GCC leaders' motivation in seeking to establish a single currency and attempt to assess the degree of political commitment to the project – undoubtedly a critical prerequisite for forming an MU.

The potential costs arising from the GCC MU are assessed in Chapter 5, as well as the conventional costs of MU, the analysis will also indicate where additional and at times region specific costs may occur. We consider the cost of losing sovereign control over monetary policy from a dynamic perspective, as well as the potential costs arising from the divergence of macroeconomic policies. The degree to which the imposition of ‘Maastricht-style’ fiscal rules will be economically costly to these oil dependent economies is also assessed. Finally we examine the perceived ‘political costs’ to the region’s ruling elites, greater fiscal budget accountability and the creation of supranational institutions will inevitably involve the ceding of some sovereign powers.

Chapter 6 considers the likely benefits of MU for the Gulf states. Many of the benefits arising from a single currency are of a microeconomic nature; we analyse the potential efficiency gains arising from reduced transaction costs, exchange rate risk and increased price transparency. The benefit of a single currency in terms of fostering increased trade and capital market growth in the region is also considered. Further associated benefits are also discussed in this chapter, such as the potential for MU to act as a catalyst for economic reform. Preparing for MU will require improvements in fiscal policy management in the region and increasing the transparency of regional budgets as well as building strong independent institutions. Finally the chapter considers the geopolitical gains from achieving full regional economic integration and the degree to which these will act as incentives to spur the process of MU.

Chapter 7 of the book acts as a conclusion to our preceding analysis, summarizing the main findings of our study and providing a preliminary cost–benefit balance sheet of MU for the bloc. It looks at the region-specific importance of the OCA and European criteria in determining how viable and potentially successful a Gulf MU may be. It also considers whether or not all member states will benefit to the same extent from joining the future MU.

Finally, Chapter 8 concentrates on future issues and controversies surrounding the MU, in particular it will focus on the external exchange rate options for the Gulf dinar. At the centre of this question is the debate over the continuing utility of the dollar peg and the possible advantages of a more flexible regime. It will also consider what bearing, if any, the region’s commodity dependency has on the prospects of establishing a viable MU. The book closes with a discussion of the geopolitical implications of the Gulf dinar and whether it has the potential to take on a wider regional and even international role.