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GULF PAPER

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Emilie J. Rutledge

The purpose of this paper is to set out the steps that members of the GCC would need to take in order to effectively implement their long planned currency union. It will be argued that the preparatory measures themselves are likely to constitute some of the key economic benefits. Optimal Currency Areas (OCA) will only manifest within a single market in which labor and capital are mobile and in which banking operations and fiscal budgetary decisions are accountable, transparent, and subject to intra-regional institutional regulation and oversight. Thus, in taking steps toward a currency union (CU), participating members would first need to establish a single market and devolve, when required, some executive decision making powers in relation to monetary and macroeconomic matters. By doing so, they would create a larger and deeper market that would be considerably more attractive to domestic and foreign investors alike. However, if member states do achieve such precursors and form a "single" currency – as opposed to a "common" one which, give or take, they effectively have with their extant relationships with the US dollar – the driving force will have been political, not economic, incentives (as it was in Europe).

As the Eurozone is the only real barometer by which to gauge the prospects and merits of forming a CU, this paper will draw heavily on its experiences to date.

Unlike other instances of CU, de facto or de jure, the 18 members of the Eurozone elected to cede monetary policy decision making powers and to make the euro their sole legal tender. They did so for a range of perceived economic and political benefits that, it was argued, would result as a consequence of this move. The adoption of the euro back in 1999 was also a driving force behind the GCC's own Unified Economic Agreement of 2001 (in which Article 22 covers the planned 'joint currency'). The euro, moreover, has survived the worst post-war financial crisis and the subsequent recession, demonstrating that CUs can be managed, perhaps not always optimally, and maintained during economic booms and busts.

In terms of progress, relatively little of concrete substance has actually occurred since the Unified Economic Agreement. The GCC Customs Union, which was partly adopted in 2003, has yet to be fully implemented and is presently targeted for completion by January 1, 2015. Forming the Customs Union is a necessary precursor for a GCC Common Market (which was originally planned for 2005). In 2008, however, four of the six member countries did sign up to a Monetary Union Agreement (Article 3 of which specifically mentions a single currency) and, in 2010 the Gulf Monetary Council began operations.

The Costs and Benefits of Adopting a Single 'Gulf Dinar'

There are a number of "conventionally" conceived costs and benefits associated with a group of countries entering into a CU. To an extent, the magnitude of a key cost – loss of independent monetary policy – will depend on pre-existing monetary policies and, in particular, exchange rate policy. The main benefit is said to be the elimination of the transactions costs associated with switching between various sovereign currencies. With respect to the GCC countries, as all of them have fixed dollar pegs, they have already forfeited a fair degree of monetary policy autonomy.[1] By the same token, the benefits in terms of reducing transaction costs may be less pronounced than they have been for Eurozone members.

It follows then that the key cost/benefit analysis regional decision makers need to undertake is with respect to the market environment that the single currency, once launched, will operate within. As the Eurozone has shown, other costs can and do occur from limited labor, capital and goods/services mobility, and inadequate institutional structures. This really is the crux of the issue: to mitigate these costs requires a functioning 'free' and single market and robust inter-regional institutions

1. Strictly speaking, only five of the six members maintain dollar pegs. Kuwait did peg its dinar to the dollar between 2003 and 2007, but currently pegs to a basket of currencies. Nevertheless, this is widely reported to remain heavily weighted towards the dollar.

that ensure transparency and whose remit inter alia is to promote financial stability, pool and manage fiscal resources and mutualize risk. Both the creation of such a market and the creation of such institutions (irrespective of the latter's location/s) can be considered as key CU pre-operational steps.

Another consideration is that the richer economies (resource or productivity wise) will at certain points need to fund poorer ones. If the euro is to remain the single currency for the Northern and Southern groups of Eurozone countries, such fiscal transfers combined with much more intensive oversight (centralized control of some description) by the richer countries of the budgetary positions of the poorer countries is said to be inevitable. Such prospects must carefully be assessed by all prospective members of a GCC CU: What are the costs and benefits likely to be for the (relatively) richer and poorer member countries and, for the region as a cohesive whole.

Monetary Issues

The elimination of currency risk within a CU reduces uncertainty over future prices for individuals and investors, helping them to make better decisions about how much to produce, invest, and consume. It also reduces inefficiencies that can arise when exchange rates fluctuate for non-fundamental reasons (e.g., speculative buying and selling of the various currencies). Conversely, flexible exchange rate policies can act as a valuable shock absorber when domestic wages and prices are inelastic. For example, if demand for a given country's exports were to fall, all other things being equal, its output would fall and this would lead to increasing levels of unemployment and a deterioration of its current account. To counter this, by way of independent monetary policy, a depreciated currency could mitigate these negative consequences by improving competitiveness (in turn stimulating increased demand for its exports).

In terms of independent monetary policy, while the GCC states do not presently freely float their respective currencies, by entering into a formal CU they would be forfeiting this option and potentially have to go along with monetary decisions that, while beneficial for the region as a whole, may not be considered as being in their individual best interest. On the other hand, if the GCC countries (or a number of them) were to form a CU with a market more integrated than it currently is and with strong intra-regional institutions, the opportunity to freely float would be that much more tenable as it would be based upon the unitary Gulf Dinar's larger domestic market and geopolitical weight. While a dollar peg may still be the optimal choice in the period following the CU's launch, in the medium term a flexible basket incorporating, for example, the euro and the Renminbi, or a managed exchange rate

may better suit a more economically diversified bloc that is seeking to promote its non-(raw)resource based international trade.

Market Issues

Robert Mundell, in the seminal theoretical work on optimal currency areas, argued that currency areas would be optimal only in regions which had high internal factor mobility.[2] Labor (and capital) by moving from areas where demand has fallen to those where it has risen would help in moderate changes in wages and unemployment. While labor movement is free, legislatively speaking, in the Eurozone, in reality it is not all that fluid due to practical impediments such as language differences. Indeed its rigidity has resulted in the need for the painful internal devaluation in an attempt to restore competitiveness that we are currently witnessing in some Eurozone member countries.

Within the Arabian Gulf, there is currently a high degree of structural convergence, although this may start to diverge if the various economic diversification programs now underway result in different sectoral specializations. The argument goes that if structural divergence increases, asymmetric shocks become more likely, and if these were to occur within a CU, a single monetary policy mechanism may not be optimal.[3] However, if an operational single market was first created, this would go some way to harmonizing (distributing and dissipating) such shocks – the proviso being that the movement of labor and capital were both unfettered legislatively and in practice. For example, an investor losing money in one part of the union would concomitantly be making money in another. Indeed, monetary economists have put forward arguments for both the viability of symmetrically linked and asymmetric groups of nations thus, being similar does not necessarily help and being different does not necessarily hinder.

Either way, CU is said to deepen integration over the longer term, and it does so by eliminating the barriers between markets, improving transparency of pricing, increasing competition, and improving the flow of technology and ideas. This also includes increasing the volume of intra-regional trade in goods and services and providing investors with access to deeper, more liquid financial markets which, it is believed, will reduce borrowing costs.

2. R.A. Mundell, "A Theory of Optimum Currency Areas," *The American Economic Review,* 51, no. 4 (1961): 657-665.
3. See, for example, M. Sturm and N. Siegfried, "Regional Monetary Integration in the Member States of the Gulf Cooperation Council," European Central Bank Occasional Paper Series, Frankfurt: European Central Bank 2005.

In these ways, members of a CU ensure greater dynamic efficiency and can exploit comparative advantage more fully. It is interesting to note that a significant percentage of business (predominantly owned by nationals) is in favor of deeper market integration and indeed some form of GCC CU.[4]

The Way Forward: the Necessary Steps

In short, the Maastricht convergence criteria are no longer considered in of themselves to be adequate monetary union preparation precursors. While seeking to harmonize such criteria (which include, for example, the harmonization of prospective member inflation rates and government debt-to-GDP ratios) in the lead up to a CU will still be necessary, it will be the fiscal coordination post union that will be of most import and have the greatest role in making the CU effective, efficient, and sustainable. The static conditions for a CU being an OCA are flexible prices and the free movement of labor, capital, and goods; in other words, a single market with free competition. A key lesson from the Eurozone crisis is that CU is viable only among countries whose socioeconomic structures are similar or among countries wishing to become similar in the medium term, however begrudgingly they acquiesce in the short term to integrate their economic systems.

It follows then that the closer a group of countries is to this, the more efficient it becomes to have a single currency. Implicit within this is the acceptance that some transfer of revenues for richer members to poorer ones will need to take place. Decision makers within the GCC must decide if the considerable financial cost of subsidizing the education, healthcare, pension, and job provision schemes of poorer members would, in the longer term, be outweighed by the considerable political (and socioeconomic) dividends of region-wide stability and security and the advantage of having a single market capable of fostering greater levels of intra-regional trade and also productivity gains in most, if not all, sectors of the economy.

A Common Currency as a First Step?

There is, in fact, difference between a single currency and a common currency. The euro is, of course, a single currency, but prior to its launch an alternative proposal had been for a common currency: the 'hard Ecu.' This, it was argued, would be capable of providing some of the economic benefits – reducing transaction costs and fostering

4. In this regard see E.J. Rutledge, "Business Expectations for a Common Currency in the Arabian Gulf," *Journal of Development and Economic Policies* 10, no. 1 (2008): 37-55; and E.J. Rutledge, "Is EMU a Viable Model for Monetary Integration in the Arabian Gulf?" *Journal of Economic Policy Reform* 11, no. 2 (2008): 123-134.

more intra-regional trade – without incurring any of the political costs. In 1990, the UK had advocated for this arguing that it offered investors and individuals a choice of currencies – their own and a common one which they could easily exchange between. Ecus never came into physical being because, as has been argued by Pedro Schwartz, among others, the European Commission was fundamentally more interested in the politics of union than in the economics of competition.[5] Nevertheless, for the GCC a common currency could be seen as a transitional step, in that it could normalize the usage of Gulf Dinars. Its utility may be limited to tourists and SMEs, unless it was to operate in a single GCC market. Nonetheless, a physical unit of exchange would help facilitate the transition to such a market.

Accountable Intra-regional Institutions with Executive Powers

As has been pointed out previously, despite there being a GCC Secretariat located in Saudi Arabia and the Gulf Monetary Council in Bahrain, all binding decision making powers rest with each of the region's respective governments.[6] However, the successful operation of a CU will require surrendering national sovereignty in a number of key macroeconomic policy areas. For example, a region-wide monetary institution would be required to conduct a single monetary and exchange rate policy geared to economic, monetary, and financial conditions for the best interests of the economic bloc as a whole. Fiscal convergence remains a challenge and needs to be supported by an appropriate fiscal policy framework.[7]

With reference to the Eurozone, Wolfgang Münchau has argued that to assure sustainability going forward, a robust institutional system of economic management will need to be constructed.[8] Effective CUs also need and require institutions that are capable of supporting an integrated and efficient financial sector (generally referred to as "banking unions") and would have a remit that covers common supervisory standards, ability to access central bank liquidity and lender of last resort facilities, common resolution mechanisms, and a credible deposit guarantee scheme.

The GCC region would need institutions capable of separating the risks of the state from the risks of the 'private' banking sector and fostering effective and harmonized resolutions systems between the respective governments and private

5. P. Schwartz, "Why the Euro Failed and How it Will Survive," *Cato Journal* 33, no. 3 (2013), 521–534.
6. E.J. Rutledge, *Monetary Union in the Gulf: Prospects for a Single Currency in the Arabian Peninsula,* (London: Routledge 2012).
7. Sturm and Siegfried, "Regional Monetary Integration in the Member States of the Gulf Cooperation Council."
8. Münchau, "The Euro at a Crossroads."

financial entities within the union. Therefore, prospective GCC CU members must develop robust regional mechanisms of surveillance, policy coordination, mutual financial assistance, and fiscal transfers, for which the current "one country, one vote" principle of decision making may need to be reworked into a system of weighted voting commensurate with, for example, the economic size and resources and the populations of each country. Without accountable region-wide institutions with some degree of executive power, no smooth operation of a single market and CU can be expected.

Prospects

According to Mark Carney, Governor of the Bank of England, a successful and sustainable single currency, "requires some ceding of national sovereignty, considerations [which are,] beyond mere economics."[9] This implies that prospective members of a GCC CU will need to abandon national sovereignty in more areas than just monetary policy at certain points of the economic cycle. Therefore, while the formation of a single market would result in economic benefits and would be capable of deepening intra-regional trade (critically non-oil trade), and while a single currency would foster deeper economic and political integration, it would at the same time, require a considerable trade-off. If CU cannot be optimal in lieu of a single market and a general acceptance of deeper fiscal coordination, the decisions must be based upon what kind of socioeconomic landscape each prospective member envisions for itself in the coming decades. If these individual visions are broadly aligned to one another, then the prospect of CU is still on the table; if not, a "common" currency may be the best option – while capable of facilitating intra-regional trade, it would not require the systemic institutional reforms and commitments that come with a "single" currency.

9. M. Carney, *The Economics of Currency Unions* (London: Bank of England, 2014).

About the Author

Dr. Emilie J. Rutledge is an Associate Professor of Economics at the United Arab Emirates University. She holds a Ph.D. in Economics from the University of Durham (2006; fully funded by a scholarship from the UK Government's Economic and Social Research Council). She has a Master's in Economics (Birckbeck College, University of London; with Distinction) and a Bachelor's in Economics and Arabic (School of Oriental and African Studies, University of London; with First Class Honors).

Emilie is the author of Monetary Union in the Gulf: Prospects for a Single Currency in the Arabian Peninsula (2009 hardback; 2012 paperback) and specializes in GCC economic diversification strategies at UAEU. In the past few years, she has published a range of articles in respected journals covering both regional economic integration and labor market reforms. During this period, she has conducted research and provided consultancy services to various regional and international institutions, including Oxford Analytica, the Dubai Council for Economic Affairs, the Emirates Foundation for Philanthropy, the UAE's Federal Demographic Council and Abu Dhabi's General Secretariat for the Executive Council.

Emilie's current research interests include GCC economic diversification – the strategic goal of transitioning from an oil-dependent to a knowledge-based economy – and ways in which private sector labor force nationalization can be implemented in a productive and internationally competitive manner.

Prior to taking up her position at UAEU, Emilie was a Fixed Income Analyst at Investec Asset Management in the City of London and has also worked for Her Majesty's Treasury (the UK's Finance Ministry), where she was a member of the Productivity and Structural Reform team.

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