



Gulf Research Center
Knowledge for All

Establishing a Successful GCC Currency Union

Preparations and Future Policy Choices

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Policy Papers

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By publishing this Issue of Policy Analysis the Gulf Research Center (GRC) seeks to contribute to the enrichment of the reader's knowledge out of the Center's strong conviction that knowledge is for all.

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Preamble

When the GCC launches the 'Gulf dinar' in 2010 it will be, after the euro, the world's most significant currency union. The 'Gulf dinar' will have far reaching economic implications, not only because it will become the single currency of an economic bloc that has a GDP of \$388 billion and controls 45 percent of the world's known oil reserves, but also because currency unions invariably increase the levels of intraregional trade; therefore helping the region to diversify its economic base away from dependence on hydrocarbons.

Once established, the GCC leadership may decide to invoice their hydrocarbon sales in the 'Gulf dinar', moving away from the current US dollar pricing system. There are some clear incentives for doing so. The 'Gulf dinar' would have great potential to become a reserve and anchorage currency, providing the GCC with significant seigniorage revenues. Furthermore, it could become the reserve currency of choice for Islamic and Arab central banks for a combination of religious and political reasons.

The currency union should not be viewed, as it sometimes is, as nothing more than an elaborate gesture by the region to reaffirm its unity. Along with clear economic and monetary consequences there will also be political ones. At present, the quality and depth of national statistical data varies substantially, as does the degree and level of commitment to structural reform. These factors will need to be synchronized and standardized in the run up to 2010 and will in turn encourage greater transparency and fiscal accountability.

Surprisingly, the implications of currency union for the region have only received slight attention. It is a matter of concern that without sufficient preparations and collective policy decisions being enacted the consequences of GCC

currency union could be detrimental. If coherent macroeconomic policies and guidelines are not adequately in place, one state's fiscal imprudence could, for instance, spill over and have repercussions for all member states.

This policy paper initially sets out some of the reasons for why the GCC states have decided to merge their currencies in 2010. It then presents and outlines the preparations and policy decisions that will be necessary for establishing a successful currency union. Finally, it looks at the options available to the GCC leaders once the currency union is in place, options that will influence the long term prospects and strength of the 'Gulf dinar'.

Background to GCC monetary policy

There is a history of monetary interdependence within the Arabian Gulf prior to the formation of the GCC. In the 1950s and early 1960s many of the states shared a single currency, the external Indian Rupee (prior to their independence, whilst under British colonial rule). After independence, Qatar and Dubai shared a common currency, the Riyal, for a number of years under the Qatar and Dubai Currency Authority. The Qatar-Dubai Currency Agreement was signed on March 21, 1966 and introduced the Qatar and Dubai Riyal as the currency unit in both states. This arrangement lasted until 1973.

On June 8, 1981 the 'Unified Economic Agreement' was approved by the GCC leaders just three weeks after the adoption of the GCC Charter. In addition to a general commitment calling for the strengthening of economic relations between the member states, it specifically sought to coordinate their financial, monetary and banking policies in an “endeavour to establish a joint currency”. However, following the agreement little individual or collective action was taken towards achieving the goal of full economic integration.

Over the past two decades, most of the GCC states effectively pegged their currencies to the US dollar, which provided them with exchange rate stability. It was not until 2003 that all the GCC States officially pegged their currencies to the US dollar in order to fix bilateral exchange rates as an intermediate stage to fixing their exchange rates irrevocably in monetary union (a transitory stage prior to currency union). Up until then, the Kuwaiti dinar had been pegged to a trade-weighted basket of currencies, which provided Kuwait with stable trade revenues as the currency was fixed against its major trading partners. During 2004 some economists and

regional central bankers were already considering the various monetary policy options that they will be presented with once the 'Gulf dinar' is launched. Any future decision taken may well reflect evolving trade patterns, for instance opting to peg the dinar to a trade-weighted basket of currencies, including the euro and yen, would reflect the GCC's increasing trade relationship with Asia and Europe. However, at least until 2010, it is likely that the GCC will stick with the US dollar peg. Indeed, this was reaffirmed at a recent meeting between the International Monetary Fund (IMF) and the GCC convened in Bahrain.

The case for currency union

Mundell's Optimal Currency Area theory (OCA) established the key criteria for assessing whether a given region constitutes a viable currency union. According to the theory, for an economic region to be an OCA it should have mobile flows of labor and capital; similar economic structures and synchronised business cycles; as well as a willingness to coordinate monetary, fiscal and other economic policies. Analysis of the GCC economic variables indicates that they do not, as yet, meet all of the necessary preconditions to form an OCA. Another of the key reasons against joining a currency union is that member states lose their ability to use national monetary policy to mitigate against cyclical downturns or inflationary pressure. Following currency union a single monetary policy and interest rate is set for the entire currency bloc and therefore it becomes important that the member states' economies are synchronised so that the single monetary policy is appropriate for each of them. According to some regional economists, there is currently little evidence of synchronisation between GCC business cycles. Moreover, there are political costs associated with forming a currency union which include the loss of national sovereignty and collective pressure on individual states for greater fiscal accountability and economic transparency.

Despite the apparent drawbacks of currency union, a number of benefits are also associated with it that are likely to accrue to the GCC states. The GCC states share many cultural, economic and political similarities and thus the option of forming a currency union appears both credible and viable. One of the main benefits of a GCC single currency will be the positive outcome it is likely to have on the region's desire to diversify their economies away from dependence on hydrocarbons. Much evidence, both analytical and empirical, points to the fact that trade substantially increases between

members of a currency union and most intra-GCC trade is in the form of non-hydrocarbon goods and services. Euro Zone studies have already indicated that trade between pairs of countries within the currency union have increased by 15 percent and the euro is still a relatively new inception. Additionally, many econometric models have found that a common currency triples trade amongst its members over time. The introduction of the GCC customs union in 2003 has already had a positive impact on intra-GCC trade, according to GCC Assistant Secretary General for Economic Affairs Mohammad bin Ebaid Al-Mazrouei, intra-regional trade has increased by 20 percent since its launch. This bodes well for increasing GCC trade further through the deeper integration that currency union will bring.

A single currency is also expected to have a positive impact on GCC capital markets and increase the flow of regional as well as international investment into the GCC's bond and equity markets. GCC companies are increasingly accessing corporate debt and there is great potential for significant growth of the GCC corporate bond market. Investment in GCC portfolios will grow particularly if legislation is enacted to make it easier for non-GCC nationals to hold shares. As the experience of European Monetary Union (EMU) has shown, a single currency significantly increases investment in the region's equity markets and capital inflows into financial products such as corporate bonds.

Recently, all the GCC states officially pegged their national currencies to the US dollar and for several decades they have all been linked to the US currency, either directly or as part of a currency basket. Consequently, GCC interest rates have been tied for some time to those set by the US Federal Reserve and therefore they have not been able to employ independent national monetary policy themselves. The cost of losing the ability to set independent monetary

policy that arises from joining a currency union therefore will have no bearing on the GCC states. Furthermore, evidence suggests that economic synchronisation among the members of a currency union will come about as a result of its formation. As trade increases amongst the GCC states so too will the synchronisation of their economic cycles. Additionally, the experience of EMU illustrates that a successful currency union can be formed without meeting all of the OCA criteria, the Euro Zone countries, for example, are characterised by relatively limited labor mobility.

The political costs of forming a currency union must be weighed against the various advantages. It must be said that the motivations to form a GCC currency union are not driven exclusively by economic rationalities, it is also a political statement of regional unity. The euro is as much a political entity as an economic one. The political incentives for establishing a GCC currency include increasing security, enhancing Arab solidarity and offering a quasi Islamic reserve currency. It is not inconceivable to see the GCC states at some future point deciding to invoice their substantial hydrocarbon reserves in the 'Gulf dinar'. The creation of a strong Arab currency would give confidence to the Arab world and would increase the GCC's prestige and bargaining power at the global level. The 'Gulf dinar' could constitute an alternative to holding US dollar reserves; a particularly attractive option for Arab and Islamic countries that are dissatisfied with US policy on Palestine and Iraq.

Preparations necessary for a successful currency union

The recent establishment of a GCC customs union, which came into being in January 2003 (creating a single regional customs tariff of five percent), is a step towards synchronising the region's economies. Nevertheless, for a smooth and successful transition to a single currency, many more steps will need to be taken collaboratively by the regional governments. Policy decisions must be made sooner rather than later in the following areas:

1. **Creating a GCC common market** – The deadline for establishing a GCC common market has recently been set for 2007. The free movement of services, labor and capital required for a common market has yet to be negotiated and is likely to involve a lot of legislative and regulatory groundwork. Free trade in the service sector such as banking and finance will require much greater coordination in terms of multilateral surveillance and regulation. While free movement of capital will require establishing greater links between national stock markets, harmonizing industry standards and enacting legislation to allow for the cross-listing of companies. Labor mobility is a key OCA criterion, but as GCC nationals are predominantly employed in the public sector and are not often inclined to migrate for employment, the decision on allowing free mobility of labor throughout the GCC must, if it is to be meaningful, include the expatriate labor force. Expatriate labor is by far the most mobile sector of the GCC labor force, which could be further utilized as an adjustment mechanism to minimise the effect of domestic shocks in these economies.
2. **Creation of a GCC Central Bank** – Initially, the GCC had decided against creating a Central Bank. They

instead proposed that a member of each of the existing banks would meet and collectively manage future monetary policy. This position has changed and it was recently announced that a central bank will be established. A GCC central bank will need to coordinate and set GCC wide monetary policy. Without it these issues would become complicated as national Central Banks would be more likely to act unilaterally, something that could jeopardize the currency union. The exact model of a central bank has yet to be decided, with finance ministers still debating the merits of merging the existing national Central Banks versus one styled on the European Central Bank (ECB). GCC leaders will also need to agree on each state's capital contribution to the bank and on the allocation of future seigniorage revenues. The structure and mandate of the central bank must be agreed upon by GCC leaders in the next few years if the bank is to function efficiently prior to currency union. Additionally, existing regional institutions, such as the GCC Secretariat, need to be strengthened and given the power to enact region wide policies.

3. **Setting convergence criteria** – Although the GCC did not set any form of entrance test for membership of the currency union it is, nevertheless, still important to set limits and targets for key economic variables that they can then work on achieving. It is likely that these convergence criteria will be similar to those of the Maastricht criteria. The Maastricht criteria stipulated acceptable levels for public debt, government budget deficits, long term interest rates, exchange rates and inflation. The European Union set limits on these fundamentals that were essentially in line with the performance of the dominant and largest economy, Germany. In the case of the GCC, it is clear that Saudi Arabia is the dominant economic member (with 55

percent of GCC GDP and 69 percent of the total GCC population). Potential problems are likely to occur particularly when setting a level for government deficits which have reached as much as 20 percent of GDP during times of low oil prices. High deficits such as these are not generally considered acceptable in the long term, for instance the EMU limit is set at just three percent of GDP. In the Gulf, however, such high deficits tend to be common and usually correlate with low oil prices. There have been suggestions that targets may be set for non-oil government deficits but again even the performance of the non-oil sector is heavily influenced by the price of oil.

4. **Agreement on bilateral exchange rates** – Prior to currency union, the GCC leaders will have to agree upon the bilateral exchange rates between their currencies that will be permanently fixed in the currency union. To date, there have been no public announcements regarding this issue. The GCC may well be considering the decisions made by members of EMU prior to the launching of the euro. In the case of the euro, the bi-lateral exchange rates were locked in at their central rates and these were announced seven months before its launch. Even though the collective peg to the US dollar provides a stable bilateral rate which could be fixed in the currency union, some states may wish to renegotiate their values against the US dollar, especially if they feel that their economic standing has improved.
5. **Coordinating economic policies** – Until now there has been little cooperation between GCC states in terms of their national economic policies. As a result, several states have invested in the development of parallel industries creating duplicity in production; this may result in some painful adjustment once a currency union

is in place. Greater efforts should now be made by all the GCC members to coordinate their economic policies. Increased cooperation will minimize the damage caused by establishing directly competing activities and intra-industry activities should be developed on a regional basis wherever possible. Fiscal policies also require coordination under a monetary union. The EMU Growth and Stability Pact was introduced to ensure fiscal discipline across the union, with hindsight it is easy to see that it was too restrictive and was not able to adapt to periods of recession. The Growth and Stability Pact placed a limit on the level of government deficit at three percent of GDP and on government debt at 60 percent of GDP, with exceptions being made under certain circumstances. Both Germany and France, however, breached these limits in 2002 and 2003, and other states such as Italy and Portugal have had great difficulties in meeting them. The GCC can learn from this and formulate a more flexible fiscal pact, factoring in the inherent volatility of hydrocarbons and economic cycles.

- 6. Increasing transparency and data standardization –** Problems of data standardization and lack of timely data provision create difficulties when it comes to analyzing the GCC economies. Furthermore, government announcements on economic policy and the related budgetary commitments are often only provided in a piecemeal and ad hoc manner. So far only Kuwait and Oman have signed the IMF's standardization of data charter. The need for clear economic data will become even more important once convergence criteria is agreed upon in order to assess whether individual states are meeting them. Once the constituent states are tied together in currency union, the need for transparency and standardization will be vital as all members will face the economic repercussions of any

one government's excessive spending and borrowing. Member states' public revenues and expenditures should be recorded in a similar fashion and produced for public scrutiny on an annual basis. The provision of reliable and timely economic data is also important in improving investor confidence in the region and explains why, despite strong economic fundamentals, the external cost of borrowing for GCC governments continues to be relatively high at present.

- 7. Preparing GCC businesses and citizens** – GCC governments will need to provide guidance to businesses, particularly small and medium enterprises which form a large proportion of GCC businesses, on how to prepare for the introduction of the new currency. In the EMU countries, concerted publicity campaigns began at least three years before the introduction of the euro. GCC businesses must be made aware of the need to ensure that their information technology, accounting, marketing, pricing and payroll systems have all been adapted for the new currency. Regulations will need to be published on the conversion of prices from the given national currency to the 'Gulf dinar'. This process will involve some rounding up or down to the nearest unit of the new currency. In order to avoid unnecessary, albeit temporary, price inflation, governments should introduce rules which specify in which circumstance rounding up is allowed. According to a survey by the European Commission carried out shortly after the launch of the euro, more than 60 percent of Euro Zone inhabitants believed that prices in all sectors had increased and another 15 percent thought that prices had risen in some sectors of the economy. It is important therefore that the GCC states avoid such surreptitious price increases by ensuring rounding rules are adhered to, especially considering the different standards of living in the GCC states. GCC citizens will also have to be

informed, through various publicity mechanisms, as to the value of the 'Gulf dinar' *vis-à-vis* existing currencies, and on how long a system of dual pricing will be in place.

Post currency union policy considerations

After the single currency has been successfully launched, the GCC leadership will be in a position to take several strategic policy decisions which will directly affect the future strength of the 'Gulf dinar':

1. **Moving away from the dollar peg** – The GCC currencies are all currently pegged to the US dollar but post 2010 it would be wise to consider the benefits of an alternative arrangement such as a peg to the euro or to a trade weighted basket of currencies. Trade with Euro Zone countries and Asia has grown significantly over the past ten years and is likely to continue to do so, therefore an exchange rate which maintains stability of trade revenues against these economic blocs would be economically prudent.

The recent decline in the US dollar has weakened the GCC currencies and has increased the relative price of imports particularly from the Euro Zone. Real wealth has been lost from the holding of reserves in dollar assets. Moreover, pegging to the US dollar alone has meant that GCC interest rates are *de facto* broadly determined by the US Federal Reserve. As a result, the GCC state's monetary policy is based on US economic conditions rather than those of the GCC. Generally when oil prices are high, the US Federal Reserve is prompted to lower interest rates in order to avoid an economic downturn caused by higher input costs. While at the same time the effect of higher oil prices in the GCC economies creates massive increases in liquidity, this combined with relatively low interest rates can create asset price bubbles. Indeed, US monetary policy is likely to exacerbate the pro-cyclical tendencies that are prevalent in the GCC economies.

The merits of a more independent exchange rate arrangement include the setting of GCC interest rates according to the GCC economic cycle. Increased exchange rate autonomy would allow the GCC states greater choice in making future economic policy decisions. The possibility of floating the single GCC currency has been taken on board by existing GCC central bankers, UAE Central Bank governor Sultan bin Nasser Al Suwaidi indicated in late 2004 that following currency union the GCC leaders would consider de-linking the currency from the US dollar and allowing it to float.

- 2. Invoicing oil in the 'Gulf dinar'** – The GCC states currently produce more than one fifth of total world oil production and collectively possess approximately two fifths of the world's proven oil reserves. Furthermore, with the exception of Bahrain and Oman, all GCC States are OPEC members. Should the GCC states decide to switch to an independent exchange rate arrangement they will then also face compelling incentives to invoice oil in the 'Gulf dinar'. A switch to invoicing oil in the new currency would create additional demand for it as Central Banks in other countries are likely to want to hold reserves in it in order to cover the costs of their oil purchases. Increased overseas demand for the 'Gulf dinar' would provide seigniorage revenues; a welcome non-oil income for the region. It would also strengthen the currency and should make it an attractive anchorage currency for other countries to peg their exchange rates against.

However, these economic and political gains would need to be weighed against the possible disadvantage of displeasing the US. There are certainly benefits accruing to the US as a result of the historical arrangement of denominating oil in dollars. The inflow of

petrodollars into US assets has in part allowed them to finance large trade and fiscal deficits and the demand for dollars has generated large seigniorage revenues for the US, in effect allowing them to purchase foreign goods and services at little cost. Seigniorage revenues for the US have been estimated at 0.5 percent of US GDP (approximately \$52 billion), though this amount does not accrue solely from US dollar oil invoicing.

3. Presenting the 'Gulf dinar' as an 'Islamic currency' –

Since 2002 there have been calls from many Islamic states for the introduction of an Islamic currency to act as a unit of exchange in all transactions. Former Malaysian Prime Minister, Mahathir Mohammed has often advocated the establishment of an Islamic gold dinar. The 'Gulf dinar', if successful, could be presented as an alternative 'Islamic' currency. Although the GCC single currency would not be strictly Islamic as monetary policy itself is contrary to Shariah law, all the GCC states are Muslim and there is an increasing amount of Islamic finance in the region. The central banks of Islamic countries such as Indonesia, Malaysia and Pakistan may be inclined to hold what they perceive to be a more acceptable 'Islamic' currency in their reserves in light of the general sentiment in the Islamic world that holding currency reserves in US dollars has helped fund some of the current Administration's controversial policies in the Middle East.

Since 9/11 there has been a move towards Islamic investments that has, no doubt, been instigated by religious and political factors. Were this trend to continue then the perception of the new GCC currency as Islamic would contribute to the currency's establishment as a strong reserve and anchorage currency. If other Islamic states were to peg their currencies against the 'Gulf dinar', then this would

further increase the seigniorage revenues for the GCC, as they would hold the 'Gulf dinar' as a large part of their currency reserves. Additionally, they may also be even more inclined to purchase GCC denominated assets and bonds.

Summary

If the governments of the GCC states legislate and enact the necessary preparatory policies and create the appropriate institutions, the formation of a GCC currency union and the launch of a 'Gulf dinar' will bring a series of economic and political benefits to the region. A currency union is more than simply rhetoric, it is a binding economic commitment that, if inadequately planned and prepared for, could have negative consequences. The willingness of all of regional governments to become more accountable, provide regular transparent economic data, publish annual budgetary reports and forecasts, submit to greater fiscal constraints and scrutiny and devolve some powers to supranational GCC institutions such as a central bank will be critical.

The currency union is sure to increase levels of intraregional trade and investment over time. The elimination of transaction costs brought by the single currency will facilitate GCC cross border business and, at the same time, allow direct comparison of costs and prices that will enhance competition and improve economic efficiency overall. Levels of foreign direct and portfolio investment are also expected to increase as will the retention level of regional private wealth. A strong independent 'Gulf dinar' that the GCC uses to invoice its oil sales will not only provide the region with substantial seigniorage revenues but would undoubtedly become the strongest currency in the Islamic world and one which Arab and Islamic states may choose to hold and peg against as an alternative to the US dollar.

About the Author

Emilie Rutledge took up her role as economic researcher at the Gulf Research Center in October 2004. She has an MSc in Economics from the University of London and is currently reading for a PhD in Economics, which focuses on the GCC's impending currency union, at the Institute for Middle East and Islamic Studies, Durham University, UK. Her previous roles include economic researcher at HM Treasury in the UK and fixed income analyst in the City of London. She worked as an economic consultant at the Syrian Consulting Bureau in Damascus and has carried out in-depth research into Bahrain's economic diversification process for the Bahrain-British Foundation.

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