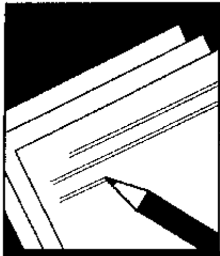

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IMF Policy Discussion Paper

On a Common Currency for the GCC Countries

Esteban Jadresic

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Research Department

On a Common Currency for the GCC Countries

Prepared by Esteban Jadresic[1]

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Abstract

The views expressed in this Policy Discussion Paper are those of the author(s) and do not necessarily represent those of the IMF or IMF policy. Policy Discussion Papers describe research in progress by the author(s) and are published to elicit comments and to further debate.

This paper assesses the eventual replacement of the currencies of the GCC countries with a common currency. It concludes that a properly implemented currency union may contribute to enhance economic efficiency in the region, deepen regional integration, and develop its non-oil economy. However, it cautions that a currency union should be seen as only one component of a much broader integration effort. This should include the removal of the distortions that inhibit intraregional trade and investment, agreements on policy frameworks to ensure macroeconomic stability, and further political integration. The paper also addresses the choice of exchange rate arrangement for the unified currency.

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Author's E-Mail Address: Ejadresic@imf.org

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I. INTRODUCTION

The creation of a unified currency system is an explicit aspiration of the Gulf Cooperation Council (GCC) countries.[2] This goal was formally declared soon after the foundation of the GCC in the Article Twenty-Two of the Council's Unified Economic Agreement of June 1982, which ascertains that "The member states shall seek to coordinate their financial, monetary, and banking policies and enhance cooperation between monetary agencies and central banks, including an endeavor to establish a common currency in order to further their desired economic integration." The example provided by the successful advent of the third stage of the European Economic and Monetary Union (EMU) in early 1999, which signified the adoption of the euro by 11 European countries, and the continuing work by the GCC member states to further integrate their economies have contributed to raise this aspiration anew. This document reviews the pros and cons of the eventual replacement of the individual currencies prevailing in each of the GCC countries with a common currency, the conditions for that replacement to be successful, and the choice of exchange rate arrangement for the unified currency.

In addressing these issues, it is useful to start by noting the remarkable convergence of the exchange rate policies followed in the countries of the region around pegs to the U.S. dollar. According to the exchange rate arrangements officially reported to the International Monetary Fund (IMF), only the rial Omani is pegged to the dollar: the Bahrain dinar, the Qatar riyal, the Saudi Arabian riyal, and the United Arab Emirates (UAE) dirham

[2] The member countries are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

all fluctuate around the value of the Special Drawing Rights (SDR)—the IMF's special accounting unit which is made up of a fixed basket of the main international currencies—and the Kuwaiti dinar is determined on the basis of a fixed but adjustable relationship between the dinar and a weighted basket of currencies. As shown in Figure 1, however, the four currencies whose values are supposedly based on the SDR are in practice pegged to the dollar—the most recent change in the dollar value of any of those currencies occurred in the mid-1980s.[3] Moreover, the dollar exchange rate for the Kuwaiti dinar, the only currency in the region whose value following the collapse of the Bretton Woods system was never pegged to that currency, has become remarkably stable in recent years, to the point that its standard deviation during the last five years was less than one percent.

Taking the revealed preference of the GCC countries for a dollar peg as a basic starting point, Sections II and III of this paper focus on the effects of and conditions for a successful currency union in the GCC countries on the assumption that the common currency also will be pegged to the dollar. In principle, of course, this only one of the several available alternatives, and thus a subsequent Section IV briefly examines the choice of exchange rate arrangement for the common currency. Section V provides concluding remarks.

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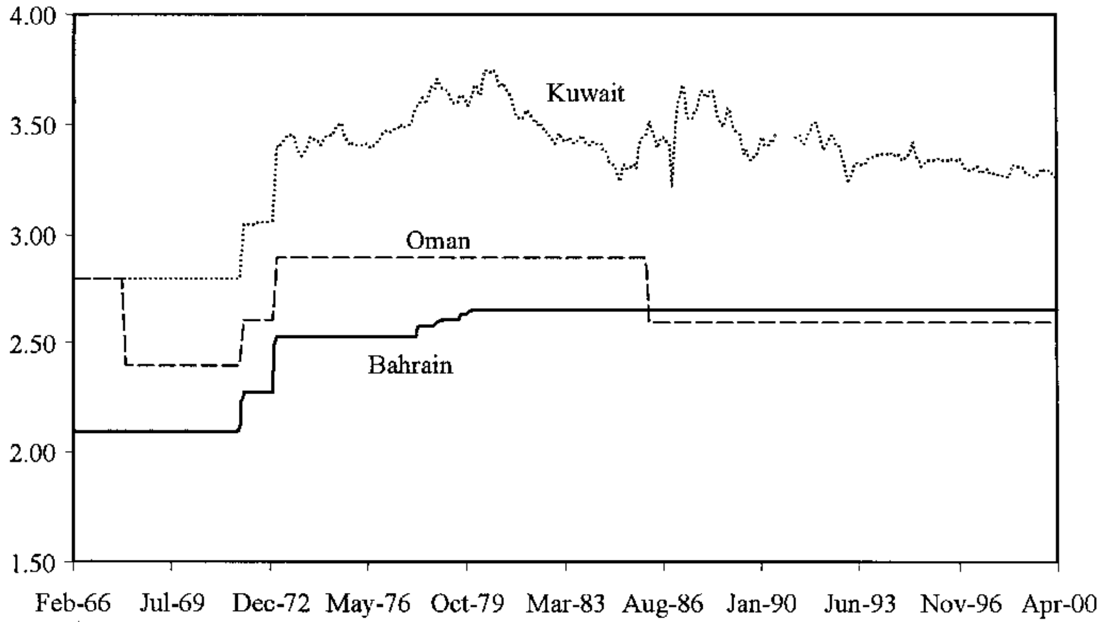
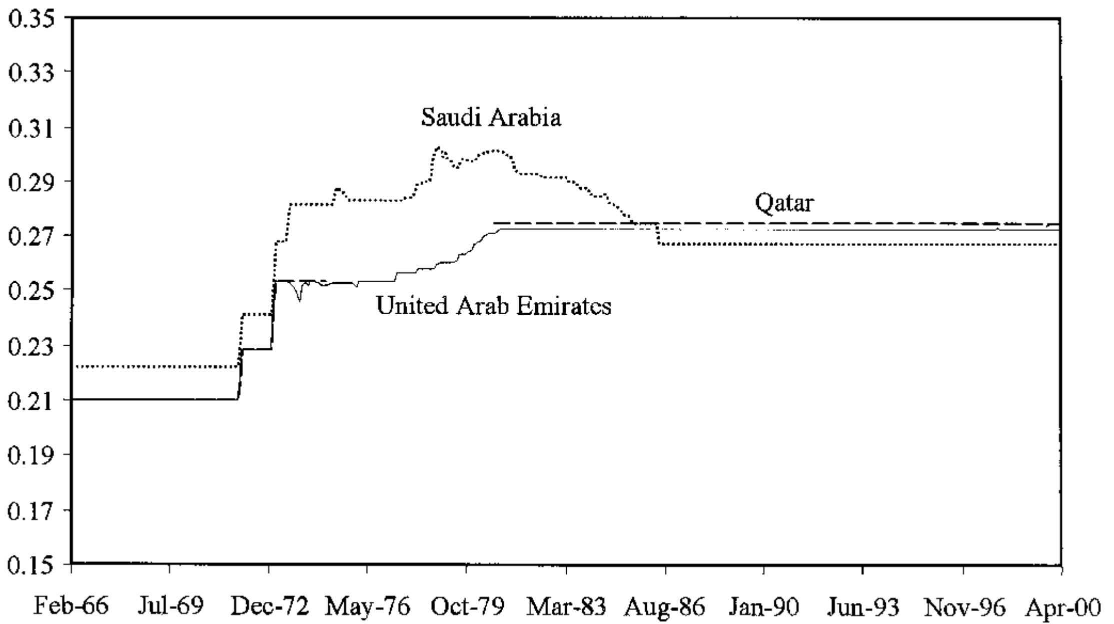
[3]In addition, while the exchange rates for Bahrain, Qatar, Saudi Arabia, and the UAE are officially pegged to the SDR, the U.S. dollar is the intervention currency.

Figure 1. Market Exchange Rates, In U.S. dollars per National Currency
Monthly, February 1966-April 2000





II. Pros and Cons of a Common Currency

The adoption of a unified currency will bring economic benefits and some potential costs to the countries in the GCC. The key benefits will stem from the elimination of the transaction costs involved in bilateral exchanges between the regional currencies and of any remaining uncertainty about the bilateral exchange rates. This will contribute to increase the general efficiency of the GCC economies, as well as to broaden their degree of economic integration and to develop their non-oil economies. The main disadvantage, in turn, is that each country will have to give up the possibility of unilaterally using monetary and exchange rate policy, and will be more exposed to potentially adverse spillovers from macroeconomic imbalances in other countries. This section examines these and some other pros and cons of the adoption of a unified currency in the region with a bit more detail. The general conclusion is that the benefits do not seem too large, but that neither do the costs.

A. Microeconomic Benefits

The main direct gain from a common currency in the GCC will be to eliminate the foreign exchange costs of intraregional transactions. A unified currency will eliminate the current costs paid by firms and households to the financial sector in the form of foreign exchange commissions and the differences between buying and selling rates when changing regional currencies. It will also contribute to reducing the accounting and other in-house costs for firms that operate in two or more of the countries in the regions, and possibly the cost and time of intraregional cross-border payments. An additional economic benefit of the adoption of a common currency will be to eliminate any remaining uncertainty about bilateral exchange rates. While at present these rates are fixed due to the general prevalence of individual pegs to the dollar, there is always the possibility that one or more of the

countries in the region unilaterally change their exchange rate pegs. Because of the time-lag between the time a contract is made and the time a trader or investor obtains or makes payment, this uncertainty may contribute to impairing the intraregional trade and investment activities of risk-averse agents. While in theory this risk could be hedged using forward or future markets, in practice these markets either do not exist or are expensive to use.[4]

It is worth emphasizing that the removal of these intraregional foreign exchange costs and uncertainties will be important not only because they will enhance general economic efficiency. Since these costs and uncertainties are essentially a tax on intraregional trade and investment, their removal also will contribute to further the region's degree of economic integration. In addition, since intraregional trade is mostly non-oil related, their removal also can be expected to contribute to the development of the non-oil economy. As is well known, these also are important economic goals for the GCC countries.

Quantifying the precise economic significance of these benefits is beyond the scope of this paper. Relative to the corresponding gains that other regional blocks may achieve by unifying their currencies, however, these gains in the case of the GCC countries are unlikely to be large. The key reason is that the magnitude of these benefits depends crucially on the number and value of the intraregional foreign exchange transactions, which in turn depend largely on the size of intraregional trade. And as it is well known, in the case of the GCC countries, intraregional trade is modest. In 1995, for instance, the value of intraregional exports represented less than 7 percent of the total value of all GCC exports (see Table 1).

[4] For a fuller description of these and other effects of a common currency, and an attempt to quantify them in the case of EMU, see Emerson and others (1992).

Table 1. Intraregional Trade Patterns, 1995

	In Percent of Total Trade		In Percent of Total Regional GDP	
	Exports	Imports	Exports	Imports
GCC 1/				
Within GCC	6.6	8.5	2.9	2.6
With Euro Area	9.0	24.0	4.0	7.2
With Japan	21.5	8.9	9.5	2.7
With United States	9.4	14.8	4.2	4.5
With Other Industrial Countries	4.0	16.1	1.8	4.9
With Other Developing Countries	39.8	35.5	17.6	10.1
Euro Area 2/				
Within Euro Area	51.2	50.7	12.4	11.4
With Japan	0.5	0.9	2.0	3.8
With United States	1.4	1.5	5.9	6.8
With Other Industrial Countries	4.4	3.8	18.3	16.8
With Other Developing Countries	5.2	4.7	21.3	21.0
ASEAN 3/				
Within ASEAN	24.6	18.0	10.6	8.8
With Euro Area	4.7	5.5	10.8	11.1
With Japan	6.2	11.7	14.2	23.8
With United States	8.1	6.8	18.6	13.8
With Other Industrial Countries	3.0	4.0	6.9	8.1
With Other Developing Countries	10.5	11.9	24.3	24.3
Mercosur 4/				
Within Mercosur	22.6	20.2	1.8	1.8
With Euro Area	1.7	2.0	21.3	22.3
With United States	1.2	1.8	15.0	20.6
With Other Industrial Countries	1.2	1.2	14.3	13.7
With Other Developing Countries	2.1	2.0	26.0	22.1
NAFTA 5/				
Within NAFTA	46.2	38.4	4.8	4.9
With Euro Area	1.2	1.5	11.7	11.6
With Japan	0.9	1.7	8.6	13.7
With Other Industrial Countries	0.8	0.8	7.2	6.2
With Other Developing Countries	2.7	3.8	26.1	29.8

Source: IMF, Direction of Trade Statistics and World Economic Outlook.
1/ GCC: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates.
2/ Euro Area: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain.
3/ ASEAN: Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam (Brunei data are not available).
4/ MERCOSUR: Argentina, Brazil, Paraguay, Uruguay, and associate members (Bolivia and Chile).
5/ NAFTA: Canada, Mexico, and the United States.

This figure was substantially smaller than the 51 percent observed in the same year in the Euro Area, and also much smaller than the corresponding figure in other potential common currency areas. An additional reason why the benefits of a unified currency in the GCC countries do not seem to be particularly large is that, as mentioned above, bilateral rates in the region are already virtually fixed. The reduction in the uncertainty about bilateral rates that can be obtained by pegging them near-irrevocably is thus much less important than in other potential common currency areas.

This assessment, however, has to be qualified in at least two important regards. First, when evaluated in terms of the contribution to the GCC's key objective of developing the region's non-oil economy, the potential benefits of a common currency in the region appear to be much more significant. This is illustrated by the data in Table 2, which show the share of intraregional exports of the GCC countries including and excluding oil exports. When both crude and refined oil exports are excluded, the share of intraregional exports for the group of countries raises to as much as 34 percent. At the individual level, in most cases this share is even larger, reaching to around 60 percent in the cases of Kuwait and Qatar. Second, as it was mentioned above, it can be expected that a currency union, especially if coupled with a broader economic and political integration effort, will contribute to raising intraregional trade and investment and thus make the magnitude of the efficiency gains more important in time. The extent to which this may occur is uncertain, but recent empirical research suggests that, while the elimination of exchange rate volatility has only small effects on cross-border trade

Table 2. Intraregional and Total Exports for GCC
(All currency listed in millions)

	All Exports 1/		NonCrude Oil Exports 2/		Non-Oil Exports 3/	
	In U.S. dollars	Percent of Total	In U.S. dollars	Percent of Total	In U.S. dollars	Percent of Total
Bahrain						
Within the GCC	385	8.4	385	26.5	352	24.2
Total Exports	4610		1454		1453	
Kuwait						
Within the GCC	288	1.9	288	56.9	288	62.4
Total Exports	15367		508		462	
Oman						
Within the GCC	711	9.9	711	48.9	668	47.3
Total Exports	7221		1457		1413	
Qatar						
Within the GCC	363	9.0	363	28.3	363	58.9
Total Exports	4055		1287		617	
Saudi Arabia						
Within the GCC	1571	2.6	1571	9.5	1579	27.0
Total Exports	60108		16509		5846	
United Arab Emirates 4/						
Within the GCC	610	3.1	610	39.8	581	39.9
Total Exports	19673		1534		1457	
Total GCC 5/						
Within the GCC	3931	3.5	3931	17.3	3832	34.1
Total Exports	111037		22749		11249	

Source: External Trade Bulletin of the Economic and Social Commission for Western Asia, United Nations, 1998.
1/ Refers to all trade and products exported.
2/ Refers to all trade and products exported except crude oil.
3/ Refers to all trade and products exported except crude and refined oil products.
4/ All export figures for United Arab Emirates are from 1993.
5/ Aggregate figures include the United Arab Emirates 1993 totals.

a currency union may have large positive effects on the same variable.[5] Such an increase would reinforce the economic value of a common currency.

B. Potential Macroeconomic Costs

In order to reap the benefits of a common currency, the GCC countries will have to be willing to accept that under certain circumstances the currency unification may bring in some macroeconomic costs. The latter stem essentially from the fact that each country will be forced to follow the union's exchange rate and monetary policy for the unified currency.

A key difficulty that a currency unification may bring about is that each country will have to surrender the possibility of unilaterally changing the value of the currency it uses. While the fact is that in the past the countries of the region have made very little use of this "exit-option," this implication is important because it is always possible to imagine situations in which a particular country faces sufficiently large macroeconomic imbalances that would make it want to change unilaterally the value of its nominal exchange rate. For instance, the country in question may suffer a large idiosyncratic shock that requires a sizable adjustment of its real exchange rate, and may assess that without a change in the nominal exchange rate, the adjustment to such a shock would require lowering nominal wages and prices through an unacceptably large recession. With a common currency, no individual country would on its own be able to undertake such a decision.

[5] Specifically, Rose (1999) has found that even after controlling for a host of features—including distance, existence of a trade agreement, volatility of bilateral rates, language, common colonial past, border sharing, and so on—two countries that share the same currency trade three times as much as they would with different currencies. While these results may overestimate the effects on trade of a currency union, they illustrate that a broad program of economic integration that includes a currency union may in the future increase substantially GCC's intraregional trade.

For each GCC country, a related cost of a regional currency union is that their individual central banks will have to give up any actual or potential use of independent monetary policy. Under the current individual pegs to the dollar, monetary policy operations are of course already very limited in each of these countries, since under such exchange rate policy liquidity is essentially determined by the demand for money. In the short-term, however, individual monetary authorities may continue to have at least some capacity to influence domestic liquidity and interest rates. Possibly most important, the fact that each country has an independent currency implies that, in extreme circumstances such as a massive crisis in the banking sector or in public finances, their individual monetary authorities can always ponder financing their lender-of-last-resort activities by printing money. Such an alternative may not necessarily be the most attractive one, but if a country uses its own currency, it remains as a feasible sovereign decision.

Another potential problem under a currency union is that countries that face no fundamental problems of their own may end suffering negative monetary spillovers from the macroeconomic imbalances in other countries in the region. For instance, one potential difficulty is that a given country may be fully satisfied with the existing monetary and exchange rate arrangement, but the union may decide or be forced to modify it despite the desires and conditions in that given country. Perhaps most important, it is possible that financial difficulties in one or a subgroup of countries lead to a general loss of credibility in the regional currency peg, with attendant adverse consequences on interest rates and liquidity in all the countries in the region, regardless of their particular circumstances.

As in the case of the efficiency gains made possible by a currency union, the significance of these potential costs also is difficult to quantify. Nonetheless, there are

several characteristics of the GCC countries that suggest that they are not as significant as in other potential currency unions. First, as was mentioned above, the fact is that in the past the countries in the region very rarely have chosen to modify their exchange rate pegs, which suggests that the likelihood that they will want to make use of an "exit-option" in the future due to different inflation preferences or other reasons is small. Second, since all the economies in the region have a similar structure highly dependent on oil exports (see Table 3), the large real shocks they are more liable to suffer are likely to be common in nature rather than idiosyncratic. This decreases the value of having an individual "exit-option" for each country, since when hit by a common shock, the interests of the different countries in the region are more likely to converge, and if needed, they may always jointly decide on changing the peg for the common currency. Third, while domestic labor markets are highly segmented between public and private sectors, and nationals and nonnationals, labor movements across borders are fairly unrestricted and the reliance on expatriate labor implies that private sector labor markets, including nominal wages, are relatively flexible. These characteristics make it easier for the economies in the region to adjust both to idiosyncratic and common shocks without changes in the nominal exchange rate. Fourth, the GCC countries' potential need to resort to money printing in order to deal with severe financial emergencies does not seem as likely as in other regions due to the large amount of foreign assets owned by the GCC states. While these assets are basically a reserve fund for future generations, in emergency cases they may also provide a comfortable safety cushion.

Table 3. Significance of Oil in the GCC Economies, 1996
(All currency listed in millions)

	Value of Oil Production 1/		Value of Oil Exports 2/	
	In U.S. dollars	Percent of Total GDP	In U.S. dollars	Percent of Total Exports
Bahrain	1043	19.4	3157	68.5
Kuwait	14959	51.8	14906	97.0
Oman	6513	43.0	5808	80.4
Qatar	3509	38.7	3439	84.8
Saudi Arabia	56769	40.9	54263	90.3
United Arab Emirates 3/	15396	32.2	18215	92.6
Total GCC	98190	40.0	99788	89.9

Source: National Authorities, IMF World Economic Outlook, and External Trade Bulletin of the Economic and Social Commission for Western Asia, United Nations (1998).

1/ Defined as crude oil and gas (Bahrain), oil production (Kuwait), crude oil, natural gas, and oil refining (Oman), oil and gas production (Qatar), oil sector production (Saudi Arabia), and crude oil production (United Arab Emirates).
2/ Refers to crude oil and refined products exported.
3/ Export figures are from 1993.
4/ Export total includes United Arab Emirates' 1993 figures.

C. Other Consequences of a Common Currency

Depending on the specifics of the common currency system implemented and how it compares with the monetary and credit policies and institutions prevailing in each country, the unification of the GCC currencies may have a number of other consequences that may be perceived as benefits (or costs) by some or all of the individual countries participating in the system. For instance, the adoption of a unified currency in some countries may increase the credibility of the peg of the currency they use, which in turn, may contribute to reducing and stabilizing their domestic interest rates. Similarly, in some countries the need to implement common and transparent rules regarding credit policy and banking activities may reduce the distortions and inefficiencies in their monetary and financial markets.[6]

From an analytical perspective, these potential consequences of a currency union should not be emphasized too much because they would not be a direct result of using a common currency but rather a result of changes in policies and institutions that could be achieved even without a currency union. For instance, a country whose pegged exchange rate lacks credibility could implement a currency board in order to strengthen credibility in its currency. Similarly, a well designed and implemented program could improve the working of domestic monetary and financial markets regardless of the adoption of a common currency. It should be recognized, however, that depending on the specifics of the common currency system and the policies and institutions prevailing in each country, a currency union may indeed bring important additional benefits (or costs) to the basic ones detailed above.

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[6] The increased pressure for transparency in regulation and policymaking that a monetary union may bring, however, may be regarded with suspicion in some GCC states.

This underlines the key importance of a proper design of the policies and institutions that will support the common currency, an issue which is addressed further below.

III. Conditions for a Successful Common Currency

That in an international comparison the main economic benefits and costs discussed above do not seem particularly large is not a reason for the GCC countries not to adopt a common currency. Rather, it suggests that a unified currency in the region would make full economic sense only if the benefits are maximized and the costs minimized. As further discussed below, this verdict points to the need to consider a currency unification as only one of the several components of a much broader regional integration effort, just as the creation of the euro is only one of the several components of Europe's process of economic and political integration.

A. Deepening Intraregional Economic Integration

From the analysis in the previous section, it is clear that reaping the full benefits of a common currency will require the GCC member states to deepen their degree of economic integration. While as mentioned above a common currency by itself will help to foster that integration, proper economic policies and agreements in other areas could make important contributions to increasing intraregional trade and investment and thus make a common currency more desirable.

Some valuable steps have already been taken or are planned to be taken to promote regional integration. Barriers to free movement of goods and services, labor and capital across borders have largely been eliminated. Also, the GCC heads of state have agreed to establish a common import tariff and to harmonize customs administration and procedures

at the latest by March 2005. In addition, there is continuing work in other areas of regional cooperation, including setting the rules for opening bank branches in the GCC countries, promoting foreign direct investment and intra-GCC capital flows, interlinking electricity grids among member countries, developing a common gas grid, and harmonizing investment codes and stock exchange regulations.

To reap the full benefits of a common currency, however, broader and bolder efforts will need to be made. At the regional level, the GCC countries may eventually have to consider initiatives to harmonize taxes, and labor market and financial sector policies. Perhaps most important in the short and medium-term, since the expansion of intraregional trade and investment will hinge crucially on a rapid growth of the private non-oil sector of the economy, much or most of the potential benefits of a common currency will depend on the capacity of the GCC countries to remove or minimize market and government-induced domestic and cross-border distortions. The fact that the pace of economic reforms in several GCC countries has recently accelerated is encouraging in this regard, but much remains yet to be done to promote an environment conducive to vibrant private sector activity.[7]

B. Enhancing Macroeconomic Stability

To minimize the potential macroeconomic costs of a currency union, it is particularly important that each country avoids major macroeconomic imbalances, which may make it regret not having the possibility of adopting an independent exchange rate and monetary policy. The same is true in order to minimize negative spillovers that may stem from

[7] A discussion of key aspects and challenges of the reform process in the GCC countries in the areas of financial systems and labor markets can be found in IMF(1997a).

macroeconomic imbalances in one individual state to other GCC members. The key concerns that countries adopting a common currency will need to have in this regard will be to avoid unsustainable budgetary positions and to prevent systemic crises in the financial sector.

The fiscal sustainability issue was indeed a key concern in the negotiations that permitted the creation of the euro.[8] Most members of the European Union suffered from chronic fiscal problems, as indicated by rising government debt ratios, public sectors of unprecedented size, and heavy and growing tax burdens. Most countries also faced the prospect of worsening budgetary positions in the medium to long term as a result of demographic developments. Moreover, there was increasing awareness of the negative effects of fiscal imbalances on medium-term growth, including through higher real interest rates. It was widely understood that these problems needed to be tackled, irrespective of the EMU project. It was also viewed as particularly important for the success of EMU to avoid negative spillovers from the fiscal policies of individual states to other members.

In theory, one option to address this type of concerns would be to leave it solely to financial markets to discourage imprudent fiscal policies by penalizing with larger borrowing spreads governments that follow such policies. But this is unlikely to be a sufficiently reliable solution. While there is empirical evidence that risk premiums increase with debt levels, it is questionable in many cases whether they tend to rise quickly enough to act as deterrent; and clearly, in Europe, significant premiums did not in practice discourage some

[8] For a fuller discussion of this and other macroeconomic issues that were raised by the creation of EMU, see IMF (1997b and 1998).

governments from building considerable indebtedness, albeit in a context where monetization and exchange rate depreciation remained a possibility.

A regional initiative to limit the chances of imprudent fiscal policies may take different forms. EMU members, for instance, agreed on the implementation of an excessive deficit exercise, an annual examination of fiscal policies whereby a country is deemed to be in excessive deficit if it violates either of two criteria relating to the deficit of 3 percent of GDP and for general government gross debt of 60 percent of GDP, to be used in judging whether there is sufficient fiscal discipline. There is some scope for allowing performance that is in breach of these reference values, notably where the deficit is elevated owing to exceptional and temporary circumstances or the debt is declining at a sufficiently fast pace.

In the case of the GCC countries, any regional agreement on a fiscal policy framework will have to address two major issues derived from the high dependence on oil of exports earnings and government revenues. The first is how to make a prudent use of finite oil resources balancing the interests of both the current and future generations, an issue that will require recognizing explicitly the differences in the size of oil reserves relative to population in the different GCC states. The second is how to deal with the effects of the large fluctuations in the price of oil on the budget. To deal with the latter, and while not a panacea nor absolutely indispensable, the implementation of oil price stabilization funds might play a useful role.[9]

[9] For an analysis of oil stabilization funds as a policy alternative in the GCC countries, see IMF (2000).

As noted above, another key condition for a successful common currency will be to minimize the risks of systemic crises in the financial sector, which as many previous experiences around the world have shown, can become a major drain on public sector resources and lead to concomitant currency crises. At present, with strong and relatively well supervised financial systems, the GCC countries appear to be on a good footing in this regard. It is important, however, that future efforts to develop an open and diversified financial system also are accompanied by a strong regulatory and supervisory framework. While not the only one, this is one of the reasons why the introduction of a common currency in the GCC countries might also call for an effort to harmonize financial sector policies.

C. Political Integration

There is little question that reaching agreements on, and implementing, the type of policies described above will demand a strong political commitment from the GCC countries. In the light of previous historical experiences with monetary unions, this is likely to require not only that the GCC countries are convinced that the economic benefits of a currency union and further economic integration surpass their costs, but also that they are interested in further political integration. Indeed, two of the main lessons from the experiences of previous monetary unions are that successful ones have generally involved also a high degree of political integration, and that in most cases, it has been the desire of political integration what has lead to currency unification, rather than the other way around.[10]

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[10] See Capie (1998).

The work that the GCC countries have done in the last two decades, and the structural fact that these countries have much in common, say in terms of their history, economic and political structure, culture and organization, suggest that increased economic and political integration in the region is feasible. Given the conditions for a successful currency union discussed above, however, there is no doubt that difficult challenges will need to be overcome to achieve that goal. Due to its relative size, Saudi Arabia's firm commitment will be particularly important, but ultimate success will require the decisive dedication of all and each of the GCC members.

IV. The Choice of Exchange Rate Arrangement

It is clear from the above discussion that adopting a common currency will involve reaching agreement in many policy areas. A central issue in this regard will be the design of a monetary and exchange rate policy framework for the unified currency. At the operational level, decisions will have to be made on issues such as the distribution of seignorage revenue across countries, the role of each country's central bank or monetary agency, the rules governing credit growth to both the private and government sectors, and the harmonization of banking supervision and regulations on monetary matters.[11] At the strategic level, the key decision will be the choice of exchange rate arrangement. This section briefly

[11] In the discussion of these issues, it may be useful to consider the lessons from the experiences of EMU, the CFA franc zone, the rand zone, and the East Caribbean dollar area.

reviews the pros and cons of some of the main alternatives in the case of the GCC countries.[12]

As was mentioned in the Introduction, it is natural to consider a dollar peg as the basic alternative for a common GCC currency. Pegging to the dollar has proven an effective and long-lasting exchange rate arrangement in the countries of the region, one that has permitted them to maintain low inflation, and to simplify trade and financial transactions and accounting both in the public and private sectors, specially given that the prices of oil and its derivatives are denominated in dollars. Moreover, the countries in the region have shown remarkably similar preferences for this type of arrangement, which may simplify the task of reaching a consensual decision. Nonetheless, whether the GCC countries may be better off under an alternative exchange rate arrangement is a valid and important question.

One hypothetical option would be to let the value of the common currency against other currencies fluctuate without any firm exchange rate anchor. The key advantage of doing so is that it would unlock the possibility of using monetary policy to try to stabilize the non-oil economy. It is questionable, however, that an active monetary policy could achieve much of significance in this regard: besides the fact that non-oil labor is internationally mobile and private wages are relatively flexible, the fluctuations in the non-oil economy are largely determined by the fluctuations in the oil economy, an issue that should be addressed through improved management of fiscal policy. For this reason, the downside risks of adopting such a strategy look at this time much more imposing: implementing it successfully

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[12] For a recent review of the choice of exchange rate regimes in both industrial and developing countries, see Mussa and others (2000).

would require developing monetary institutions substantially more complicated than the current ones, with the danger that errors of design, insufficient technical expertise, shallow financial markets, and lack of credibility could lead in the end to larger fluctuations in non-oil output and higher and more volatile inflation. On top of this, letting the unified currency fluctuate also would introduce a new type of uncertainty and risk on international transactions, and complicate budgetary accounting.

In principle, another possible option for the GCC countries would be to peg the value of their unified currency to a basket of currencies or to the SDR, as they are currently reported to be doing according to the official classifications submitted to the IMF. Relative to a dollar peg, this alternative has the potential advantage that, while retaining the main anchor properties of an exchange rate peg, it permits some adaptability to the fluctuations among the exchange rates of the major international currencies.[13] However, the fact that contrary to their declared intentions the GCC countries have ended up pegging to the dollar suggests that in their case this may not be a very sensible alternative. In hindsight, it has to be acknowledged that, relative to single currency pegs, basket pegs have the problem that they dispense with the microeconomic and informational benefits of maintaining constant at least one of the bilateral exchange rates relevant for price comparisons and economic transactions. In addition, it appears that in practice basket pegs tend to be less transparent, partly because they are more difficult to explain to the public, and partly because there is no actual basket currency that can be used as intervention currency, which introduces technical difficulties for

[13] Or put in more precise terms, it permits a reduction in the volatility of the nominal effective exchange rate, where the latter is a weighted average of the bilateral currency exchange rates that the economy has with its main trading partners.

pegging strictly to a basket. Finally, fluctuations in the major currency exchange rates represent only a minor part of the external disturbances that the GCC countries are exposed to, which lessens the relative value of a basket peg.

If the relevant options are trimmed down to a single currency peg, as the above considerations suggest, then a key decision that will need to be made concerns the degree of commitment that the GCC countries should establish regarding the maintenance of the peg. The tradeoff here will be pretty much one of flexibility versus credibility; i.e., between the increased degrees of freedom for dealing with potential macroeconomic imbalances that an "exit-option" from the peg would have, and the noises that may arise from the speculation that the peg may change, and their concomitant consequences on capital flows, interest rates, and the real economy. In deciding where to compromise in the range between an adjustable peg and a fully fledged currency board, one of the key factors that the GCC policymakers will have to consider is that, with the rising integration of international capital markets, sustaining a successful exchange rate peg is requiring stronger signals of commitment than in the past.

Adopting an exchange rate peg also would imply making a decision about the international currency used to anchor the value of the common currency. As mentioned above, past and current exchange rate policies in the region suggest that the dollar is the natural choice in the case of the GCC countries. EMU's recent success in creating the euro, however, offers a new alternative that might also merit consideration in a further analysis about the proper exchange rate arrangement for a unified GCC currency.

V. Concluding Remarks

The considerations in this paper suggest that the eventual replacement of the current individual currencies by a common regional currency can be a worthwhile objective for the GCC countries, one that if implemented properly will contribute to enhance their general economic efficiency, deepen regional integration, and foster the development of the non-oil economy. To reap fully the gains of a common currency, however, the currency union should be seen as only one component of a much broader integration effort. This would have to include the removal of domestic and cross-border distortions that inhibit intraregional trade and investment, agreements on policy frameworks to minimize the risk of imprudent financial policies, and further political integration to firmly lock in each country's commitment with the union. Assuming that the GCC countries are willing to follow that route, a peg to the dollar emerges as the natural choice of exchange rate arrangement, with a peg to the euro providing the main alternative.

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