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**A Gulf Cooperation Council Currency Union:
Appropriateness and Implications**

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PhD

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2006

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12 DEC 2006

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A Gulf Cooperation Council Currency Union: Appropriateness and Implications

By Emilie Rutledge

Abstract:

The six states, that together comprise the Gulf Cooperation Council (GCC), plan to adopt a single currency by 2010. If they are able to enact the necessary policy reforms and devolve some national sovereignty to supranational monetary and statistical institutions, capable of conducting a common monetary policy and managing the 'Gulf dinar', it will undoubtedly become the world's second most significant currency union. It may also be seen as a viable reserve currency, particularly by neighbouring states, and could even be used to invoice oil sales.

The aim of this thesis is two-fold. Firstly, it assesses the appropriateness of a currency union for the GCC, against the optimal currency area criteria. It also examines the degree to which the GCC states have implemented the policy prerequisites for currency union, according to the experience of European Monetary Union.

Secondly, it undertakes a qualitative cost – benefit analysis of currency union for the GCC as a whole and for each constituent state. This, in part, involves a review of post currency union monetary policy options and political-economy implications. The analysis employs both primary evidence collected through a GCC-wide business survey and from interviews with a panel of regional experts, and secondary evidence from published official sources.

This research should add to the ongoing debate on the utility of currency unions in general and assess the validity of employing optimal currency area theory to a region which remains, to a high degree, dependent on oil. It also provides contextually based findings useful to regional policy makers.

It concludes that a currency union will have significant benefits, but primarily indirect ones. Conventional benefits such as reduced transaction costs and eliminating exchange rate risks will be outweighed by benefits which will accrue from greater budgetary transparency, increased fiscal discipline and further economic diversification.

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List of Abbreviations

AMF	Arab Monetary Fund
CAGR	Compound Annual Growth Rate
CPI	Consumer Price Inflation
CU	Currency Union
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
MU	Monetary Union
OCA	Optimal Currency Area
SA	Saudi Arabia
SAMA	Saudi Arabian Monetary Agency
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 Indicators
WTO	World Trade Organisation

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Chapter 1: Introduction

In July 2006, the UAE's central bank governor Sultan Bin Nasser Al-Suwaidi, in an interview with the *Financial Times*,¹ stressed that despite some economic integration obstacles "plans for a single currency were serious and would be implemented by 2010." Nevertheless the path towards a Gulf Cooperation Council (here on referred to as GCC²) currency union, first set out in 1981 and restated in 2001, has been slow and the scheduled launch date of 2010 is fast approaching.

The idea of a common currency among the GCC states is not new. Prior to the GCC's formation in 1981; the external Indian Rupee was used by many Gulf states whilst under British colonial rule. Initially, after their independence, Qatar and Dubai had a common currency, the Riyal, as they had established a currency board, this arrangement was terminated in 1973.³ In 1975, the Central Bank of Kuwait commissioned a report from Robert Mundell into the possibility of establishing a regional currency union (here on referred to as CU). Interestingly the plan, which never came to fruition, was for a CU which would only include the smaller Gulf Emirates, excluding Oman and Saudi Arabia.⁴

The region's historical experience with economic and monetary cooperation therefore seems to imply the presence of an underlying preference for CU. Indeed, soon after its formation in 1981, the GCC adopted a far reaching Economic Agreement⁵ which provided a framework for economic integration in the region and set out the necessary steps towards achieving full economic and monetary

¹ Khalaf, Roula "UAE shifts 10% of its reserves into euros", *Financial Times*, July 13 2006.

² The GCC states include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.

³ The Qatar-Dubai Currency Agreement was signed on 21 March 1966 and introduced the Qatar and Dubai Riyal as the currency unit in both states, this arrangement lasted until 1973. See www.pjsymes.com/au/articles/QatarDubai.htm (accessed at 25/02/04).

⁴ Al-Hajji, A. F., "A Special Interview with Robert Mundell - Nobel Laureate in Economics" *Al Watan*, (translated from Arabic) 1999.

⁵ The Economic Agreement, which was signed in 1981, envisaged, even at this early stage, a process of economic integration which would lead to a CU.



integration; the 'Unified Economic Agreement' stated that the GCC would "endeavour to establish a joint currency."⁶

A shared culture, language, religion and resource dependence has endowed the GCC with a strong unified direction. This has resulted in the bloc, without doubt, becoming the most effective regional organisation within the Middle East. Yet, apart from the signing of a Free Trade Agreement in 1983, between 1981 and 2000 little progress was made towards deepening economic integration.

It was not until the 22nd GCC summit convened in Muscat in 2001 that the GCC re-energised their economic integration efforts. A revised Economic Agreement was signed, it set out concrete steps towards creating a common market and a GCC single currency. Although broadly based on the original 'Unified Economic Agreement' of 1981, the language was more specific. Article 4 of the new Economic Agreement stipulated that all members would work to a specific time table in order to prepare for monetary and currency unification.⁷

The new Economic Agreement listed specific steps that would need to be taken in order to establish a GCC CU. 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 be in place by 2007 and for the GCC single currency to be launched by 2010.⁸

⁶ GCC Secretariat General, "Unified Economic Agreement", Kingdom of Saudi Arabia, Riyadh, 1981, (online:available at:www.gcc-sg.org).

⁷ A new economic agreement was ratified at the 22nd GCC summit in Muscat on 21 December 2001.

⁸ The Cooperation Council for the Arab States of the Gulf (GCC), Secretariat General, The Economic Agreement Between the GCC States, Adopted by the GCC Supreme Council, 22nd Session, Muscat, Sultanate of Oman, 31 December 2001. (Available at: <http://www.gcc-sg.org>).

Kuwait's move in 2002 to peg its currency to the dollar aligning itself with the other five state's *de facto* dollar pegs was one concrete step towards CU.⁹ Then, in 2003 the GCC set up a customs union that harmonized external tariffs to 5 percent and removed intra-regional ones. However, more recently, the process seems to have faltered somewhat. The final stage of the customs union, scheduled for the end of 2005, was delayed following discord resulting from Bahrain's decision to "go it alone" and sign a bilateral FTA with the US.¹⁰

It was widely anticipated that the GCC would officially adopt convergence targets at the 2005 GCC summit convened in Abu Dhabi. Indeed in the months prior to the summit several regional newspapers indicated that GCC bureaucrats had agreed on the style of convergence criteria and that these would be along the lines of the European Maastricht criteria. In the event, the summit's final communiqué made no specific mention of CU convergence criteria. At the time of writing, it is clear that significant preparations still need to take place, and they will need to be implemented soon if the 2010 deadline for CU is to remain viable.

As all of the GCC state's sovereign currencies are now pegged to the US dollar, therefore the bloc already meets a key CU precondition; stable bilateral exchange rates. However a range of convergence targets, particularly fiscal policy ones, still need to be officially agreed upon. A GCC common market has yet to come into being and no final decision has been made on the nature and mandate of the GCC central bank – which itself has yet to be created.

1.1 Thesis Objectives

The thesis has two main objectives, firstly to assess the appropriateness of a CU for the GCC economic bloc and secondly to undertake a qualitative cost – benefit

⁹ Prior to this, most GCC states had *de facto* exchange rate pegs against the US dollar, only Kuwait was pegged to an undisclosed basket of currencies. Consequently this was not considered to be a particularly difficult step for the GCC states in the CU preparation process.

¹⁰ For more information on this please refer to chapter six (section 6.3.4).

analysis of a GCC CU.¹¹ This analysis will first deal with the bloc as a whole then consider the costs and benefits for each of the six constituent states individually. Primary evidence has been gathered through conducting interviews with a panel of regional experts and a GCC wide business survey. It is hoped that in meeting these objectives, this thesis will be the first in depth and most comprehensive assessment of the planned GCC CU to date.¹²

The GCC economic bloc is significant on the global stage primarily because of its hydrocarbon resource endowment. GCC states control 40 percent of the world's proven oil reserves and currently provide the market with 18 million barrels of oil per day (some 23 percent of total world oil supply).¹³ Even though the GCC has a population of just 35 million and a combined GDP of \$597bn (comparable to that of the Netherlands), a single GCC currency would undoubtedly constitute, after the European Monetary Union (here on referred to as EMU), the most important instance of CU to date.

Any cost – benefit analysis of a group of countries considering forming a CU must take into account Robert Mundell's seminal work on Optimum Currency Areas (here on referred to as OCA).¹⁴ In 1961 Mundell set out a series of OCA criteria, which together act as a benchmark against which a given region's suitability for CU can be tested. According to OCA theory, groups of economies with high levels of intra-regional trade, factor market mobility, economic diversification and business cycle synchronisation stand to benefit most from having a CU.

¹¹ For reasons which will become clear a quantitative cost-benefit analysis is not feasible i.e. many of the cost and benefit variables cannot be adequately quantified.

¹² Notable works that cover some aspects of the proposed GCC CU and are covered in the literature review include: Abed, G.T., Erbas, S. N. and Guerami, B. "The GCC Monetary Union: Some Considerations for the Exchange Rate Regime", *IMF Working Paper*, April 2003; Fasano, U. and Staff Team, *Monetary Union among Member Countries of the Gulf Cooperation Council*, IMF, 2003; Laabas, B. and Limam, I., *Are GCC Countries Ready for Currency Union?* Arab Planning Institute, Kuwait, April 2002 and Sturm, M. and Siegfried, N. "Regional Monetary Integration in the Member States of the Gulf Cooperation Council", *European Central Bank, Occasional Paper Series*, No. 31, June 2005.

¹³ BP Statistical Review of World Energy, 2006.

¹⁴ Mundell, R. A. "A Theory of Optimum Currency Areas" *The American Economic Review*, Vol. 51, No. 4, pp. 657-665, September 1961.

The principle advantage of CU, from a Mundellian point of view, is the reduction in transaction costs and the elimination of exchange rate risk, while the key disadvantage is the loss of independent monetary policy (no longer being able to adjust interest rates to absorb economic shocks). It follows, that the more economically synchronised the prospective members are prior to CU the more likely it is that they will be suited to a 'one size fits all' monetary policy.

Research by Laabas and Limam carried out in 2002¹⁵, concluded that the GCC did not, at that point, meet all of the OCA criteria adequately and that the bloc was particularly weak in terms of intra-regional trade, factor market mobility and economic diversification. It is worth noting that the countries that now make up the Eurozone, did not themselves, meet all of the OCA criteria satisfactorily prior to the launch of the euro.¹⁶ It is also widely acknowledged that in reality, a CU will never be entered into for economic reasons alone. Ultimately any decision on CU will be borne out of political, as well as economic considerations, and only achieved through concerted political will. This thesis measures the GCC against the full range of OCA criteria and assesses the political rationale behind the policy of GCC economic integration which is set to culminate in CU.

The experience of EMU both in the decisions and preparations in the lead up to the euro and its performance *ex post*, as well as the role played by the European Central Bank (ECB) and Eurostat, offers the GCC a great deal of tangible guidance; this thesis also draws on evidence and findings garnered from EMU. Indeed the GCC secretariat itself has consulted with the ECB, and the latter in 2005 produced a working paper "Regional Monetary Integration in the Member States of the GCC"¹⁷, which focused on outstanding CU preparations and assessed the level of economic convergence between GCC states.

¹⁵ Laabas, B. and Limam, I., *Are GCC Countries Ready for Currency Union?* Arab Planning Institute, Kuwait, April 2002.

¹⁶ Issing, O. "Economic and Monetary Union in Europe: political priority versus economic integration?" ECB Speeches Published in 2001, 23 February 2001, online: available <http://www.ecb.int/press/key/date/2001/html/index.en.html>

¹⁷ Sturm, M. and Siegfried, N. "Regional Monetary Integration in the Member States of the Gulf Cooperation Council", *European Central Bank, Occasional Paper Series*, No. 31, June 2005.

The issue of GCC CU does receive periodic press coverage in the Arabian Gulf, but much of the commentary tends to be superficial. Two contentions in particular are often put forward. One argues that the transition to a CU will be relatively straightforward because all the GCC currencies are pegged to the dollar, the other argues that few benefits will accrue to the GCC, because the common peg already reduces exchange rate risk and that levels of intra-regional trade are weak.

In fact, this thesis will demonstrate that a GCC CU has the potential to bring about many economic benefits – direct and arguably, more importantly, indirect ones. However these benefits will very much depend on the degree of preparations made in the lead up to CU. At the regional level the GCC will need to have strong (autonomous) institutions capable of managing future monetary decisions, including a GCC central bank and a statistical organisation similar to that of EMU's Eurostat.

1.2 Specific Research Questions

The aim of this doctoral research is to examine the appropriateness and implications of the scheduled 2010 GCC CU and to assess whether it is the optimum choice of currency regime as a bloc and for each GCC state individually.

In order to achieve this aim this research will address the following questions:

1. To what extent have existing exchange rate regimes been appropriate for the GCC economies in enabling them to meet their economic policy objectives?
2. How appropriate is CU for the GCC economies and to what extent do they meet the OCA criteria?
3. Are the GCC states taking adequate steps to adopt and implement the prerequisite policies for the establishment of a successful and sustainable CU?

4. What are the potential costs and benefits, both direct and indirect, of a GCC CU?
5. Will CU bring net benefits for each GCC member state or will there be losers as well as winners?

1.3 Research Methods

A combination of qualitative and quantitative research methods is employed in addressing these research questions. Substantial fieldwork was carried out in the region in order to better understand the institutional and political framework of the GCC economic bloc. This primary evidence ensured that the research would not only provide contextually based and credible conclusions, but may also be of use to GCC policymakers in the lead up to CU.

In-depth interviews with a panel of regional experts form a substantial element of the thesis' qualitative research and provide valuable primary evidence from which to draw upon. It was deemed crucial to document the opinions and views of regional experts so as to be able to gain a deeper insight into the potential economic and socio-political implications of the project. Semi-structured interviews with regional 'stake-holders', including GCC government officials, central bankers, economists and academics, provides 'insider' information on the perceived costs and benefits of CU which will feed into the cost – benefit assessment in this thesis.

Considering the increasing role being given to the private sector in the development of the GCC economies it was also considered important to survey the opinions of GCC businesses. A GCC-wide business survey was carried out in order to gauge business sentiment towards the proposed CU. It also set out to assess the potential impact of GCC CU on the region's business community as well as shedding light on the level of preparation within the business community.

The use of quantitative techniques will also play an important part in the analysis presented in this thesis. Using descriptive statistics, a comparative examination of GCC macroeconomic indicators, economic structures and existing exchange rate arrangements will be undertaken. An in-depth, empirical examination of intra regional trade will contribute to the assessment of the degree to which the GCC meet the OCA criteria and a historical analysis of the GCC's monetary and fiscal indicators will establish the extent to which Maastricht style¹⁸ monetary and fiscal convergence targets are satisfied.

In addition, this thesis will employ econometric techniques to test for the long run convergence of the GCC economies: an important OCA criterion. Specifically it will test for cointegration between the real national incomes of the GCC states using Vector Auto Regression methods and for pair-wise cointegration between each GCC state and Saudi Arabia. Saudi Arabia is chosen because it is by far the largest economy within the GCC. Its economic conditions are therefore likely to have considerable weight in the future monetary policy of the bloc, therefore economic integration with Saudi Arabia should reduce the potential costs of a common monetary policy for other prospective members.

1.4 Structure of Thesis

The breakdown of this thesis is briefly set out below and its structure is as follows:

The “**Literature Review**”, (Chapter Two), begins with an assessment of the theoretical and applied literature on CU. It goes on to examine the contemporary research on CU, which has been particularly topical since the inception of EMU. Finally it reviews the literature that focuses specifically on GCC CU. In conclusion, the literature review summarises the salient issues surrounding the research topic which steer the direction of our investigation in following chapters.

¹⁸ The Maastricht criteria included convergence in inflation rates, interest rates and exchange rates and limits on government deficits and debt, of which the final two were also part of the European Union's Stability and Growth Pact.

Chapter Three, **“Methods and Methodology”**, discusses the mixed methodological approach taken in addressing the research questions and the quantitative and qualitative methods which will be employed. It discusses the extensive fieldwork carried out in the region (semi-structured interviews with regional experts and a GCC wide business survey) and the specific econometric models and statistical techniques to be employed in analysing whether the GCC states meet various convergence and OCA criteria.

Chapter Four, **“Economic Performance and Policy 1980 – 2005”**, has two objectives. Firstly, it provides a comprehensive economic background to the GCC for our analysis, and secondly, it addresses research question one. The chapter examines the stability and performance of the GCC economies since 1980. It then attempts to identify the national economic objectives of each of the GCC states, summarising similarities and contrasts between these policies. It concludes by evaluating how far existing exchange rate arrangements have been effective in achieving national economic policy objectives.

Chapter Five, **“Assessing the Suitability of the GCC States for Currency Union”**, examines the degree to which the GCC economies are suitable for CU, thus addressing research question two. This chapter investigates quantitatively and qualitatively the extent to which the GCC economies meet the five core OCA criteria: significant intra-regional trade, flexible labour and capital markets, diversified economies and synchronised economic cycles. It also analyses the GCC economies using econometric techniques specifically in order to determine the degree to which the OCA criterion of economic synchronisation is met.

Chapter Six, **“Policy Prerequisites for a Successful Currency Union”**, addresses research question three. It begins by testing the GCC economies against Maastricht style monetary criteria and fiscal limits. Drawing on the findings from our primary research we ascertain the pace of preparations being made towards establishing supranational institutions, coordinating economic policies and preparing the private sector. Finally it attempts to establish whether there is sufficient political commitment to the CU project.

Chapter Seven, **“The Potential Costs and Benefits of a GCC Currency Union”**, addresses research question four in determining the costs and benefits (both direct and indirect) of CU for the GCC as a whole. The analysis will draw upon the findings of previous chapters and that provided by the panel of regional experts and the GCC business survey. In addition to analyzing the economic costs and benefits of CU, several political economy factors are also considered. In particular, the case for establishing the single GCC currency as a regional anchorage and reserve currency will be assessed.

Chapter Eight, **“The National Distribution of Costs and Benefits”**, considers the relative costs and benefits of the CU for each GCC state individually. It examines the specific economic and political characteristics of the given state that will have a direct bearing on the degree to which they are affected by the CU. In addressing research question five the findings of the GCC business survey are again utilised. This chapter concludes by presenting a ‘qualitative cost-benefit analysis’ of the case for CU for each GCC state and whether there are net benefits for all or whether there are losers as well as winners from establishing the CU.

Chapter Nine, **“Conclusion”**, specifically addresses the main research questions by presenting the key findings of this research. It discusses the significance of a GCC CU and looks ahead to consider the prospects for progress to be made towards a GCC CU between now and 2010. Finally, it is also left to this chapter to indicate associated areas for further research.

Chapter 2: Literature Review

2.1 Introduction

Since the early 1990s there has been a great deal of literature focusing on CU. The inception of European Monetary Union (EMU), which began with the Maastricht Treaty in 1991 and culminated with the eventual launch of the euro in 2002 has brought the issue to the forefront of contemporary economic debate. While the Eurozone case is the most recent example of CU, it is not the first, other unions such as the East Caribbean CU (1950)¹ and the CFA Franc zone (1948)² are well established. CU is also topical at present due to the increased advocacy of a 'bipolarisation of exchange rate regimes'³, and the perceived financial stabilization benefits accruing from fixed currency arrangements.⁴ In spite of the fact that GCC CU has not yet taken place, a number of important papers have been written on the subject, in particular those by Laabas and Limam,⁵ Fasano⁶, Jadresic⁷ and Sturm and Siegfried.⁸

It is generally accepted that the founding theoretical work on CU dates from the early 1960s with Mundell's seminal work on Optimal Currency Areas (OCA).⁹ This literature review will first examine Mundell's OCA, which is still considered by most to provide the theoretical underpinnings for researching CU. Secondly, the review will analyse more contemporary empirical work that has built upon the OCA criteria. Thirdly it shall look at the experience of EMU which should

¹ Eight East Caribbean States, formerly the British Caribbean Territories (Eastern Group), formed a currency board in 1950.

² The CFA Franc, pegged to the French Franc in 1948, is the common currency of fourteen countries in Central and West Africa.

³ Either fully fixed or flexible, see Fisher, S. "Exchange rate regimes: Is the bipolar view correct?" *Journal of Economic Perspectives*, Vol. 15, No.2, pp. 3-24, Spring 2001.

⁴ Fixed exchange rate arrangements such as CU, currency boards or dollarisation have proved attractive for a number of developing countries experiencing national currency crises in recent decades.

⁵ Laabas, B. and Limam, I., *Are GCC Countries Ready for Currency Union?* Arab Planning Institute, Kuwait, April 2002.

⁶ Fasano, U. and Staff Team, *Monetary Union among Member Countries of the Gulf Cooperation Council*, International Monetary Fund, Washington D.C., 2003, and Fasano, U. and Iqbal, Z. "Common Currency", *Finance and Development: A Quarterly Magazine of the IMF*, Vol. 39, No. 4, December 2002.

⁷ Jadresic, E., "On a Common Currency for the GCC Countries" *International Monetary Fund Policy Discussion Paper*, December 2002.

⁸ Sturm, M. and Siegfried, N. "Regional Monetary Integration in the Member States of the Gulf Cooperation Council", *European Central Bank, Occasional Paper Series*, No. 31, June 2005.

⁹ Mundell, R. A., "A Theory of Optimum Currency Areas", *The American Economic Review*, Vol. 51, No. 4, pp. 657-665, September 1961.

provide valuable lessons for the GCC. Finally it will review the literature that specifically focuses on the planned GCC CU.

2.2 OCA Theoretical Literature

More than forty years ago, Mundell¹⁰ coined the term Optimal Currency Areas (OCA). In his ground breaking article, entitled "A Theory of Optimal Currency Areas" he discussed the appropriate domain of a currency area and the criteria required for its establishment. This work has become a benchmark for evaluating the likely success of CU for a given region. This thesis will in part, draw upon Mundell's OCA criteria when examining the potential success of the GCC's CU.

Mundell proposed that an OCA constitutes an economic region comprising of a homogenous collection of producers who face the same economic shocks. By 'optimality', Mundell implies an exchange rate regime that can both maintain full employment and balance of payments equilibrium. According to Mundell's early work, a region can be considered an OCA if complete labour and factor mobility exists within it, which can substitute for flexible intra-regional or national exchange rates.

Another key criterion of Mundell's OCA, is that the economic shocks affecting the states in a given region must be correlated. It follows that the greater the similarity of production structures among countries the greater the correlation will be between them. There has been much empirical work on economic shock correlation between prospective members of a CU.¹¹

McKinnon¹², building on Mundell's initial OCA theory elaborates on several opaque terms. One such term, 'factor mobility', McKinnon assumes Mundell uses in a geographic sense because complete factor mobility between

¹⁰ *Ibid.*

¹¹ See Bayoumi, T and Eichengreen, B., "Shocking Aspects of European Monetary Unification", *CEPR Discussion Paper* No. 643, London, May 1992 and Kim, Y. and Chow, H.K. "Optimum currency area in Europe: an alternative assessment" *Economic Letters* 81, pp. 297-304, 2003.

¹² McKinnon, R. I., "Optimum Currency Areas" *The American Economic Review*, Vol. 53, No. 4, pp. 717-725, September 1963.

industries – as Kenen¹³ also points out – presents several practical problems.¹⁴ McKinnon contends that the more open the economies forming a CU are, the greater benefits accruing to them will be. Openness to trade, suggests McKinnon, will amplify the benefits from reducing transaction costs. In addition he also felt that the efficiency gains resulting from a common currency are more obvious for smaller economies.¹⁵

Kenen¹⁶ believed labour mobility within a given CU 'region' can never be sufficiently mobile to completely mitigate the impact of economic shocks. As Mundell suggests, labour is not homogenous therefore we cannot assume that labour is fully mobile. Kenen presented an alternative to complete labour mobility within a region arguing that well diversified economies are less likely to suffer from asymmetric shocks, therefore CU among such economies could be appropriate. On the other hand, he suggests that economies, characterised by a high degree of specialisation are more likely to suffer from asymmetric shocks. Therefore a flexible exchange rate and independent monetary policy are more appropriate for such countries so that they can adjust their terms of trade in an attempt to restore equilibrium to the balance of payments and achieve full employment.

A decade later Mundell¹⁷ developed his theory of OCAs to include a role for risk sharing and portfolio diversification – this somewhat diminished the salience of his previous criterion – the symmetry of economic shocks. Mundell argued that by holding claims on each other's output¹⁸ members of a CU could be insured against asymmetric shocks. Hence, through capital market integration, the impact of asymmetric shocks will be mitigated. This, he argues, is because income from capital assets in other member states will offset the decline in

¹³ Kenen, P. B., "The Theory of Optimum Currency Areas: An Eclectic View", in *Monetary Problems of the International Economy*, (eds. R.A. Mundell and A.K. Swoboda) pp. 41-60, University of Chicago Press, Chicago, 1969.

¹⁴ In reality labour is not a homogenous input into every production process and therefore an employee in one industry cannot be immediately substituted for an employee in another industry, as the phrase 'complete factor mobility' suggests.

¹⁵ Through gaining preferential access to a larger market, small open economies could greatly benefit from the exploitation of new economies of scale using existing export industries.

¹⁶ *Op.cit.*

¹⁷ Mundell, R. A., "Uncommon Arguments for Common Currencies", in *The Economics of Common Currencies*, (eds. H.G. Johnson and A.K. Swoboda), pp.114-132, 1973.

¹⁸ In the form of equity shares, dividends, interest payments and rental revenues.

domestic income in the affected state, allowing for consumption smoothing and providing a form of insurance. Mundell's later analysis creates a pivotal role for financial market integration in the adjustment to disturbances and the smooth functioning of an OCA.

Later on Mundell¹⁹ expanded his OCA theory to look at the main incentives and disincentives for a group of countries in forming a CU. Mundell took into consideration the wider political economy implications of CU as well as the economic arguments, some of which have particular resonance for the GCC economies. For example, out of 17 factors which Mundell lists as disincentives for joining a CU, he cites "(if a country) wants to protect the secrecy of its statistics". In the list of 17 factors for joining, he cites "(if the countries want) to reinforce or establish an economic power bloc that will have more clout in international economic discussions".

The core OCA criteria – the degree of intra-regional trade and economic diversification, labour mobility, capital flows and symmetry of economic shocks – as formulated by Mundell, McKinnon and Kenen have been applied quantitatively in later research. These criteria have been shown to provide a valuable explanation for a country's exchange rate regime. We will now discuss the empirical literature. Following this we will look at the applicability of OCA criteria to the case of the Eurozone (see section 2.4) and the GCC (see section 2.5.2).

2.3 Empirical and Applied Analysis

A body of empirical literature examining the costs and benefits of CU through econometric analysis has been stimulated, in part, by the controversial findings of Rose.²⁰ Using econometric analysis²¹ Rose measured the effect of a CU on

¹⁹ Mundell, Robert A. "Updating the agenda for monetary union" in *Optimum Currency Areas: New Analytical and Policy Developments*, (eds. Blejer, M.I., Frenkel, J.A., Leiderman, L., and Razin, A.), International Monetary Fund, 1997.

²⁰ Rose, A.K., "One Money, One Market, Estimating the Effect of Common Currencies on Trade" *National Bureau for Economic Research Working Paper 7432*, Cambridge, Massachusetts, December 1999.

²¹ Rose uses a multivariate regression model with cross sectional data of 186 countries spanning five separate years. In the model trade between two countries is dependent on the following explanatory variables; real GDP, real GDP per capita, volatility of nominal bilateral

bi-lateral trade between countries. Somewhat surprisingly, he found that a CU between countries would triple their bi-lateral trade. Rose undertakes several modifications of the 'gravity' model in order to reduce the possibility of model misspecification and he concludes that his results are robust. However, Rose admits that his model can give no indication of the causal direction between increasing trade and CU and he does not rule out the possibility that CU may in fact be the *result* of large bi-lateral trade flows and not vice versa.

Rose's contention that a CU could triple bi-lateral trade between members has arguably increased the attractiveness of CU for a number of regions. One objective of economic policy in the GCC has been to increase intra-regional trade – which is currently considered to be rather low (see section 2.5.2).²² The proposed CU is seen to be an important pillar of the GCC's regional economic integration strategy. However, an issue of sustained controversy in the econometric literature – one which may greatly influence the costs and benefits of a GCC CU – is where the direction of causality lies in the strong relationship between CU and trade.

The empirical literature has shed some light on issues where the theoretical literature has been ambiguous. This has been the case in assessing the effect of CU on the economic specialisation of member states and consequently the degree of business cycle correlation between members. Authors such as Kenen²³ and Krugman²⁴, previously claimed that greater trade between countries would lead to the specialisation of production structures in those countries. In turn greater economic specialisation would result in a weaker correlation between those countries incomes and their supply shocks. However, Frankel and Rose²⁵, using empirical analysis, find that in fact there is a positive correlation between bilateral trade intensity and business cycles. They argue that greater trade integration between two countries will itself lead

exchange rates, distance between the two countries, whether the two countries share a land border, have a common official language, share a trade agreement and have been colonized by the same power.

²² A full analysis of intra-GCC trade is carried out in chapter 5, section 5.2.

²³ *Op. cit.*

²⁴ Krugman, P., "Lessons of Massachusetts for EMU" in *The Transition to Economic and Monetary Union in Europe*, (eds. F. Giavazzi and F. Torres) Cambridge University Press, New York, pp. 241-261, 1993.

²⁵ Frankel, J.A. and Rose, A. K., "Is EMU more Justifiable ex post than ex ante?" *European Economic Review* 41, pp. 753-760, 1997.

to convergence in terms of income and business cycles. Therefore, trade cannot be considered independently from the business cycle in assessing the suitability of a country for membership of a CU because, to an extent, they are jointly determined. Moreover, levels of trade are influenced by national trade policy, as is the degree of economic convergence between countries at any one time. Therefore the criteria of significant intra-regional trade and synchronised business cycles might be considered to be 'endogenous' to the policy of forming a CU.²⁶

Critically, Frankel and Rose propose that even if countries are not economically suited to joining a CU *ex ante*, they will be *ex post* of joining. If we extend this analysis regarding new entrants to EMU to other potential CUs, it appears that any concerns regarding the efficacy of a single monetary policy for new CU members are unwarranted. Even if business cycles are not correlated prior to joining a CU they will become synchronised following membership.²⁷

Frankel and Rose²⁸ also assert that when examining historical trade patterns it is important to evoke the Lucas critique.²⁹ They argue that because trade between two given countries is dynamic, history is not necessarily a reliable guide to the future and therefore simply analyzing historical trade data is inadequate to be able to draw any conclusions regarding a region's future suitability as an OCA.

2.4 Evidence from EMU and Possible Lessons for the GCC

Sets of economic criteria for establishing an OCA cannot adequately provide a simple positive or negative answer to any given group of countries, on whether they should form a CU. It is therefore important to look at the GCC case comparatively in order to be able to gauge the potential success of its CU and draw lessons from the experiences of other CUs. However we must be careful

²⁶ Frankel, J.A and Rose, A.K. "The Endogeneity of the Optimum Currency Area Criteria", NBER Working Paper 5700, August 1996.

²⁷ *Ibid.*

²⁸ *Ibid.*

²⁹ Lucas, R. E., "Econometric policy evaluation: A critique" *Carnegie-Rochester Conference Series on Public Policy* 1, pp. 19-46, 1976.

in giving too much credence to such lessons as the economic and political composition of the GCC is unlike any previous CU region.

While there are currently five CUs in existence³⁰, the largest and most significant is that of the EMU, with 12 member states where the single currency in circulation is the euro. There is a significant body of literature relating to the experience of the EMU from which we draw upon in this section.

Since the official launch of the euro a number of papers have examined the effect of the common currency on issues such as financial markets and economic stability in the Eurozone. The rather short history of the euro makes it somewhat difficult to draw strong conclusions with regard to the long term impact of the CU on member states. Having said this, certain matters have already begun to stand out as potential lessons for other regions, such as the GCC, that are considering embarking on a similar monetary course. This thesis will draw upon the experience of the EMU throughout the analysis in the following chapters.

This section will cover the following areas:

- Initially it focuses on the political impetus and rationale behind the establishment of EMU (section 2.4.1).
- Following this, it looks at the literature related to the OCA criteria in the case of EMU; intra-regional trade (section 2.4.2), labour market mobility (section 2.4.3), financial market integration (section 2.4.4) and economic convergence and growth (section 2.4.5).
- Lastly it will examine the literature that assesses fiscal stability within the Eurozone and the impact of the Stability and Growth Pact on fiscal discipline and economic performance (section 2.4.6).

³⁰ Fasano, U. and Staff Team, *Monetary Union among Member Countries of the Gulf Cooperation Council*, International Monetary Fund, Washington D.C., 2003.

2.4.1 Political Impetus

Difficulties in the operationalisation of OCA theory often leaves as assessment of the cost-benefit balance of CU open to debate. Consequently the case can always be made for or against entering a CU based on political ideology. The debate within the UK provides a prime example of this.³¹

The importance of political unity among the member states of a monetary union cannot be overstated. It is clear that the strong political will to form a CU in the case of Europe has been able to override the fact that the Eurozone in many instances is not a model OCA. EMU has been seen by some observers as a means to achieving greater political cohesion in Europe and indeed such rationale was initially stated by the architects of EMU. Willet³² argues that the process of economic integration in Europe which culminated in a single currency secured primary national security and foreign policy goals for its main architects.

Willet contends that the European political elite ignored warnings which indicated that the region was not an OCA and that monetary union would only have net benefits for some countries. De Grauwe³³ suggests that EMU appears to be welfare enhancing for a core group of members, but such a welfare case cannot be made across all member states. While Feldstein³⁴ doesn't hesitate in claiming that the driving force behind EMU is primarily political and not based solely on economic merits.

2.4.2 Intra-Regional Trade

According to the empirical literature on CUs (section 2.3) the effect of a single currency on trade between members should be substantial. In particular research by Rose³⁵ suggested that trade in a single currency could lead to a

³¹ Munchau, W., "Lessons from Monetary Union" *Financial Times*, 4 January 2004.

³² Willett, T. D., "Some Political Economy Aspects of EMU" *Journal of Policy Modeling* 22 (3), pp. 379-389, 2000.

³³ DeGrauwe, P., *The Economics of Monetary Integration*, Oxford University Press, Oxford, 1992.

³⁴ Feldstein, M., "The Political Economy of the European Economic and Monetary Union: Political Sources of an Economic Liability" *The Journal of Economic Perspectives*, Vol. 11, No. 4 (autumn), pp. 23-42, 1997.

³⁵ Rose, *op.cit.*

tripling of trade between members. However, evidence drawn from the experience of EMU suggests that the real impact of the single currency on trade between members has been of a smaller magnitude and that the establishment of the single market was an important factor in stimulating intra-regional trade.

Micco, Stein and Ordonez³⁶ examine a panel data set of post 1999 bilateral trade flows between the EMU members states. The authors find that the effect of EMU on bilateral trade between member countries has ranged between 4 and 10 percent, much less than that initially presented by Rose. However, the authors conclude that while the size of the effect has been less than previous estimates, nevertheless the effect of EMU on trade is economically significant. Furthermore, as the sample used in the study examines only the first four years of the monetary union the effects may well become larger over time.

Another study examined the impact of increasing trade among the EMU countries on price level integration. The removal of barriers to trade should lead to increasing cross border competition and arbitrage thus reducing price differences across the union. Rogers³⁷ compared micro level annual price data of 139 items across 25 European Cities and 13 US cities between 1990 and 2001. The author found striking evidence of price convergence in traded goods across European cities and that the price dispersal between European cities is now similar to that in the US. Importantly, most of the convergence in prices was found to take place between 1991 and 1994, the period when the 'single market' was being completed and much less convergence occurred after 1998 after the single currency was launched. The evidence presented by Rogers therefore suggests that price convergence across Europe has been an ongoing process but was stimulated more by the establishment of the single market rather than the formal adoption of the common currency.

³⁶ Micco, A., Stein, E. and Ordonez, G. "The currency union effect on trade: Early evidence from EMU" *Economic Policy*, pp.315 – 356, October 2003.

³⁷ Rogers, J.A. "Monetary union, price level convergence, and inflation: How close is Europe to the United States?" *International Finance Discussion Paper*, No. 740, Board of Governors of the Federal Reserve System, October 2002.

In chapter seven of this thesis, "The Potential Costs and Benefits of a GCC Currency Union", we examine the potential micro efficiency gains from the single currency and the potential effect on intra-regional trade and price levels using the findings of a GCC wide business survey carried out for this thesis (see section 7.2.1 and 7.2.2).

2.4.3 Labour Mobility

Labour mobility is a key criterion for Mundell's OCA and one that can be used as an alternative adjustment mechanism to economic disturbances in the absence of a fully flexible exchange rate. While the contention holds that the more mobile labour is within an economic region the more likely it is to perform successfully as an OCA, the Eurozone has illustrated that a relatively low level of labour mobility is not in itself a barrier to establishing a CU.

European labour markets have been frequently compared with those of the US. Research by Dohse *et al*³⁸ suggests that adjustments to economic shocks in the US often take the form of labour migration yet in Europe it is more often the case that individuals will simply leave the labour market. Additionally they found that regional unemployment disparities in Europe are particularly large while inter-regional labour mobility is limited.³⁹ While legal barriers to labour migration within the EU have been more or less dismantled the presence of language differences still poses a formidable barrier.⁴⁰

Eichengreen,⁴¹ using a time-series model, examines the speed with which unemployment adjusts in various EU countries to the long-run equilibrium EU-wide unemployment level. The results were compared with the same model for the US and again Eichengreen found that the US regional labour markets could adjust more quickly to their long run level than the Europeans, about 20

³⁸ Dohse, D., Krieger-Boden, C., and Soltwedel, R., "EMU Challenges European Labour Markets" *International Monetary Fund Working Paper* 99/131, Washington D. C., 1999.

³⁹ *Ibid.*

⁴⁰ Feldstein, M., "The Political Economy of the European Economic and Monetary Union: Political Sources of an Economic Liability" *The Journal of Economic Perspectives*, Vol. 11, No. 4 (autumn), pp. 23-42, 1997.

⁴¹ Eichengreen, B., "Is Europe an Optimum Currency Area?" *Centre for Economic and Policy Research Discussion Paper* No. 478, London, November 1990.

percent faster. This empirical research illustrates how a high degree of labour mobility improves a country's ability to adjust quickly to economic shocks.

Eichengreen⁴² puts forward a number of factors that affect labour mobility; these include incentives to move such as regional disparities in income, the incidence of asymmetric shocks, border controls and legal barriers, cultural patterns and historical trends. There is also a consensus that structural rigidities in Europe impede labour market mobility. Feldstein⁴³ considers the obstacles to increasing the flexibility of Europe's labour markets as high unemployment benefits and minimum wages, excessive regulation and mandated fringe benefits.

As we shall see later on in this literature review, GCC national labour mobility, much like that in the Eurozone, is fairly limited. However, the presence of a large expatriate labour force which is highly responsive to national shocks greatly increases the overall flexibility of the GCC labour market (see section 2.5.2).

2.4.4 Financial Market Integration

The impact of the euro on the European financial markets has been particularly positive. According to research by Galati and Tsatsaronis⁴⁴ the euro has led to the deepening of many of Europe's financial markets by lowering transaction costs, eliminating exchange rate risk and the relaxation of regulatory restraints. They argue the benefits have been clear in the corporate bond and equity markets, which collectively are now greater in size than the sum of their component national markets. Eichengreen⁴⁵ argues that the effect of the euro on Europe's financial markets has been far more reaching than could have ever been expected and implies that Europe will become far more market

⁴² Eichengreen, B., "One Money for Europe? Lessons from the U.S. Currency Union" *Economic Policy* 10, pp. 117-187, 1990.

⁴³ *Op. cit.*

⁴⁴ Galati, G. and Tsatsaronis, K., "The Impact of the Euro on Europe's financial markets", *Bank for International Settlements Working Paper* No. 100, July 2001.

⁴⁵ Eichengreen, B., "The Euro One Year On" *Journal of Policy Modeling* 22 (3), pp. 355-368, 2000.

driven as a result. Galati and Tsatsaronis⁴⁶ argue that the introduction of the euro has exposed areas where barriers to further financial market integration remain. They consider obstacles to include the diverging legal and taxation frameworks in member states as well as a lack of coordination in the issuance of sovereign bonds.

Karlinger⁴⁷ finds that the markets for sovereign debts have remained segmented in the Eurozone illustrated by widening yield spreads since 1998. Karlinger suggests that this has resulted from the separate agencies issuing the bonds but also reflects the varying credit worthiness of the issuing country and the market's belief in the ECB's 'no bail-out' clause. However, in contrast Bernanke⁴⁸ finds that there has been a convergence in sovereign debt yields among the Eurozone members. He concludes that this convergence has occurred as a result of the reduction in inflation risk and exchange rate risk provided by the single currency and has benefited many Eurozone economies.

Diverging cross-border payments systems also constitute a significant obstacle to fully integrated financial markets in Europe. Important economic gains, argues Karlinger, could be realized if the cost of cross border transactions within the Eurozone were reduced to domestic levels. There have been some institutional efforts directed at removing some of these obstacles, such as the establishment of real-time gross settlement systems of the European System of Central Banks and European Banking Association.

Prior to the launch of the euro, Eichengreen⁴⁹ analysed the degree of economic integration in Europe by looking at differentials between regional stock prices in Paris and Düsseldorf and then compared this with the equivalent in Canada (using Toronto and Montreal stock market indices). Eichengreen found that the differentials between European markets were significant and that compared with those in Canada were five times more variable. On the other hand,

⁴⁶ *Op. cit.*

⁴⁷ Karlinger, L., "The Impact of Common Currencies on Financial Markets: A Literature Review and Evidence from the Euro area", *Bank of Canada Working Paper 2002-35*, 2002.

⁴⁸ Bernanke, B. S., "The Euro at Five: An Assessment" in *The Euro at Five: Ready for a Global Role?* (ed. Posen, A.S.) The Institute for International Economics, Special Report 18, April 2005.

⁴⁹ Eichengreen, B., "One Money for Europe? Lessons from the U.S. Currency Union" *Economic Policy* 10, pp.117-187, 1990.

Eichengreen's results did show a convergence over time of stock prices in Europe when comparing the 1970s with the 1980s. An analysis of the equity returns in Europe provides a contrasting picture. Karlinger⁵⁰ shows that the responsiveness of equity returns in various EMU countries to shocks originating from the Eurozone increased substantially in the run up to EMU and during its first two years. Such results indicate an increasing correlation among EMU equity returns and thus indicate growing financial market integration across the Eurozone.

Before 1999 much debate centred on the strength of the new currency and its potential attractiveness as a reserve currency – as a possible competitor to the US dollar. Since its launch, the euro has performed, perhaps unsurprisingly, very similarly to the constituent currencies of the member countries, particularly the German mark.⁵¹ Even though the euro is now the main rival to the US dollar its introduction has not as yet resulted in a major reallocation of official reserves outside of the Eurozone.⁵² The attractiveness of the euro as a major reserve currency is correlated with its strength in international foreign exchange markets. The significant appreciation of the euro against the US dollar since its official launch in 2002⁵³ will increasingly lead to future reallocations of foreign exchange reserves, particularly in Asia but also those of the GCC, out of a weakening dollar into the strengthening euro.⁵⁴

Russia and Iran – both oil exporting countries – have considered denominating their oil sales in euros.⁵⁵ Iraq, prior to the second Gulf war, was benefiting from its switch to invoicing oil in a strengthening euro. The future GCC currency may also challenge the dollar and euro to become the oil-invoicing currency. With nearly two fifths of the world's oil reserves held by the GCC states and

⁵⁰ *Op. cit.*

⁵¹ Galati and Tsatsaronis, *op.cit.*

⁵² Bernanke, *op.cit.*

⁵³ From the beginning of 2002 to the end of 2003 the US dollar declined by 30 per cent against the euro, according to Wolf, M., "The underrated dangers of the dollar's orderly decline" *Financial Times*, 17 December 2003. Since then there have been periods when the dollar has regained some ground but in the first half of 2006 the dollar continued to fall against the euro and by July 2006 the dollar's value had declined by 30 percent against the euro since its launch.

⁵⁴ Eichengreen, B., "The Euro One Year on" *Journal of Policy Modeling* 22 (3), pp. 355-368, 2000.

⁵⁵ Islam, F., "When will we buy oil in euros?" *The Observer*, 23 September 2003.

increasing energy dependence upon them there could be a strong rationale for the GCC to switch to oil invoicing in its fledgling unified currency. Under this scenario instead of investing petro-dollars back into the US economy, in order to avoid exchange rate risk⁵⁶ the GCC governments would hold them in their own currency and invest in domestic assets, greatly benefiting their financial markets and economic development. The prospect of such a scenario will be discussed later in this thesis (see chapter seven, section 7.5.1).

2.4.5 Economic Convergence and Growth

The Eurozone's economic experience since the launch of the euro has been somewhat mixed. While the euro has proved itself to be a strong trading currency against the US dollar, and inflation rates in Europe have remained low, Eurozone economic growth rates proved less resilient to the global economic downturn in 2000-2002 than the US and since the transfer of monetary sovereignty to the ECB output in the larger Eurozone economies has become more volatile.⁵⁷ Despite the occurrence of several demand side shocks, it appears that supply side dynamics have an important role to play in the persistence of weak economic growth in Europe. Consequently, Eurozone growth rates have also been disappointingly low over the last decade.⁵⁸

Literature on economic convergence among the Eurozone members prior to monetary union suggested that a single monetary policy would not suit all members of the union.⁵⁹ Bayoumi and Eichengreen⁶⁰ found that shocks to output and prices were significantly more idiosyncratic across the member states than across US states. Research on economic convergence post monetary union has shown that growth and inflation differentials continue to persist among the members,⁶¹ although Alesina *et al*⁶² argue that this is not

⁵⁶ Islam, *op. cit*

⁵⁷ Posen, A. S., "The Euro's Success Within Limits" in *The Euro at Five: Ready for a Global Role?* (Ed. Posen, A.S.) The Institute for International Economics, Special Report 18, April 2005.

⁵⁸ *Ibid.*

⁵⁹ Bayoumi, T and Eichengreen, B., "Shocking Aspects of European Monetary Unification" *CEPR Discussion Paper* No. 643, London, May 1992.

⁶⁰ *Ibid.*

⁶¹ Alesina, A. F., Blanchard, O.J., Gall, J., Giavazzi, F. and Uhlig, H., *Defining a Macroeconomic Framework for the Euro Area: Monitoring the European Central Bank* No. 3, Centre for Economic Policy Research Report, 30 March 2001.

necessarily problematic as long as it is a temporary phenomenon and reflects a process of economic adjustment.

Bayoumi and Eichengreen⁶³ develop an OCA index which operationalises the OCA criteria using econometric techniques which sheds light on the economic convergence of the EMU countries. The authors use this index to identify three groups of countries, those that are ready to join the CU, those that are converging and those that show no signs of converging. The authors find that there is a strong relationship between trade and monetary integration. According to their index, the authors conclude that "countries among whom the completion of the single market has led to the greatest increase in bilateral trade have experienced the greatest increase in their readiness for monetary integration".⁶⁴

One assumed benefit of the introduction of the euro was to be price convergence resulting from the enlarged market and greater competition. Thus far there appears to be little evidence of Purchasing Power Parity (PPP) within the Eurozone. Not only is there considerable anecdotal evidence of price disparities between Eurozone countries there is also formal evidence that PPP has not occurred. Lopez and Papell⁶⁵ found some evidence of a process of price convergence beginning as early as 1992 with the adoption of the Maastricht Treaty. They also found that evidence of PPP was greater within the core Eurozone countries compared to the periphery members, but this evidence was statistically insignificant. Overall their econometric analysis rejected the presence of PPP in the Eurozone.

2.4.6 Fiscal Stability and Discipline

The European Union's Stability and Growth Pact (SGP) was designed to ensure discipline over government deficits and debt. According to Eichengreen

⁶² *Ibid.*

⁶³ Bayoumi, T and Eichengreen, B. "Ever Closer to heaven? An Optimum-Currency-Area Index for European Countries", *European Economic Review* 41, pp.761-770, 1997.

⁶⁴ *Ibid.*

⁶⁵ Lopez, C. and Papell, D.H., "Convergence to Purchasing Power Parity at the Commencement of the Euro" University of Houston, April 2003.

and Wyplosz⁶⁶ the fiscal rules in the SGP of the EU were designed with the aim of avoiding a situation where the debt default of a member state leaves the ECB with no option but to bail it out. In short, under the SGP, government budget deficits have to be kept to below 3 percent of GDP⁶⁷ and debt under 60 percent of GDP.⁶⁸ Currently the ECB has a 'no bail-out' clause stating that it will not act as lender of last resort but in reality most believe that it would have little choice in such a position.

Furthermore, if a sovereign bond default in the Eurozone was not dealt with promptly it could, suggest Eichengreen and Wyplosz⁶⁹, in an integrated financial system lead to contagion in the government debt markets of the other member states. The economic consequences of such financial market contagion would be detrimental for the entire Eurozone. The risks of a systemic crisis in the Eurozone have not been addressed directly and instead are left to the 'constructive ambiguity'⁷⁰ of the SGP. Consequently, salient questions remain over whether banking and finance supervision at a national level in the Eurozone provides sufficient scrutiny of the entire system.

The design of the SGP has been criticised by academics and policy makers alike because it does not take into account the economic cycle and therefore prevents the full utilization of automatic stabilizers in the given economy. It is argued that unless government's can run significant surpluses in an economic upswing they would not be in a position to allow the automatic stabilizers to work in a downturn and in such a situation they would be likely to incur fines for breaching the SGP's deficit rule.⁷¹ In fact this situation came to light in late 2003 when Germany and France (the union's two largest economies respectively) found themselves breaking the deficit ceiling for a third year

⁶⁶ Eichengreen, B. and Wyplosz, C., "Stability Pact: More than a Minor Nuisance?" *Economic Policy*, April 1998.

⁶⁷ Except in conditions where GDP has declined by 2 percent and the deficit is small and temporary.

⁶⁸ Eichengreen and Wyplosz, *op.cit.*

⁶⁹ *Ibid.*

⁷⁰ Duisenberg, W. F., Presentation of the ECB's Annual Report 1998 to the European Parliament, Introductory statement delivered by President of the European Central Bank, Strasbourg, 26 October 1999.

⁷¹ Eichengreen and Wyplosz, *op. cit*

running and facing punitive fines.⁷² However, the commitment of the European Finance Ministers to enforce such fines faltered and as a result the credibility of the Pact was called into question.

Thus, the outlook for the SGP in its current form appears uncertain and there are increasing calls for a reworking of the pact. It is argued that what is required is a more flexible approach to short term deficits combined with strong commitment to medium-term fiscal discipline.⁷³ The design of future fiscal discipline rules for the GCC CU will therefore be important not just for stability but also for potential growth within the union. This issue is discussed in more detail later in this thesis (see chapter seven, section 7.3.1)

2.5 GCC Currency Union Research

A small, but growing body of literature focuses specifically on the subject of GCC CU. Several reports by the IMF, the ECB and Arab based research institutes have focused on the proposed monetary unification in the GCC. This section groups the literature into the following areas:

- First, it looks at literature dealing with the historical roots of the GCC, intra-regional political integration and the political implications of CU (section 2.5.1).
- Second, it surveys the literature on OCA criteria in the case of the GCC and GCC economic convergence (section 2.5.2).
- Third, it discusses those papers that attempt to judge the overall cost – benefit balance of GCC CU (section 2.5.3).
- Fourth, it focuses on literature that specifically relates to the potential costs of a GCC CU (section 2.5.4).

⁷² Staff writer "Europe and the Euro: The Death of the Stability Pact" *The Economist*, 29 November 2003.

⁷³ HM Treasury, *The Stability and Growth Pact: A Discussion Paper*, London, March 2004.

- It then moves on to survey the literature concerned with the necessary preparations and preconditions for a GCC CU (section 2.5.5).
- Finally, it reviews the literature analysing the choice of exchange rate arrangement for the future single currency (section 2.5.6).

2.5.1 GCC Formation and Political Integration

According to Looney⁷⁴ the main catalyst for the formation of the GCC was security. The Iran-Iraq war of 1979 involved two of the Gulf region's largest countries and dramatically increased the desire for greater cooperation in the field of defence among the other smaller Gulf states. The GCC came into being, argues Peterson⁷⁵ primarily due to cultural and ideological reasons, rather than economic. The continuing search for a broad Arab unity along with binding religious ties provided the cohesion among what became the Gulf Cooperation Council in 1981. While the GCC has ideological underpinnings, it has not allowed itself to become bogged down by these, as have many previous and contemporary Arab alliances. Unlike other alliances the GCC has embarked on a practical course for achieving mutual interests and objectives. In this regard Peterson argues that the GCC is succeeding, where other Arab attempts at unity and cooperation have largely failed.

Laabas and Limam⁷⁶ seem certain that the political drive to achieve and sustain monetary union is present among the leaders of the GCC states. While the statistical tests for economic convergence, as presented by Laabas and Limam, do not in their opinion provide a convincing economic case for CU, the authors argue that the political will – a pivotal pre-condition for a successful CU – is in place. In order to achieve their long term economic development objectives Peterson⁷⁷ suggests that there is a wide acknowledgement within the GCC for economic integration and cooperation. He quotes a previous GCC

⁷⁴ Looney, R.E., "Economic Integration in the Gulf Region: Does the Future Hold More Promise than the Past?" Center for Contemporary Conflict, Strategic Insight, 1 March 2003.

⁷⁵ Peterson, E.R., *The Gulf Cooperation Council: Search for Unity in a Dynamic Region*, Westview Press, Boulder, Colorado, 1988.

⁷⁶ Laabas, B. and Limam, I., *Are GCC Countries Ready for Currency Union?* Arab Planning Institute, Kuwait, April 2002.

⁷⁷ Peterson, *op. cit.*

Secretary General, Abdulla Y. Bishara, as suggesting that there is a consensus among GCC leaders to move towards some form of confederalist system – the closest form of political and economic union. In order to achieve this far reaching regional integration the GCC states will require substantial political determination and coordination.

Contrary to Peterson's argument other academics, such as Looney,⁷⁸ have suggested that while governmental rhetoric embraces greater regional coordination the slow pace of the unification process indicates the hesitancy of GCC national leaders to relinquish sovereign powers as a precursor to CU.

What is clear – as the Eurozone has shown – is that the process of full economic integration cannot be successful without a strong political will. In chapter six of this thesis, we discuss the political motivation behind the decision of the GCC leaders to form a CU and their political commitment to the project (see chapter six, section 6.5).

2.5.2 OCA Criteria and Economic Convergence in the GCC

The theoretical OCA literature laid down several key criteria for examining the potential for CU in a given region. To reiterate, these include a high degree of intra-regional trade and investment; labour and capital mobility, and correlation of economic shocks. Several papers reviewed below examine these criteria in relation to the GCC.

In their report, Laabas and Limam⁷⁹ examine the degree to which the GCC states meet the OCA criteria using quantitative and qualitative analysis. The authors conclude that the GCC states do not satisfy all of the OCA criteria. In particular, they find that intra-GCC trade is weak, there is not sufficient factor market mobility, the GCC economies are not diversified and there is no evidence of synchronised business cycles. They argue that the main factor favourable to the establishment of CU is the implicit political commitment of the

⁷⁸ Looney, *op. cit.*

⁷⁹ Laabas, B. and Limam, I., Are GCC Countries Ready for Currency Union? Arab Planning Institute, Kuwait, April 2002.

GCC leaders to achieve economic integration, although they do not elaborate on their assumption.

Looney⁸⁰ argues that the most prominent area where integration efforts have failed to achieve returns thus far among the GCC states has been in intra-regional trade. According to Looney Intra-regional GCC trade is small and has grown little over the past decades. Jadresic⁸¹ also focuses on the low level of intra-regional trade and compares it with that of other regions. He illustrates that regional trade flows among European countries have been six to seven times greater than those in the GCC.

Looney⁸² suggests that the low regional trade volumes have partly resulted from the pursuit of conflicting development strategies. Whilst states such as Saudi Arabia have pursued import substitution policies, others such as the United Arab Emirates have followed a free trade strategy. This has made it difficult for these countries to agree on the direction of joint trade policy. Laabas and Limam⁸³ also comment on the weakness of intra-regional trade and point out that there has been little increase in the amount of intra-regional trade over the past four decades.

Despite the fact that intra-regional trade volumes are low as a proportion of total GCC trade, Jadresic⁸⁴ reveals that when oil related trade is excluded intra-regional trade accounts for a much more significant proportion of total GCC trade. Consequently, Jadresic asserts that CU will stimulate intra-regional trade, which is predominantly non-oil trade and will thus lead to the realization of another important GCC economic policy objective – that of economic diversification and reducing dependence on hydrocarbons. In the case of the UAE, one report finds that a significant amount of non-oil trade - approximately one third of non-oil and re-exports - are destined for other GCC states and Iran.⁸⁵

⁸⁰ Looney, R.E., "Economic Integration in the Gulf Region: Does the Future Hold More Promise than the Past?" Center for Contemporary Conflict, Strategic Insight, 1 March 2003.

⁸¹ *Op. cit.*

⁸² *Op. cit.*

⁸³ *Op. cit.*

⁸⁴ *Op. cit.*

⁸⁵ Goyal, R., "Non-oil Growth, Competitiveness, and the Labour Market, in UAE: Selected Issues and Statistical Appendix" *International Monetary Fund Country Report 03/67*, 2003.

Little research has been carried out on the dynamics of the GCC labour market, but generally national labour mobility is considered to be low for reasons such as strong family ties and responsibilities. Evidence from Saudi Arabia has shown that Saudis were unlikely to be willing to relocate, even within the kingdom, in order to find employment.⁸⁶ As well as this geographical inertia, there is little mobility of nationals between the public and private sectors. Sassanpour *et al*⁸⁷ illustrates how most GCC Governments provide life-long employment for their nationals, and have enshrined these rights in legislature. The public sector provides generous wages and benefits that do not reflect labour productivity indicating a low level of wage flexibility. This has led to a preference among GCC nationals to work in the public sector and an aversion to working in the private sector, which is considered as less attractive and therefore less prestigious. Consequently the GCC states suffer from highly segmented labour markets, with the private sector employing mainly expatriates.

It is important to consider the fact that a large proportion of the GCC populace – approximately one half according to Sassanpour – is expatriate. This element of the labour force is likely to be highly mobile, after all these agents have already emigrated on economic grounds. However, Sassanpour⁸⁸ points out that the ability of these economic migrants to move between jobs, once resident in the Gulf, is restricted by the requirement that their employment is sponsored by a national. Without this national sponsorship, migrant labour, on which the private sector in the GCC states is heavily dependent, could become even more flexible in response to economic adjustments. In addition to this, according to Goyal⁸⁹ the wages of non-nationals in the private sector are highly flexible and expatriate workers have been a key source of growth in the non-oil sectors of GCC economies.

⁸⁶ Bosbait, Mohammed and Wilson, Rodney, "Education, school to work transitions and unemployment in Saudi Arabia" *Middle Eastern Studies*, Vol. 41, No. 4, pp. 533-545, July 2005.

⁸⁷ Sassanpour, C., Joharhi, G. Kireyev, A. and Petri, M., "Labour Market Challenges and Policies in the Gulf Cooperation Council Countries", International Monetary Fund, Washington D.C., November 1997.

⁸⁸ *Op. cit.*

⁸⁹ *Op. cit.*

Integration in the banking and finance sectors among countries of a monetary union is seen to be beneficial, as has been previously noted, in terms of greater risk sharing and opportunities for portfolio diversification ultimately improving the efficiency of capital and concomitantly economic growth. Additionally the banking sectors in the GCC would benefit from increased competition and more cross border activities by GCC banks on top of restructuring and consolidation in the industry. However, as Karlinger⁹⁰ points out financial market integration presents new challenges that pose systemic risks to the entire financial system. It is therefore crucial that banking and finance supervision and regulation are designed to minimize existing and new risks.

Jaber⁹¹ argues that significant economic integration has yet to materialize in the GCC banking and finance sector. This sector will require greater consolidation in order to take advantage of important economies of scale. Among a list of reforms, Jaber stresses that the development of deep and liquid capital markets through greater privatization in the GCC, as well as liberalization of restrictions on company listings and non-national investors, will lead to a more efficient allocation of resources and capital mobilization in the region.

The symmetry of economic shocks impacting the GCC states is dependent on the similarity of their economic structures. The GCC economies tend to be highly specialized, this has occurred at an intra-industry level in the field of oil and gas production and its derivatives such as petrochemicals. However, other parts of the Gulf, such as Bahrain and Dubai (one of the seven Emirates of the UAE) have diversified into service sector areas such as banking, finance and tourism.⁹² Stern and Siegfried⁹³ argue that while there is a high degree of structural convergence among the GCC economies at present, as the diversification process continues this convergence will diminish making them less well suited to a common monetary policy.

⁹⁰ *Op.cit.*

⁹¹ Jaber, M., "GCC Financial Markets and the Quest for Development" *Middle East Policy*, Washington, February 2000.

⁹² Asad Rizvi, S.N., "From Tents to High Rise: Economic Development of the United Arab Emirates" *Middle Eastern Studies*, Vol. 29, No. 4, pp. 664-678, October 1993.

⁹³ Sturm, M. and Siegfried, N. "Regional Monetary Integration in the Member States of the Gulf Cooperation Council", *European Central Bank Occasional Paper Series*, No. 31, June 2005.

Darrat and Al-Shamsi⁹⁴ analyse the degree of economic convergence between the GCC states using econometric techniques.⁹⁵ The authors test for cointegration between several economic and financial variables of the GCC states, such as real GDP, inflation rates and money stock. They find evidence of a long run cointegrating relationship between the economic and financial variables of all six GCC states and therefore conclude that the slow process of economic integration cannot be due to any economic incompatibility. Instead, the authors suggest that this may be attributed to sociopolitical factors, although they do not elaborate as to their precise nature.

In pointing out important areas for further research, Darrat and Al-Shamsi stress the value of establishing whether Saudi Arabia is the driving force behind the integration process. They recommend calculating impulse response functions of the underlying Vector Auto Regression Systems in order to identify the relative importance and causality of relationships between various GCC members. We employ such techniques in chapter five of this thesis, when we investigate the precise economic relationship between each GCC state and that of Saudi Arabia (see section 5.6).

The degree to which the GCC economies meet each of the OCA criteria, as described in the literature review above, is discussed in detail in chapter five of this thesis.

2.5.3 Assessing the Balance of Costs and Benefits of a GCC CU

An in depth IMF study of GCC CU by a team led by Fasano⁹⁶, examines the likely net benefits of the proposed exchange rate regime. The authors argue that the GCC states are well positioned to successfully enact and sustain monetary union, provided that they undertake a range of supporting structural

⁹⁴ Darrat, A. F. and Al-Shamsi, F. "On the Path of Integration in the Gulf Region" *Applied Economics*, 37, pp. 1055 - 1062, 2005.

⁹⁵ The authors test for unit roots in five economic variables of each GCC states, the variables are real GDP, CPI, M1, local exchange rates to SDRs and the monetary base. Having established that the time series are integrated of order one, they then test for cointegration between each of the economic variables for all six GCC states. In each case, they find evidence of at least one cointegrating vector, but sometimes two.

⁹⁶ Fasano, U., *op.cit.*

and institutional reforms. Some of these important reforms are discussed below in more detail (see section 2.5.5). Fasano points out the obvious benefits from CU as being lower transaction costs and the elimination of exchange rate uncertainty. While Fasano considers the indirect benefits to be the boosting of domestic investment and intra-regional trade, a bigger role in international capital markets as well as the potential for enforcing monetary and fiscal discipline.

IMF papers, such as that by Jadresic⁹⁷, also assess the costs and benefits of CU for the GCC. Jadresic suggests that while the costs are likely to be low the benefits depend on a number of other integration measures. He stresses that CU should only be part of a broader economic strategy and policy base to generate further economic and political integration among the GCC states.

A paper by Laabas and Limam⁹⁸ of the Kuwaiti based *Arab Planning Institute* uses a combination of econometric techniques and qualitative analysis to assess the suitability of the GCC states for the CU. Their paper uses a Generalized Purchasing Power Parity model (G-PPP), of the type presented by Enders and Hum,⁹⁹ and other informal tests¹⁰⁰ based on the OCA literature to find if the GCC countries constitute an OCA. The authors find that G-PPP holds in the case of the GCC states and therefore that the GCC meets the requirements for an OCA. However, they point out that the G-PPP test was likely to hold from the outset because GCC exchange rates are stable and have been anchored to the US dollar for many years. This suggests that the G-PPP test is perhaps not the best model for investigating whether the GCC constitutes an OCA.

Interestingly, the econometric analysis presented by Laabas and Limam¹⁰¹ indicates that some GCC states are less favourable candidates to join a CU than others. One example they put forward to substantiate this is that there is a

⁹⁷ Jadresic, E., *op.cit.*

⁹⁸ Laabas and Limam, *op. cit.*

⁹⁹ Enders, W. and Hum, S., "Theory and Tests of Generalized Purchasing Power Parity: Common Trends and Real Exchange Rates in the Pacific Rim" *Review of International Economics* 2 (2), p179-190, 1994.

¹⁰⁰ Informal tests included analysing and rating OCA criteria such as openness, labour and capital mobility, commodity diversification and production structures.

¹⁰¹ *Op. cit.*

relatively low correlation between certain macroeconomic variables of Oman with those of other GCC states. This suggests that the distribution of costs and benefits arising from CU are unlikely to be uniform across the member states.

A central part of this thesis weighs up the costs and benefits of CU for each individual GCC state and analyses whether there will be losers as well as winners in the founding of a single GCC currency. A country by country analysis of the costs and benefits of CU is therefore presented in chapter eight.

2.5.4 Potential Costs of a GCC CU

The most significant cost involved with CU is the loss of ability to implement national monetary policy. Monetary policy is not widely deployed by the GCC states, largely due to their fixed exchange rate arrangements. Such fixed exchange rates, with free movement of capital, preclude the independent setting of interest rates. As Jbili and Kramarenko¹⁰² point out, monetary policy is directed at stabilizing the exchange rate and to maintaining the dollar peg and that it is limited to managing short term liquidity. While interest rates in the GCC must track those set by the Federal Reserve Bank of America in order to maintain the dollar pegs the GCC central banks do have a certain amount of discretionary monetary policy control. According to Jadresic, "In the short-term, individual monetary authorities may continue to have at least some capacity to influence domestic liquidity and interest rates". In chapter seven of this thesis we examine the potential cost of losing discretionary monetary policy to the GCC states (see section 7.3.1) and the appropriateness of continuing the existing exchange rate peg to the dollar following the launch of the CU (see section 7.3.2).

Fasano¹⁰³ proposes that the loss of independent monetary policy will be limited because of the dominance of oil in the GCC economies. He suggests that important external shocks such as oil price changes will affect each economy similarly. Fasano's comments however, represent an over-simplification of their economic structures. Whilst all GCC economies are oil dependent they are not

¹⁰² Jbili, A. and Kramarenko, V., "Choosing Exchange Regimes in the Middle East and North Africa" International Monetary Fund, Washington D.C., 2003.

¹⁰³ *Op. cit.*

homogenous (as we shall see in chapter four) and therefore the response to an oil price shock and its duration will vary across the GCC states.

In addition to foregoing monetary policy as an economic tool, another 'cost' of CU is that it necessarily involves some fiscal policy restrictions for member states. It is generally considered that member governments of a CU should refrain from running 'excessive' budget deficits and not carry the burden of large debts because this could undermine the single currency. Excessive government borrowing by one member of a CU will not only raise the cost of borrowing for themselves but also by association for the other members of the CU.

The implications of fiscal policy restrictions, of the type embodied in the EU's SGP, could be substantial for the GCC states; as currently they rely heavily on fiscal policy as a tool with which to manage their economies. When oil prices have been low GCC Governments have been reluctant to cut back on expenditure – particularly current spending – for fear of negatively affecting growth in the non-oil sectors of their economies. During times of weak oil prices, most GCC governments have run significant budget deficits and therefore they are likely to face difficulties in meeting fiscal deficit and debt to GDP limits.¹⁰⁴ The degree to which the GCC states would be able to meet such fiscal discipline rules as part of the prerequisite conditions for establishing the CU is therefore discussed further in chapter six (see section 6.2).

However, a paper by Fasano and Wang¹⁰⁵ presented econometric evidence with strong implications for fiscal policy in the GCC. Fasano and Wang examined the short and long run relationship between non oil GDP and government expenditure – both current and capital – over the period 1980-1999 using econometric techniques.¹⁰⁶ The results indicated that there was no discernible relationship between changes in government spending and non oil

¹⁰⁴ Fasano, U. and Wang, Q., "Testing the Relationship Between Government Spending and Revenue: Evidence from GCC Countries" *International Monetary Fund Working Paper*, November 2002.

¹⁰⁵ Fasano, U. and Wang, Q., "Fiscal Expenditure Policy and Non-oil Economic Growth: Evidence from GCC Countries" *International Monetary Fund Working Paper*, December 2001.

¹⁰⁶ The authors use a multivariate cointegration and error-correction model to investigate the long run equilibrium relationship between fiscal expenditure policy and non-oil real GDP among members of the GCC.

GDP in the GCC states. The authors therefore concluded that government spending in these countries could be cut without jeopardizing non-oil economic growth. The underlying reasons for this result, suggest the authors, are in part due to recent structural and development strategy changes that have taken place in the region, such as progress in the privatization of utilities and their increasing openness to foreign private investment.¹⁰⁷

The research by Fasano and Wang may suggest that GCC efforts to diversify economies and reduce the role of the state in favour of the private sector have paid off in reducing the dependence of non-oil economic sectors on government spending. *Prima facie*, such results appear to indicate that the fiscal prudence required by CU may not be as potentially harmful or limiting to these countries, as first thought. Yet, the true extent of economic dependence on oil revenues is clearly much greater if we include oil sector GDP, on which other activities classed as non-oil GDP, such as petroleum-processing industries¹⁰⁸, are heavily dependent.

Another paper by Fasano and Wang¹⁰⁹ explored the nature of fiscal policy among the GCC states. Using econometric methods they find that government revenue and expenditure are cointegrated and therefore that fiscal policy in the GCC states is pro-cyclical to changes in oil revenues.¹¹⁰ Accordingly the GCC states conform to a 'revenue-spend hypothesis', so that when oil prices fall and concomitantly government revenues decline, expenditure also falls (primarily through capital expenditure cut backs), when oil prices rise and government coffers swell spending thus increases. A number of recommendations are made by the authors that would enable the GCC states to avoid the volatility of the 'revenue-spend' economics. They recommend a medium-term expenditure framework and that formal oil stabilization funds should be adopted. Such medium-term economic policies are already being implemented in Oman and

¹⁰⁷ Fasano, U. and Wang, Q., *op.cit.*

¹⁰⁸ In most GCC national accounts such oil-based industrial activity is categorized as part of the 'Manufacturing' sector.

¹⁰⁹ Fasano, U. and Wang, Q., "Testing the Relationship Between Government Spending and Revenue: Evidence from GCC Countries" *International Monetary Fund Working Paper*, November 2002.

¹¹⁰ The authors use cointegration techniques including vector error-correction and vector auto-regression models to examine the dynamic relationship between government revenue and expenditure among the members of the GCC.

Kuwait. To some degree they have reduced volatility in economic activity through smoothing government income and spending.¹¹¹ Other GCC states, such as the UAE and Saudi Arabia have unofficial funds that can act like oil price stabilization funds, with investment returns possibly acting to offset declines in hydrocarbon income following an oil price decline. Jadresic¹¹² argues that these oil price stabilization funds should play a role in allowing GCC states to meet future fiscal discipline rules.

Fiscal policy has undoubtedly been influenced by government dependence on oil revenues in the GCC. However, the existing literature has not dealt sufficiently with the overall real costs to the GCC states of losing their ability to carry out fiscal policy over the course of the economic cycle. It is clear that the design of any fiscal rules as part of monetary union will need to take into account the strong correlation between oil prices and government incomes in the region if they are to be at all practical. This has been argued strongly by Jadresic.¹¹³

The pro-cyclical fiscal policies of the GCC states, and their high degree of hydrocarbon dependence, implies that certain types of nominal fiscal rules, such as the EU's SGP, which do not take into account the economic cycles of the member states are unlikely to be appropriate for the GCC. Indeed as has already been mentioned (see section 2.4.6) many European finance ministers and academics themselves would like the Stability and Growth Pact to be more flexible and pro-cyclical. In chapter seven of this thesis, we return to the issue of appropriately designed fiscal discipline rules for the GCC CU (see section 7.4).

¹¹¹ Fasano and Wang, *op. cit*

¹¹² *Op.cit.*

¹¹³ *Op. cit.*

2.5.5 Preparations for CU

A paper by Fasano and Iqbal¹¹⁴ discusses the design of an effective CU in the GCC and suggests a number of logistical and practical steps that still need to be taken. These include; choosing quantitative convergence criteria, fiscal rules, policy convergence, institutional design and development and complementary structural reform.

Fasano¹¹⁵ makes the distinction between steps which must be taken before the establishment of the CU and those that if also taken will allow the GCC nations to achieve the full benefits from CU. He asserts that the following steps are necessary; establishing a common exchange rate policy and setting bilateral exchange rates, pooling foreign reserves, maintaining a sustainable fiscal position based on a medium-term framework with conservative oil price assumptions, determining targets for monitoring these balances.

Several papers by the IMF have highlighted the importance of improving data provision across the GCC states as an essential part of the process of forming a CU. Improved data collection is necessary in order to assess economic and monetary convergence and adherence to policy objectives leading up to unification. According to Krueger and Kovarich¹¹⁶ major changes to national statistical programs are needed that should begin as soon as possible. In addition to this, they point out that a significant lead time will be needed to build institutional capabilities and the legal infrastructure for comprehensive data collection. Fasano¹¹⁷ also stresses the value of adopting international standards in data dissemination. Based on the experience of the EU and the role of its statistical agency 'Eurostat', Al Mansouri and Dziobek¹¹⁸ suggest that a GCC regional statistical agency, "Gulfstat", should be formed. 'Gulfstat' should be tasked with developing a common methodology for collecting,

¹¹⁴ Fasano, U. and Iqbal, Z. "Common Currency", *Finance and Development A Quarterly Magazine of the IMF*, Vol. 39, No. 4, December 2002.

¹¹⁵ Fasano, U. and Staff Team, *Monetary Union among Member Countries of the Gulf Cooperation Council*, International Monetary Fund, Washington D.C., 2003.

¹¹⁶ Krueger, R. and Kovarich, E. "Some Principles for Development of Statistics for a Gulf Cooperation Council Currency Union" *IMF Working Paper*, June 2006

¹¹⁷ Fasano, *op.cit.*

¹¹⁸ Al-Mansouri, A.K.L. and Dziobek, Claudia "Providing Official Statistics for the Common Market and Monetary Union in the Gulf Cooperation Council (GCC) Countries: A Case for "Gulfstat" *IMF Working Paper*, February 2006.

standardizing and harmonizing data across the GCC, a role which the authors consider to be of overriding importance.

In an ECB report, Sturm and Siegfried¹¹⁹ recommend that the process of integration should be accompanied by the strengthening of national and supranational institutions in advance of CU and the coordination of national policies. The authors also stress the importance of setting up a supranational monetary institution at the GCC level in order to support the single monetary and exchange rate policy of the union. A number of issues related to the set up of the GCC central bank will need to be determined prior to the launch of the single currency, such as the mandate of the central bank, distribution of seigniorage and legal issues relating to its structure. The authors therefore recommend that such preparations are made well in advance of CU.

Ensuring that preparations are made and preconditions for CU are met is critical if the GCC states are to achieve CU on time and to secure its future durability. Chapter six of this thesis, therefore examines in detail what concrete steps are being taken towards CU and the pace at which preparations are being made.

2.5.6 The Post CU Choice of Exchange Rate Regime

The choice of exchange rate arrangement will affect the credibility of the emerging GCC currency and to a degree the macroeconomic stability of these countries. Various papers have investigated the possible alternative exchange rate mechanisms following the establishment of a single GCC currency. Through qualitative analysis Jadresic¹²⁰ concludes that a peg to the dollar emerges as a natural choice with a peg to the euro being the main alternative.

A paper by Iqbal and Erbas¹²¹ examines the external stability of GCC exchange rates under a dollar peg compared with an SDR¹²² peg. Despite the greater

¹¹⁹ Sturm and Siegfried, *op.cit.*

¹²⁰ *Op. cit.*

¹²¹ Iqbal, Z. and Erbas, S.N., "External Stability Under Alternative Nominal Exchange Rate Anchors: An Application to the GCC Countries" International Monetary Fund, January 1997.

¹²² Special Drawing Rights, created by the IMF, is an international reserve asset and is based on a basket of key international currencies.

exchange rate volatility of the dollar relative to the SDR, the authors conclude from analyzing export and import elasticities that switching to an SDR peg is unlikely to improve exchange rate stability.

Abed *et al*¹²³ specifically examine the impact of a dollar peg compared with a euro-dollar basket peg on two likely exchange rate regime objectives, that of external stability and international competitiveness. Through quantitative analysis they conclude that in retrospect the dollar peg has dominated the alternative euro-dollar basket peg in terms of the overall external balance of the GCC states. This is not necessarily surprising, considering the dominance of dollar-denominated oil exports in GCC trade. However, in terms of non-oil trade, despite being statistically insignificant, their results estimate that a euro-dollar basket peg would have been preferable to the dollar peg in providing exchange rate stability.

A qualitative assessment of the effect of both pegs on competitiveness is also provided by Abed *et al* and they suggest that in the future it is likely that a euro-dollar basket peg, or a more flexible arrangement, would be superior to a fixed dollar peg. Their conclusion is reached in light of the fact that GCC policies are aimed at greater economic diversification and the long anticipated expansion in non-oil trade will require greater exchange rate flexibility in order to help improve international competitiveness. The authors add the caveat that the exchange rate regime alone cannot ensure global competitiveness for non-oil exports and that the GCC will need to use other tools, such as labour market reform, to guarantee future non-oil export growth.

An examination of the dynamics of inter-regional trade patterns of the GCC states is instrumental in choosing an appropriate exchange rate mechanism for the new GCC currency and indeed in assessing the suitability of the existing dollar pegs in the region. Wilson¹²⁴ reveals the increasing importance of GCC trade with Asia. During the 1990s, the GCC benefited from trade surpluses with

¹²³ Abed, G.T., Erbas, S. N. and Guerami, B., "The GCC Monetary Union: Some Considerations for the Exchange Rate Regime" *International Monetary Fund Working Paper*, April 2003.

¹²⁴ Wilson, R. J. A., "The Changing Composition and Direction of GCC Trade" *The Emirates Occasional Papers*, Issue No.18, The Emirates Center for Strategic Studies and Research, Abu Dhabi, 1998.

the Asian region. The GCC trade position with Europe has almost been a mirror image of that with Asia. Whilst the GCC is Europe's sixth largest export market, with exports consisting mainly of manufactured products GCC exports to the region, which are predominantly oil and its derivatives, have dwindled. Recently only Saudi Arabia has exported a significant amount – although less than a fifth of its total exports – to the Eurozone economies.

While GCC imports from Europe are significant GCC exports to Europe continue to be rather weak in spite of efforts to raise the level of trade between them through policies such as the Cooperation Agreement of 1989. According to Wilson¹²⁵, in many cases the expected rewards of this agreement have not accrued to the Gulf states. Joint EU-GCC Council meetings have taken place with the overarching aim of establishing a free trade area. Wilson argues that, thus far, little has been achieved, in part, due to institutional and organizational problems in the GCC as well as an inability to subvert national interests in favour of regional ones.

Jbili and Kramarenko¹²⁶ suggest that a peg to the euro, or a basket of currencies, or even a floating currency all present viable alternatives for the GCC and the possibilities for such exchange rate options deserves further analysis.

The potential for the new GCC currency to become a reserve and anchor currency within the wider gulf region is an issue that this research will consider. A strong and stable GCC currency could prove to be an attractive asset to domestic, regional and international investors, such a scenario would provide GCC governments with increased seigniorage revenues and substantially boost GCC financial markets. Additionally other regional central banks may choose to hold reserves in the currency as a hedge against exchange rate risk on their oil imports from the GCC.

¹²⁵ Wilson, R.J.A., EU-GCC relations: Towards a Free Trade Agreement and Beyond, A paper presented at a Conference on Gulf Cooperation Council Economies: 21st Century Opportunities, Al Ahsa, 13-15 Feb 2001.

¹²⁶ Jbili, A. and Kramarenko, V., "Choosing Exchange Regimes in the Middle East and North Africa" International Monetary Fund, Washington D.C., 2003.

In chapter seven of this thesis, we discuss whether continuing to peg to the US dollar is the optimum regime for the new currency or whether an alternative choice would be more likely to enable the GCC states to achieve their economic policy objectives (see section 7.3.2). Following this chapter seven also discusses the potential economic and political case for establishing the new currency as an anchorage and reserve currency (see section 7.5.1).

2.6 Summary

This literature review has revealed a number of important issues to be addressed in analyzing the appropriateness of the GCC states for CU and the potential costs and benefits of full economic integration. The most salient issues raised will be analysed in detail in later chapters of this thesis.

It has been established that the theoretical roots of OCA criteria date back to the 1960s with Mundell's groundbreaking research that presented a number of economic criteria required by member states in forming a CU, with important additions to the theory being made by McKinnon and Kenen. In later decades further developments in the OCA debate took place with the emergence of European integration and Mundell updated his OCA argument to include vital political economy considerations.¹²⁷ This theoretical and applied literature underpins our analysis of the prospective GCC CU.

As we have seen, many papers on the experience of EMU have attempted to assess the optimality of the union through operationalising the OCA criteria. For example, Bayoumi and Eichengreen¹²⁸ used econometric techniques to create an OCA index while Feldstein¹²⁹ took a political-economy approach in assessing the balance of costs and benefits arising from CU. From this we can conclude that the variety of OCA criteria requires a mixed methodological approach to be taken, employing both qualitative and quantitative techniques.

¹²⁷ Mundell, Robert A. "Updating the agenda for monetary union" in *Optimum Currency Areas: New Analytical and Policy Developments*, (Eds. Blejer, M.I., Frenkel, J.A., Leiderman, L., and Razin, A.) International Monetary Fund, 1997.

¹²⁸ Bayoumi, T and Eichengreen, B. "Ever Closer to heaven? An Optimum-Currency-Area Index for European Countries", *European Economic Review* 41, pp.761-770, 1997.

¹²⁹ Feldstein, M., "The Political Economy of the European Economic and Monetary Union: Political Sources of an Economic Liability" *The Journal of Economic Perspectives*, Vol. 11, No. 4 (autumn), pp. 23-42, 1997.

In the next chapter the methodological approach of this research is discussed in detail. While chapter five of the thesis employs the main OCA criteria discussed in this literature review in order to assess the appropriateness of CU for the GCC states.

Previous research examined in this literature review, such as that by Fasano¹³⁰ and Sturm¹³¹, has discussed many of the prerequisite conditions and preparations required for a sustainable CU, from meeting convergence criteria to the building and designing of institutions to support the CU. This literature review has laid the ground work for an in-depth analysis of the presence of these policy prerequisites and the preparations being made for GCC CU, which is presented in chapter six of this thesis.

A number of notable research papers discussed here have analysed the potential costs and benefits of the future GCC CU. In particular, Laabas and Limam¹³² and Fasano¹³³ have attempted to establish the advantages and disadvantages of CU for the region, yet they have not been able to undertake a sufficiently in-depth assessment, nor have they attempted to gauge the distribution of costs and benefits across the GCC states. A central part of this thesis weighs up the costs and benefits of GCC CU for the region as a whole but also for the individual GCC states, and is presented in chapters seven and eight of this thesis.

¹³⁰ Fasano, U., *op.cit.*

¹³¹ Sturm, M. and Siegfried, N. *op.cit.*

¹³² Laabas and Limam, *op.cit.*

¹³³ Fasano, *op.cit.*

Chapter 3 : Methods and Methodology

3.1 Introduction

This thesis uses the OCA theory as its theoretical framework. In examining the application of OCA criteria to the GCC a combination of research methods and a pragmatic approach is adopted. The research attempts to establish whether or not CU is appropriate for the GCC regardless of whether or not it constitutes an OCA and to assess the potential costs and benefits of GCC CU. Both qualitative and quantitative techniques are used to determine the appropriateness of a single currency and to assess the costs and benefits for individual States and the GCC as a whole.

The qualitative research included a considerable period of fieldwork in the region and collaborative work with the Dubai based Gulf Research Center (GRC).¹ Fieldwork helped ensure the credibility of the research and provided first hand experience of the contextual factors that are involved in the transition towards CU. Primary methods such as semi-structured interviews with regional experts, attending relevant conferences and presenting at seminars were used to collect information and data.

Quantitative and empirical work was undertaken to assess the overall economic appropriateness of CU and to establish the potential costs and benefits of GCC CU. This included macroeconomic convergence testing and econometric modelling to test for shock symmetries. An important method of assessing the appropriateness was to gauge business sentiment on the issue. Collaborative work with the GRC included carrying out an extensive GCC business survey on the subject. The survey aimed to provide some insight on the potential micro economic impact of the CU as well as business expectations and their preparedness for the adoption of a single currency.

¹ The Gulf Research Center is an independent research institute located in Dubai, United Arab Emirates (UAE). The GRC was founded in July 2000 and is an entirely independent organisation that publishes a wide range of research papers and convenes conferences. The GRC (www.grc.ae) also incorporates Gulf in the Media (www.gulfinthemedial.com).

This chapter discusses the aforementioned methods which were employed to address the research objectives and specific research questions as set out in chapter one. It is divided into the following sections: the first, section 3.2, discusses the pluralistic methodological approach which was adopted and the rationale behind it. In section 3.3 the formulation of the research process, its design and the stages involved in its construction are laid out. The qualitative and quantitative research methods are discussed in sections 3.4 and 3.5 respectively. The final section, 3.6, provides a summary of how the results of the various types of research methods were analyzed and interpreted.

3.2 Methodological Approach

The development of the OCA theory in the early 1960s greatly aided the analysis of monetary and economic integration and the basic contentions of the theory have continued to be valid until the present day. Yet the analytical approach of the original theory remains rather narrow and it was not able to provide a specific framework measuring the appropriateness of CU for a given region nor for identifying the potential costs and benefits.²

In fact, a number of different branches of economic theory are involved in analysing the appropriateness of CU for a given region and its potential costs and benefits. The subject area currently lacks a fully integrated methodology but several branches of economic theory have been able to provide analytical tools with which a more comprehensive approach to the costs and benefits of CU can be taken. For example, theories of microeconomics can provide some insights into how the adoption of a single currency affects business investment decisions; whereas international monetary economic theories are important in assessing the trade off between flexible versus fixed exchange rate regimes.

² Commission of the European Communities, *One Market, One Money An Evaluation of the Potential Benefits and Costs of Forming and Economic and Monetary Union*, October, European Economy No. 44, 1990.

The additions made to the OCA theory by Mundell in 1997³ also added a further analytical dimension to the debate on CU, as did the experience of EMU, which was the contribution of political economy theories to the analysis of the cost – benefit balance. Therefore, analysing the prospects of a given CU involves utilising a number of different methodological approaches (see Table 3.1).

Consequently, this thesis employs a combination of quantitative and qualitative research methods in order to provide a comprehensive analysis of the appropriateness, and cost–benefit balance, of CU for the GCC states. According to Knox "The ability to blend, and use methods, which are appropriate for each individual piece of research, is an important issue for researchers and students to realise and incorporate into their research."⁴ The appropriate methods for assessing the various costs and benefits of CU are set out in Table 3.1.

³ Mundell, R. A. "Updating the agenda for monetary union" in *Optimum Currency Areas: New Analytical and Policy Developments*, (eds. Blejer, M.I., Frenkel, J.A., Leiderman, L., and Razin, A.), IMF, 1997.

⁴ Knox, Karl "A Researcher's Dilemma - Philosophical and Methodological Pluralism" *Electronic Journal of Business Research Methods*, Vol. 2, Issue 2, pp. 119-128, October 2004.

Table 3.1: Major Effects of GCC CU and Methods of Evaluation

CU Economic Issue	Underlying Theory	Direct Channels of Effect	Indirect Channels of Effect	Methods of Assessment
Microeconomic Efficiency	Microeconomics of Imperfect Markets	Savings in transaction costs/ elimination of exchange rate uncertainty	Enlarged market/ economies of scale Effect on investment decisions	Direct evaluation through regional business survey
Macroeconomic Stability	Macroeconomic Theory	Loss of adjustment to asymmetric shock/ Coordination of economic and exchange rate policies/ Greater availability of external financing	Price stability and fiscal prudence as a consequence of convergence criteria rules	Econometric techniques and empirical testing of Convergence Criteria
	Political Economy	Credibility of the CU project	Loss of sovereignty over monetary and fiscal policy making/ Jeopardise sustainability of CU	Qualitative assessment including regional Interviews
Regional Equity	Micro and Macro	Spatial distribution of micro and macro effects	Spatial distribution of micro and macro effects (as above)	As with micro and macro (as above)
	Economic Integration	Trade creation	Economic diversification	Empirical analysis of intra-regional trade patterns
External Effects	International Monetary Economics	Additional seigniorage revenues	Increased bargaining power in international negotiations	Qualitative assessment including regional Interviews
	Political Economy	Credibility of monetary policy and the economic integration project	Increase investor confidence in region	Qualitative assessment including regional Interviews

Adapted from Commission of the European Communities, 1990, *Op.Cit.*

Whilst the methods outlined in table 3.1 prove useful tools in our investigation, it must be said that in assessing the overall appropriateness of CU for any given region, there is some difficulty in operationalising the OCA criteria and in particular the extent to which a region must meet any given criteria. In most cases, a quantitative measurement cannot be provided and instead the researcher must rely on qualitative analytical techniques.

This thesis also draws on the pragmatic philosophy as described by Johnson.⁵ He describes the philosophy of pragmatism as being "identified with the test of workability in ascertaining the truth of empirical propositions", and goes on to say that "workability is a crucial criterion in judging the truth or falsity of any empirical statement." Assessing the appropriateness and implications of CU for the GCC states involves an examination of not only the economies of these countries but also their specific political, institutional and cultural characteristics which will influence the outcome on any change of economic system.

As a key part of this thesis is to ascertain the suitability of the GCC states for CU, in part within the framework of the OCA, it is necessarily pragmatic. This is because it looks at the real-life economic and political situations in the GCC that will have a bearing on the eventual outcome and potential success of CU.

3.3 Research Process Design

The research process consisted of six key stages and the outline of its design is illustrated in Figure 3.1. These stages are outlined in more detail below.

Stage 1 The initial idea for this PhD resulted from several factors, not least the lack of detailed research on the subject of GCC CU. A general interest in the region arose from research into Bahrain's economic diversification experience that was carried out while the author was based at Bahrain University in 1998. As part of a post graduate degree in economics the author focused upon the experience of EMU and read extensively on the topic of CU. Subsequent to the revised GCC economic agreement in 2001 and a renewed commitment by

⁵ Johnson, Glen. L. *Research Methodology for Economists*, Philosophy and Practice, Macmillan Publishing Company, 1986.

GCC leaders to achieve full economic and monetary integration by 2010 an interest in the specific area was developed.

Stage 2 involved a thorough analysis of both the theoretical and applied literature on CUs. As well as the literature on OCAs a large amount of empirical literature exists on the EMU.⁶ In addition an examination of the existing literature that specifically focused on the process of GCC economic integration was undertaken. This literature review guided the author in devising the main research questions of this thesis.

Stage 3 involved selecting a range of research methods which were used to address the research questions. As has been discussed it was necessary to employ a range of methods as the research had political economy implications as well as purely economic ones. GCC academics and research institutions were contacted in order to facilitate the necessary fieldwork, and to participate in some form of collaborative work. Fieldwork involved interviews and a survey with stake holders in order to better understand the contextual variables influencing the process of integration and to ascertain the views of regional experts on the issue. A timetable for undertaking the planned fieldwork was also established.

Stage 4 initiated the process of gathering and processing the data and information and the selected research methods were employed. GCC economic data was collected from regional statistical organizations, semi-structured interviews with regional experts throughout the region were carried out and a GCC wide business survey was undertaken. Preliminary research findings were presented at seminars, and in published papers and newspaper articles. Additionally a substantial amount of empirical analysis was carried out involving assessing quantitative convergence criteria and econometric modelling of the GCC economies.

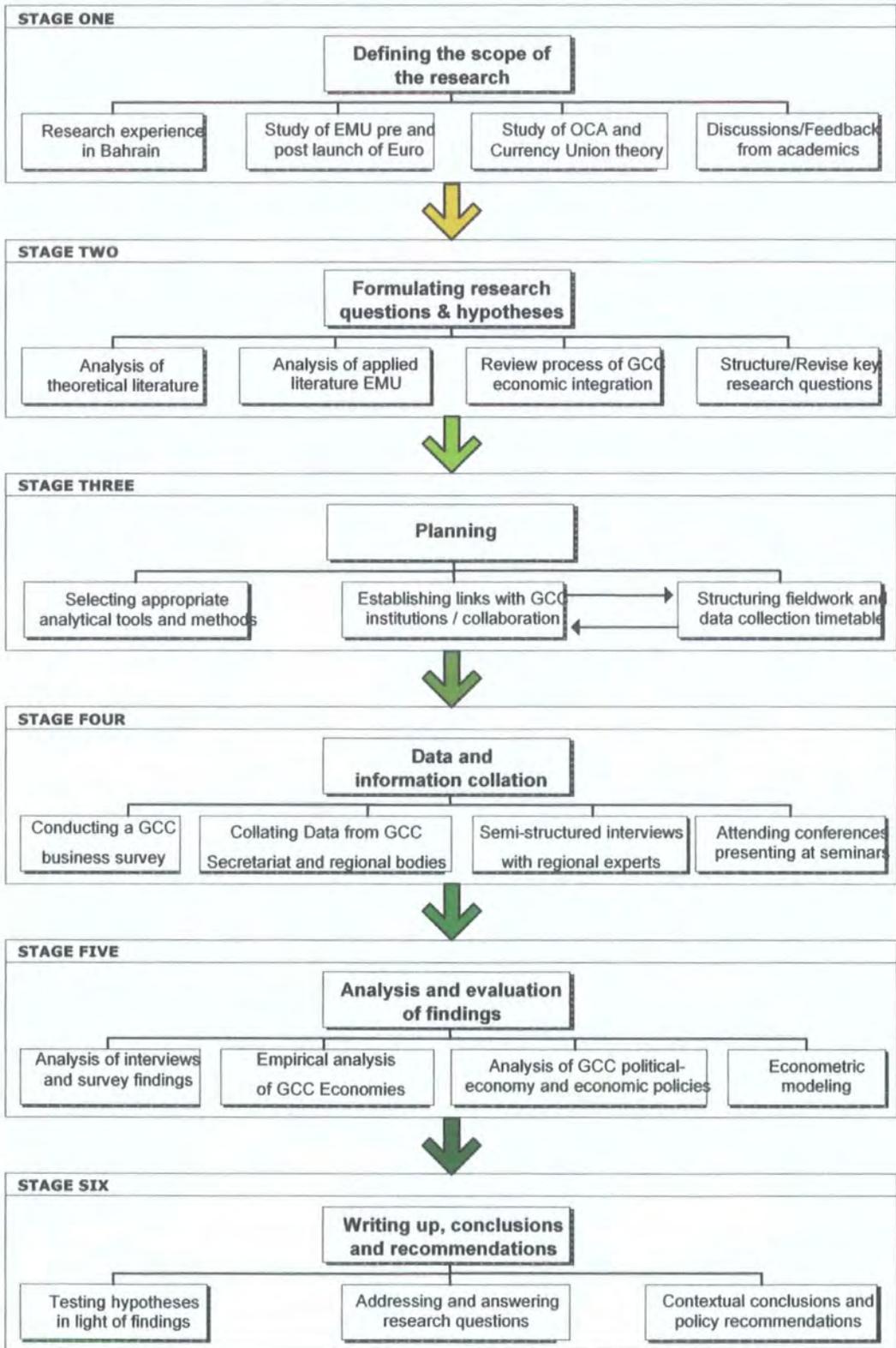
Stage 5, involved analyzing and evaluating the information and data collated during stage 4. The results of the semi-structured interviews, the findings of the

⁶ See chapter 2, the literature review for further details.

business survey and the empirical and econometric analysis of the GCC economies all provided evidence with which to answer this thesis' main research questions.

Stage 6, the final stage of the process, involved providing credible conclusions which might be of use for policy makers in the GCC states in their transition towards CU. Furthermore it sought to contribute to the canon of literature on OCA theory.

Figure 3.1: Research Design Process



3.4 Qualitative Research Methods

A thorough analysis of the institutional and political factors that led to the GCC's decision to embark on a process towards CU was necessary to adequately answer the questions put forward by this thesis. As a consequence, a considerable amount of fieldwork in the region was deemed necessary in order to see the contextual variables operating first hand. By being based in the region the political-economy factors behind the policy of economic integration were easier to ascertain. The fieldwork ensured that the research findings would more accurately reflect the potential implications of forming a CU.

Visits to several GCC states and a period of research collaboration in the UAE provided substantial contextual knowledge; it allowed the author to investigate, through semi-structured interviews and meetings (both formal and informal) with policymakers, the domestic and regional preparations being made. These interviews with regional experts provided valuable information regarding the potential impact of the CU. Qualitative methods such as interviews with policy makers and independent economists with 'insider' information on a range of important factors provided valuable insights on issues such as political resolve, institutional integration and the degree of preparations being made by the public and private sectors.

3.4.1 Collaborative Research

In order to adequately address this contemporary and policy-relevant research it was felt that some collaboration with regional experts would provide more valid and credible, contextually based conclusions. Several institutes were contacted and the response from the GRC was particularly positive. The GRC is one of the few independent research institutes in the region and it brings together national and international researchers specialising in the region.

Collaboration at the GRC took place on elements of the thesis' fieldwork in particular the business survey (see 3.5.1). Additionally, being based at the GRC provided the author with office facilities and opportunities to network at conferences which brought together many regional experts. A policy paper

entitled "Establishing a Successful CU – Preparations and Future Policy Choices"⁷ was produced and received press attention in Saudi Arabia, the UAE and Qatar. Additionally several articles on, or related to, the subject of this thesis were published in local newspapers which helped to generate feedback.⁸

3.4.2 Semi-structured Interviews

Semi-structured interviews – a key element of the qualitative research – provided a valuable primary source of information on CU from regional experts. In order to fully understand the economic and socio-political implications of CU within this region it was crucial to understand and document the opinions and views of GCC experts and policymakers. Semi-structured interviews also helped to clarify the progress being made towards the synchronisation of GCC monetary policies and their economic systems. Broadly speaking interviews were conducted with regional economists, including central bank governors and executives, government ministers and officials, GCC Secretariat and AMF officials, academics, independent researchers and commercial bankers (see Table 3.2).

⁷ Rutledge, E. "Establishing a Successful GCC Currency Union: Preparations and Future Policy Choices" Gulf Research Center, Policy Analysis, Dubai, December 2004.

⁸ Rutledge, E. and Janardhan, N., "US-Bahrain Trade deal exposes GCC chinks" *The Daily Star*, Beirut, 28 December 2004, Rutledge, E., "GCC: High on rhetoric, low on action?" *Khaleej Times*, 1 May 2005 and Rutledge, E. "High time for a single GCC currency" *Aljazeera.net*, published online, 3rd October 2005.

Table 3.2: Semi-Structured Interviews in the GCC states

Professional Category of Interviewee	No. Interviewees
Central Bank and Government officials	16
GCC Secretariat and AMF officials	5
Academics	7
Independent researchers	6
Commercial bankers	6
Total number of interviewees	40

The GRC provided access to an extensive network of regional academics and government officials and decision makers, across the GCC states, which facilitated access to relevant interviewees. Other contacts with interviewees were made when attending relevant conferences in the region. For example, attendance of a high-level seminar organised jointly by the Arab Monetary Fund and the IMF on the process of Arab economic integration provided several valuable contacts at central banks and ministries across the region.⁹

The interview questions were designed to provide insights into some of the key questions of this thesis, such as determining the appropriateness of CU and the level of monetary and institutional preparations taking place towards CU. The research questions were formulated and researchers at the GRC also provided feedback on the design and appropriateness of the interview questions. Interviews were carried out in the United Arab Emirates, Oman and Kuwait. Nationals from the other GCC states were interviewed whilst attending an AMF conference in Abu Dhabi and also via the telephone.

'Elite' interviewees were chosen according to their expected knowledge of the economies of the GCC states, and regional experts with specialised or 'insider' knowledge on the issue of GCC economic integration and monetary union were approached (see Appendix A). The majority of interviewees were GCC nationals otherwise they were individuals who had held long standing positions

⁹ Arab Monetary Fund and International Monetary Fund, 'High-Level Seminar on Arab Economic Integration: Challenges and Prospects' Abu Dhabi, UAE, 23-24 February 2005.

of relevance in the region. Potential interviewees were initially approached by letter or fax (see Appendix B) and invited to be interviewed if a given candidate was willing to be interviewed appointments were then made by telephone. Out of the 63 prospective interviewees identified, 48 agreed to be interviewed, of which only 40 interviewees were considered to be sufficiently informed on the subject area.

Interviewees – including several central bank governors and government ministers – were interviewed using open-ended questions (see Appendix C). At times additional questions were asked depending upon the individual's expertise. The majority of interviewees preferred not to be recorded so they could express their personal views more freely; therefore responses and key points were taken in note form. After each interview the responses were logged into a Microsoft Access database. This type of database has the advantage of being able to display all the responses to a given question at one time, allowing themes and trends to be easily identified and analysed.

After a satisfactory and representative sample of GCC experts had been interviewed a qualitative analysis of the results was undertaken. By using the database overlapping patterns and common themes were identified. The results of the interviews contributed to the analysis in chapters five, six and seven of this thesis.

3.4.3 Seminars

Whilst based in the region the author was able to present the initial research findings at several seminars. These provided good opportunities to receive useful feedback and generate dialogue on the subject. For instance, a seminar assembled at Al Ain University provided an opportunity to hear opinions and views on the issue from a group of academics (participants were encouraged to discuss the issues and express their points of view). This method augmented the information collected from the semi-structured interviews and offered an opportunity to discuss unanticipated issues that arose, in an informal manner.

3.4.4 Other Qualitative Resources

The region's Arabic press and other local publications provided additional sources of information on the subject of CU and related economic integration. Due to the contemporary nature of the research topic, many of the preparations being made towards CU are unofficially disclosed through the region's press and therefore this is a valuable research resource. The GRC has an extensive database of publications on the GCC states and in addition translates many articles from Arabic into English that aren't available elsewhere. The GRC's *Gulf in the Media* web portal has collated more than one million articles from 2001 focusing on the GCC countries from English and Arabic newspapers, as well as reports, background papers from academia and various international institutions. While based at the GRC the author had access to this valuable database and was able to carry out structured searches for relevant material.

3.5 Quantitative research methods

Quantitative research methods involved collating statistics in order to analyse the GCC economies, both in terms of the appropriateness of existing monetary policies and the region's suitability for CU. Statistical analysis of the macroeconomics of the GCC states was undertaken as well as convergence testing and econometric modelling. Data was collected from a number of institutions including the GCC Secretariat, the Arab Monetary Fund, regional central banks, and Ministries of Economy and Planning. A business survey was also carried out to look at the microeconomic impact of the CU.

3.5.1 Business Survey

A key area of collaboration with the GRC was formulating and carrying out a survey of GCC businesses. The survey "Business Survey on GCC Currency Union" was carried out in order to assess the micro economic impact of the CU on the private sector. The survey provides policy relevant evidence on the state of current GCC business expectations regarding the CU. The survey sought to ascertain the expectations of GCC companies regarding the effect of the single currency on their business and to assess business confidence on the potential success of the CU overall. It also questioned businesses on their preparations

for the CU which will have a bearing on the smoothness of the transition (see Appendix E).

From the outset it was not possible to establish the sample frame of the survey, i.e. the size of the GCC business population, because the GCC states do not undertake and publish industrial censuses and therefore figures on the total number of private businesses operating in each of the individual GCC states are not available. In the absence of reliable data on the number of GCC businesses in operation, the required sample size could not be accurately estimated.

A list of GCC companies was compiled from each GCC national Chambers of Commerce database. However, coverage of businesses at chambers of commerce was sometimes poor and therefore business contacts were also collected from a number of private online business directories. Only those companies with fax numbers and /or email addresses were selected to participate in the survey, these being the type of businesses most likely to be of economic significance and furthermore companies without fax or email would not have been able to participate in the survey. Once duplication of firms or branches of the same company was omitted, the number of companies collated from these sources amounted to more than eleven thousand.

The number of businesses which were contacted per GCC state depended on several factors. While companies in the UAE were well represented in Chambers of Commerce and business directories, those in Bahrain and Qatar for example, were much less so (see Table 3.3). Also, more businesses in the UAE had email addresses than those in Saudi Arabia for example, therefore it was relatively cheaper to contact a greater number of companies in the UAE than it was in Saudi Arabia where companies had to be faxed the survey. (The project inevitably had some financial constraints).

Prior to undertaking the survey a pilot survey of 20 companies was carried out in advance, face to face and over the telephone. Several amendments to the original business survey were then made, certain questions required more clarification, needed to be simplified or were removed altogether. It was

apparent from the pilot survey that some companies were not prepared to give information on their sales turnover as they felt this confidential. The anonymity of the responses therefore was guaranteed in the cover letter to the survey (see Appendix D).

Following the pilot survey, 532 companies were contacted directly by telephone, and asked to participate in the survey which was then emailed or faxed to them. The survey consisted of 'closed-end' questions which respondents could 'self-administer' either by fax or online. An Arabic version of the survey was also available to be administered via fax. In addition 10,781 companies were sent a fax and email (with link to the online survey - www.gcc-economics.com) requesting their participation. The process of contacting companies and asking them to participate in the survey as well as the process of entering the results into SPSS was time consuming and labour intensive. Two interns working at the GRC – both economic graduates from American University of Sharjah – assisted in contacting companies, sending out the survey via email and fax.

From the outset it was expected that the response rate from GCC businesses would be low. Due to the fact that surveys carried out via the internet tend to have low response rates. Furthermore, the survey did not offer any financial incentives for participation, unlike many polls now conducted by commercial polling agencies in the Middle East.

The survey response rate, especially from those not directly telephoned, as expected was low at just 2.7 percent overall. The method of telephoning companies and asking them to participate in the survey was considerably more successful than that of fax and email request for participation. Overall the total number of responses received was 307, 104 from telephoning (19.5 percent response rate) and 203 from fax and Online (1.9 percent response rate). The distribution of response rates across the GCC states ranged from 1.4 percent to 5.8 percent. The highest response rates were from Bahrain and Kuwait, which could suggest that there was more interest in CU in these two countries and the lowest response rates were from Oman and Qatar where it seems there may be more indifference concerning CU.

Table 3.3: Survey Distribution and Response Rate

GCC State	Call & Fax/Online	Fax/Online Only	Total	Actual Responses	Response Rate
Bahrain	50	312	362	21	5.8%
Kuwait	54	725	779	31	4.0%
Oman	46	2530	2576	36	1.4%
Qatar	47	409	456	8	1.8%
SA	168	2887	3055	113	3.7%
UAE	167	3918	4085	98	2.4%
Total	532	10,781	11,313	307	2.7%

Source: GCC Business Survey on Currency Union, June-September 2005

It must be said that the rather low overall response rate increases the likelihood of sampling error in the survey results. However, confidence intervals for a number of the survey's findings are provided where feasible throughout the analysis. The potential problem of sample bias – where those businesses who responded to the survey may be inherently more interested in and in favour of GCC CU – must also be taken into consideration. Consequently, the survey results should be taken as only broadly indicative of the perception of GCC private businesses and a guide to further research which should be carried out by the GCC governments themselves whose greater resources might be expected to elicit a much broader response. Nevertheless, it is hoped that this preliminary research should provide helpful guidelines as to the direction and content of any such additional investigation.

The survey findings feed into the analysis throughout the thesis and in particular contributed towards the analysis of the preparations being made towards CU in chapter six and towards the costs and benefits for each state individually in chapter seven. In addition, a detailed analysis of the main economic characteristics of the business survey respondents is provided as an appendix to this thesis (see Appendix F).

3.5.2 Data Collation and Statistical Analysis

Data was collated from a number of regional organizations including the Arab Monetary Fund, regional Central Banks and GCC Secretariat. In some cases statistical publications only available in Arabic were also utilised. Public provision of data in the GCC states and from some of these organizations is inadequate and several organizations had to be contacted directly and in some cases repeatedly in order to obtain data. In particular cases and in certain states economic data from the GCC states is frequently unavailable or inconsistent, as a consequence international sources of data, such as the International Monetary Fund and the World Bank, were also required for the empirical analysis. In addition, data from the GCC Secretariat and Arab Monetary Fund on occasions contradict that of National Ministries of Economy even though the two regional organizations source their data from these ministries.¹⁰ The GCC secretariat also declined to provide contemporary data on certain key convergence criteria such as government debt.

The quantitative analysis in this thesis entailed examining comparative macroeconomic profiles of the GCC states using descriptive statistics. Relevant economic indicators were analysed over time and these included both GDP and income per capita growth, inflation rates, money supply growth and interest rates, as well as nominal and real exchange rates. The descriptive statistics of these economic indicators were examined, such as the mean and standard deviation of these variables across the GCC states as well as their dynamic trends.

This statistical analysis of the GCC economies and their existing currency regimes was necessary in order to assess the stability and performance of their economies since following a *de facto*¹¹ or *de jure*¹² exchange rate peg to the US dollar and to be able to come to some conclusions as to whether these existing arrangements have therefore proved appropriate thus far for these economies (see chapter four). This assessment of the economic performance

¹⁰ The author previously undertook research into Bahrain's economic diversification process and found that the sectoral breakdown of national income presented in Bahrain's national accounts was quite different to that presented in Arab Monetary Fund publications.

¹¹ For Bahrain, Kuwait, Qatar, UAE and Saudi Arabia who have been pegged to the SDR.

¹² Oman is the only GCC state that was officially pegged to the US dollar prior to 2003.

of the GCC economies since pegging to the US dollar prepared the ground for an evaluation of the comparative benefits of CU (in chapters five and six).

3.5.3 Empirical Convergence Testing

The traditional OCA theory encompasses a number of economic criteria that the GCC states are assessed against in chapter five. In particular, the extent of GCC intra-regional trade, economic diversification and economic synchronisation was examined empirically in order to help determine whether the GCC can be considered an OCA or at least be able to form a viable CU.

The share of intra-GCC trade as a proportion of total GCC trade and total non-oil GCC trade was examined and its changing pattern over time was analysed. Further evidence was presented by calculating the Trade Intensity Ratios between the individual GCC states (in chapter five, section 5.2). The extent of GCC economic diversification was examined through an analysis of the sector contribution to GDP and hydrocarbon dependency ratios (in chapter four, section 4.2.2).

In addition, empirical tests for economic convergence were undertaken using the Maastricht criteria and Stability and Growth Pact of the EMU as a starting point (see chapter six, section 6.2). This involved examining over time both monetary and fiscal indicators such as inflation rates, short term interest rates, as well as government budgets to GDP ratios, government debt to GDP ratios and foreign reserve cover to months of imports. Such statistical analysis indicated the extent of convergence since the forming of the GCC and the prospects for a sustainable GCC CU.

3.5.4 Econometric Modeling

Econometric analysis was undertaken in chapter five (section 5.6) in order to estimate the degree of economic integration and synchronization among the GCC economies. The specific techniques employed included testing for multivariate cointegration between the economic output of the GCC states. The presence of a cointegrating vector indicated a long term causal relationship

between these economies. Previous research by Darrat and Shamsi¹³ used this technique to test for integration between various economic and financial variables in the GCC states.

In chapter five the econometric analysis undertaken by Darrat and Shamsi is extended and tests for pair-wise cointegration between the dominant economy in the region, Saudi Arabia, and each of the smaller GCC economies were undertaken. In addition to this, in the presence of cointegration, the short term dynamics were modelled using a Vector Error Correction Model and impulse response functions which indicated the adjustment time taken following a shock to return to the long run causal relationship.

The degree of cointegration between each of the smaller GCC states and Saudi Arabia has important implications for the regional distribution of costs and benefits arising from CU. As the dominant regional economy Saudi Arabia stands to have considerable influence over regional monetary policy and therefore a lack of economic integration with the Kingdom may eventually result in a sub-optimal monetary policy for certain individual smaller GCC states.

3.6 Summary

This chapter has set out the research methodology and the methods used to address the thesis's key questions, outlined in chapter one. It explains why certain methods were used, why they were relevant and provides details on how information collated was interpreted and incorporated into the thesis. Due to the fragmented nature of the economic methodology and the difficulty in operationalising certain OCA criteria, some of the potential costs and benefits of GCC CU cannot be quantitatively or precisely measured. Having said this, it is possible to make partial quantifications or a qualitative assessment which can provide evidence for investigating the case for GCC CU.

The qualitative and quantitative research presented in this thesis aims to shed light on the research questions which are addressed in detail in subsequent

¹³ Darrat, Ali. F and Al-Shamsi, Fatima "On the Path of Integration in the Gulf Region" *Applied Economics*, 37, pp. 1055 – 1062, 2005.

chapters of this thesis. The qualitative research in particular, provides information on the political-economy and institutional factors shaping regional economic integration policies. The quantitative methods help in assessing the macroeconomic convergence of the GCC states and in determining the likely costs and benefits of CU collectively and individually and ultimately its economic appropriateness for the region.

Chapter 4 : Economic Performance and Policy 1980 – 2005

4.1 Introduction

The purpose of this chapter is to present an overview of the GCC's economic performance between 1980 and 2005 and an examination of the various states' economic policy objectives. It also seeks to establish how effective the economic policies, in particular the exchange rate and monetary policies, have been in meeting the economic objectives. It also looks at the similarities and contrasts between both their economic structures and policies in order to gauge how cohesive the GCC is as an 'economic region', and thus suitable for monetary union.

Assessing the relative success of national economic policies is complicated by the fact that it is hard to isolate their impact from those caused by external shocks. This is particularly the case in the GCC states where cyclical global growth trends have a large bearing on both the demand for, and price of oil. It is also difficult to separate demand-side shocks from supply-side shocks in these economies. For instance, an increase in the price of oil will lead to a supply-side shock in the form of improved terms of trade, but at the same time, it will lead to a demand-side shock through increased liquidity and government expenditure.

A lack of consistent and comprehensive economic data complicated the empirical analysis of these economies. National data sources were consulted, but because these data sets are sometimes incomplete and at times unreliable, data from regional and international organisations were also employed which tend to be more consistent for comparative purposes. As a consequence the empirical analysis uses data from various national, regional and international organizations.

The chapter begins by providing an overview of the GCC state's economic performance between 1980 and 2005. It charts the region's economic growth and

development, initially focusing on hydrocarbon dependence it then looks at private versus public sector growth, the Balance of Payments and finally exchange rate performance.

The second section of the chapter focuses on the economic policies that the GCC states have adopted to address their economic challenges. In particular, it details the economic policies of economic diversification, labour force nationalization, promoting the private sector, attracting FDI and the choice of monetary policies. It concludes by reviewing the level of GCC economic integration achieved thus far and focuses on intra-GCC economic policies and agreements.

The chapter concludes by first summarising regional economic challenges and the contrasts between GCC states with respect to these. It then assesses the degree to which GCC economic policies have been, and can expect to be, successful in achieving their objectives. In particular, it considers the impact of GCC monetary policies on economic performance and assesses the utility of the existing monetary policies by weighing up the pros and cons of the pegged exchange rate regimes.

4.2 GCC Economic Performance

Before discussing in detail the GCC economic performance since 1980 we shall first provide a broad overview of this by way of an economic introduction. The 1980 to 2000 period was characterized by low levels of growth and minimal inflation in the GCC states. With the exception of Oman, most GCC states experienced several years of negative growth during the 1980s. However, throughout the 1990s, GDP growth performance improved, for instance averaging 3.1 percent in Saudi Arabia over the decade.¹ The 1980s period was characterized by falling nominal levels of income per capita as population growth kept outstripped GDP growth, in the 1990s as population growth kept pace with GDP growth nominal GDP per income more or less stagnated. The highest average inflation rate during

¹ World Bank, *World Development Indicators*, June 2006.

the 1980s was recorded in Qatar at 3.8 percent and during the 1990s a maximum rate of 3.4 percent was recorded in the UAE.²

Since 2000 the performance of the GCC economies has improved, particularly since the oil price boom began in 2002, in 2003 the median growth rate had increased to 7.2 percent. Even those non-OPEC member GCC states with low oil production have benefited economically from the increase in regional liquidity, illustrated by the 74 percent average growth of the GCC's stock market indices in 2005.³ Despite this recent upturn in growth generating sufficient employment for nationals continues to be a problem and is of particular concern in Bahrain, Oman and Saudi Arabia.

In general, the structure of GCC GDP by income over this period has changed little and has been dominated by the hydrocarbon and the public sectors. In addition, the growth of the hydrocarbon sector has outperformed that of the non-hydrocarbon sectors in all GCC states with the exception of the UAE. In terms of government revenues, all GCC states remain heavily dependent on hydrocarbon revenues. For instance, during the 1990s oil revenues formed on average 75 percent of total GCC government revenues. Such dependence has caused severe budgetary deficits during times of low oil prices and has led to unstable spending plans. The public sector's share of spending in the GCC economies has been consistent over the period of analysis averaging 39 percent in 1980, rising to 41 percent in 1990 and falling slightly to 37 percent in 2003.⁴

The GCC's balance of trade has been heavily dependent on the global price of oil over this period. Since 1980 the composition of GCC trade has shifted away from the US, and now the majority of trade – both imports and exports – is with Asia and Europe. On the whole the GCC has consistently underperformed in attracting FDI, although inflows have been increasing in recent years, nearly doubling from 0.4

² IMF, International Financial Statistics, May 2006.

³ AMF, Regional Stock Market Websites.

⁴ AMF, National Accounts, 2004.

percent in 2002 to 0.7 percent in 2004, however they remain low by global standards.⁵

In terms of monetary policy, all GCC currencies have had *de facto* pegs against the dollar throughout this period of analysis. While only Oman has had an official peg to the US dollar, the other GCC states, through pegs to the SDR or a basket of currencies have been effectively tied to the dollar and US interest rates for decades. Although this has afforded them exchange rate stability and a low inflation environment it has at times of dollar depreciations led to rising import costs, for example in 2004, and has also prevented GCC central banks from using monetary instruments to foster growth during repeated times of low oil prices.

4.2.1 Economic Growth and Development

The median of average growth rates in the GCC economies during the period from 1980 to 2004 is 4.1 percent. Yet there was considerable dispersal in the average economic growth rates, ranging from a high of 6.5 percent for Qatar to a low of 1.7 percent for Saudi Arabia (see Table 4.1). The performance of the GCC economies fared reasonably well when compared to the EMU average growth rate over the period, at 2.2 percent.⁶

Over the period of analysis, the GDP growth rates in the GCC economies have also been very volatile. The standard deviations from the average growth rate and the coefficient of variations have been for the most part high. This has been the case in particular for Qatar and Kuwait and may well reflect the dominance of oil and gas sales in their national income. Compared to the EMU region, volatility in the GCC economies has been much higher. The coefficient of variation for the EMU GDP growth rates was only 0.54. With the exception of Oman which had a coefficient of 0.85, all other GCC economies had coefficients more than twice that of EMU's (see Table 4.1).

⁵ United Nations Conference on Trade and Development, *World Investment Report*, 2005.

⁶ As was mentioned in chapter 1 and 2 of this thesis, the GCC states are compared throughout with those of the EMU countries which have successfully formed a CU.

Table 4.1: GCC Countries GDP* Growth Rates

	Average 1980-2004	Standard deviation	Coefficient of Variation
Bahrain	4.0%	0.05	1.23
Kuwait	2.7%	0.13	4.59
Oman	6.3%	0.05	0.85
Qatar	6.5%	0.15	2.34
SA	1.7%	0.05	2.95
UAE	4.2%	0.09	2.10
EMU	2.2%	0.01	0.54

Source: World Development Indicators (June 2006).

* Annual percentage growth rate of GDP based on constant US\$ 2000 prices. Qatar data based on current US\$.

In general, inflationary pressures have been contained in the GCC states during the period under study. Following the monetary policy of the US Federal Reserve Bank provided GCC Central Banks with credibility which helped to create a low inflation environment overall. The highest average inflation rate over the period of analysis was in the UAE at 3.6 percent, followed by Qatar at 3.4 percent (see Table 4.2). While Oman and Saudi Arabia recorded the lowest inflation rates in the group at just 0.43 percent and 0.51 percent during the period of analysis.

Average inflation rates of below 3.6 percent over the last two and a half decades reflect a stable price environment albeit on diverging paths. Since 1991 the UAE has had the highest average inflation rates at almost 3.6 percent while Oman's inflation has been negligible at close to zero on average.⁷ The standard deviation among GCC inflation rates in 2005 was 3.1, and the range was above 8 percent.

⁷ Omani economists have expressed concern that Omani inflation rates have been far below the global rate of inflation for too long and have suggested that Omani CPI doesn't properly reflect prices in the economy (Interview with Dr. Hatem Al Shanfari at Sultan Qaboos University, Muscat, Oman, 14 May 2005).

Table 4.2: GCC Inflation Averages and Volatility

	Average 1980-2005	Median	Standard Deviation	Coefficient of Variation
Bahrain	1.33	0.79	3.12	2.35
Kuwait	3.01	2.00	2.91	0.96
Oman	0.43	0.36	1.52	3.55
Qatar	3.39	2.83	2.53	0.74
SA	0.51	0.45	2.06	4.02
UAE	3.61	3.00	1.70	0.46

Source: IMF International Financial Statistics, May 2006 and AMF data for the UAE.

Note: Data for Oman and the UAE begins 1991.

For most years during the 1990s the average GCC inflation rate was below 3 percent. In general inflation has moved in tandem across the GCC states coming down substantially in the late nineties when oil prices were low and growth levels were weak. However, there have been periods when inflation rates have peaked and often such periods coincided with depreciations in the US dollar. One such period was in 1991, the dollar fell and average inflation was significantly higher at almost 5 percent, but this was a temporary phenomenon and following this peak inflation rates eased considerably. In 2004 when the dollar declined substantially against the euro and the yen and oil prices soared inflation rates also grew rapidly in several GCC states, with money supply growing on average by 29 percent in 2003 and 21 percent in 2004 across the GCC.⁸ Oil price booms have also led to inflation peaks in some GCC states, for example inflation rates reached 8.8 percent and 6 percent in Qatar and the UAE in 2005 respectively.

Non-hydrocarbon GDP growth is strongly correlated with oil sector growth in these economies. Government spending is highly cyclical and when oil prices are high government current and capital spending increases generate increased demand in the whole economy.⁹ As a result the non-oil sectors of the economy also benefit from increased aggregate demand during times of high oil prices and are therefore, in part, determined by the growth of the oil sector.¹⁰

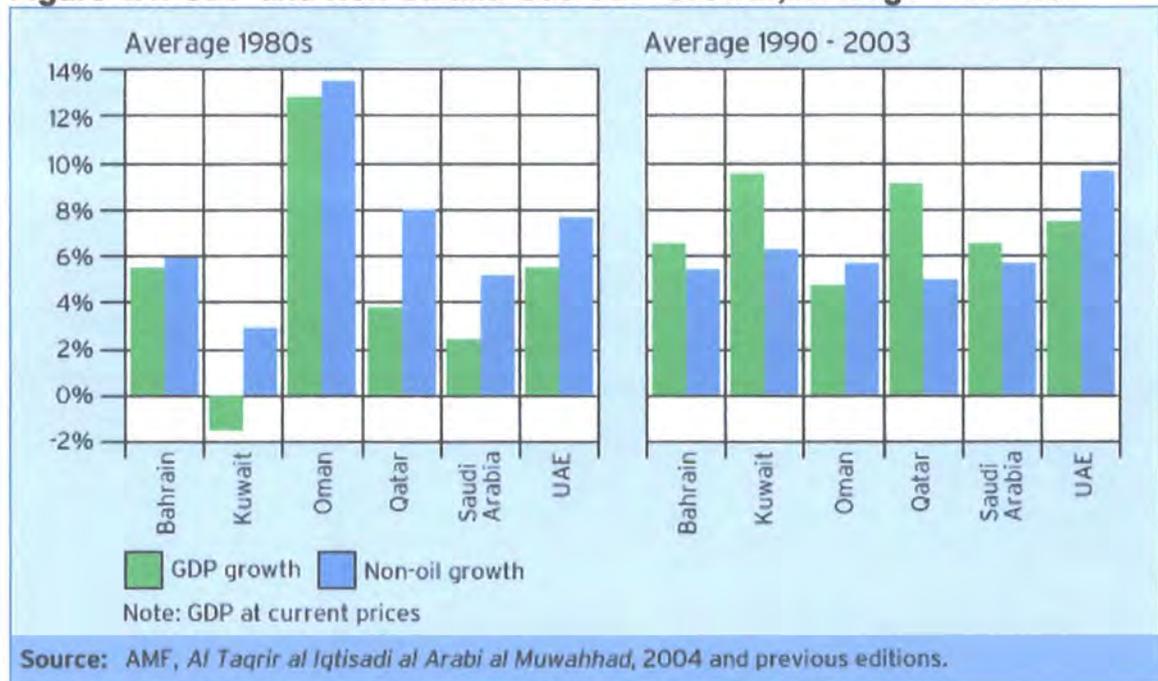
⁸ International Monetary Fund, *International Financial Statistics*, November 2005.

⁹ Fasano, U. and Wang, Q. "Testing the Relationship Between Government Spending and Revenue: Evidence from GCC Countries" *IMF Working Paper*, November 2002.

¹⁰ Al-Faris, A. F. "Public expenditure and economic growth in the Gulf Cooperation Council Countries" *Applied Economics*, 34, pp. 1187-1193, 2002.

With the exception of the UAE and Oman, in most GCC states during the 1990s, non-hydrocarbon GDP growth lagged behind growth in the wider economy which included that of the hydrocarbon sector. Between 1990 and 2003 the pace of economic growth in the non-hydrocarbon sectors of the UAE's economy outstripped that of the wider economy by 1.8 percent (see Figure 4.1). Oman's non-oil growth also surpassed that of the wider economy, by 0.6 percent. This might indicate a dynamic process of diversification occurring in the UAE, and to a lesser extent in Oman, which has not yet been met by the other GCC economies. In comparison in both Qatar and Kuwait non-hydrocarbon economic growth was only about half that of the growth in the wider economy. In the 1980s non-hydrocarbon growth in all of the GCC states outstripped that of the wider economy (see Figure 4.1) due in large part to the fact that oil revenues had fallen considerably.

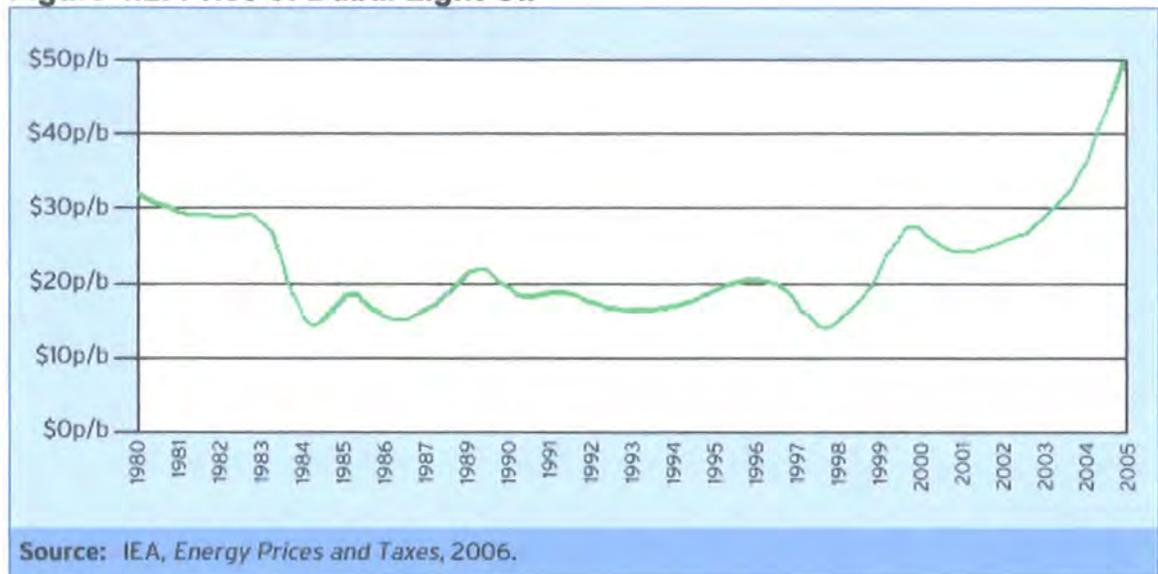
Figure 4.1: GDP and Non Oil and Gas GDP Growth, Average 1980-2003



The 1980s were characterized by falling oil prices (see Figure 4.2) and consecutive years of negative growth in the hydrocarbon sector. In contrast, during the 1990s oil prices were stagnant and growth in oil revenues were marginally positive, it is

perhaps surprising therefore that during this period the UAE's and Oman's non-hydrocarbon sectors still managed to outpace the growth of the oil sector.

Figure 4.2: Price of Dubai Light Oil



There are strong similarities between the structures of all the GCC economies, with the sector contribution to GDP ranking roughly the same (see Table 4.3). Oil and gas production, has been the largest contributing sector to GDP since 1980. Over the period of analysis government services has ranked high in most of the GCC states indicating the heavy involvement of the public sector in these economies. The available data shows that the rank position of this sector changed little over the period, ranking second and third in all the GCC states in 2003 with the exception of the UAE where it ranked fourth. The manufacturing sector has increased its contribution to GDP in all GCC states over the period with the exception of Bahrain. In 2003 this sector ranked the highest in the UAE which was the only GCC state where it ranked second.

Table 4.3: Rank of Sector Contribution to GCC GDP

ECONOMIC SECTOR	BAHRAIN			KUWAIT			OMAN			QATAR			SA			UAE		
	1980	1990	2003	1980	1990	2003	1980	1990	2003	1980	1990	2003	1980	1990	2003	1980	1990	2003
AGRICULTURE, FISHING & FORESTRY	10	11	11	8	8	9	6	8	9	8	10	9	9	6	7	10	10	9
MINING, QUARRYING & FUEL	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1
MANUFACTURING INDUSTRIES	2	4	3	5	3	3	9	7	4	6	3	4	5	4	3	6	4	2
ELECTRICITY, WATER & GAS	11	10	10	9	9	7	9	10	10	9	9	8	11	11	11	8	9	11
CONSTRUCTION	7	8	9	6	7	8	4	9	8	4	6	6	2	3	5	2	5	7
COMMERCE, REST. & HOTELS	3	3	6	3	4	5	3	3	2	5	5	5	4	5	4	3	3	3
TRANSPORT, COMM. & STORAGE	6	7	7	7	5	6	7	6	6	7	7	7	6	7	8	7	7	5
FINANCE, INSURANCE & BANKING	4	6	4	4	6	3	11	11	11	3	4	3	8	8	9	5	8	8
HOUSING	8	5	5	..	..	..	5	4	7	..	..	..	7	10	6	..	6	6
GOVERNMENT SERVICES	5	2	2	..	..	2	2	2	3	..	2	2	3	2	2	4	2	4
OTHER SERVICES	9	9	8	2	2	..	8	5	5	2	8	10	9	9	9	9	11	10

Source: Calculated from the Arab Monetary Fund, National Accounts data

The finance, insurance and banking sector is important in Bahrain, where it now ranks fourth, and in also in Kuwait and Qatar, it is less important in Oman, where it ranks eleventh, and in Saudi Arabia and the UAE. Finance is an area where many GCC states are now attempting to diversify, in fact Qatar and Dubai as well as Bahrain are all establishing new financial centres.

Table 4.4: Average GCC Population Growth Rates

	1980s	1990s	2000-2004
Bahrain	4.4	3.0	2.0
Kuwait	4.7	3.9	3.1
Oman	4.2	4.1	2.5
Qatar	8.2	2.0	2.4
SA	5.5	2.9	2.8
UAE	5.9	6.1	7.2

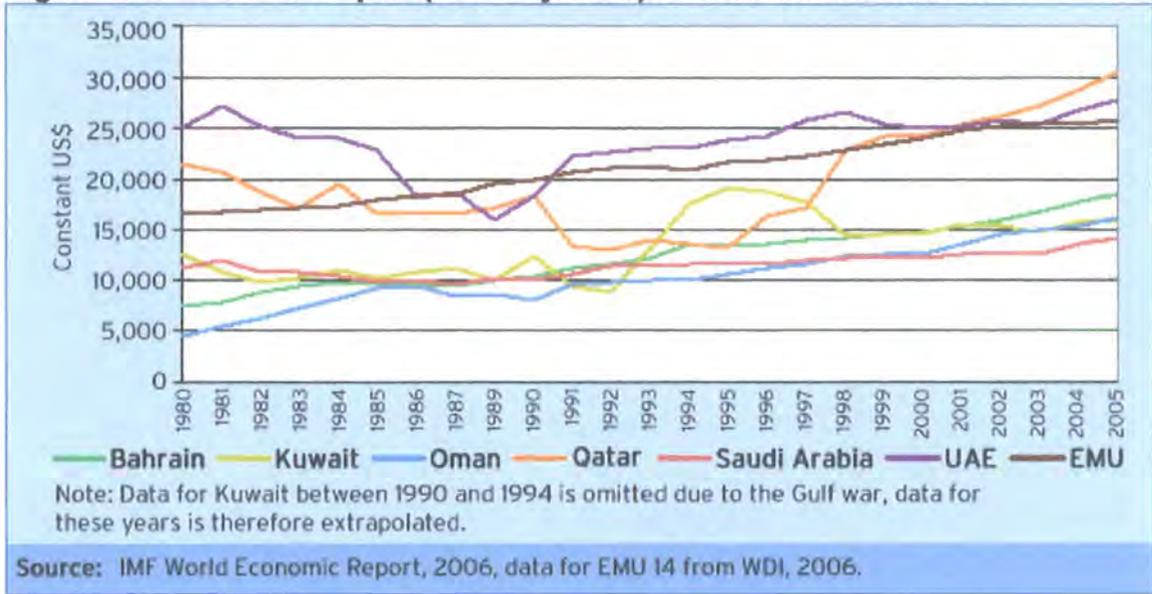
Source: World Bank, World Development Indicators 2005.

Note: Data for Kuwait omits years 1991-1995

A combination of modest and sometime stagnant economic growth rates in the period of analysis combined with relatively high rates of population growth, above an average of 4 percent during the 1980s (see Table 4.4) has meant that GDP per capita fell in several GCC states between 1980 and 1985 and then stagnated for the most part between 1990 and 2003 (see Figure 4.3). In comparison GDP per capita in the 14 EMU countries has risen gradually over the period of analysis. On average GDP per capita in the GCC in 2004 stood at \$20,570, but significant differences between the GCC states exist with GDP per capita in the UAE and Qatar higher than the average and GDP per capita in Saudi Arabia 30 percent below the average, at just \$14,280.¹¹

¹¹ The IMF WEO data for GCC GDP per capita adjusted for PPP is presented in figure 4.3. It shows that Kuwait's GDP per capita is less than that of Bahrain's and equal to Oman's. This however, is somewhat surprising and counter intuitive considering Kuwait's huge oil wealth and relatively small population. In fact, compared to figures from the World Bank's World Development Indicators (April 2006) Kuwait's GDP per capita in constant prices (2000) is \$17,674 in 2004 whereas Bahrain's is \$13,852 and Oman's is \$8,961. This raises questions over the methods used to calculate the IMF WEO statistics and perhaps the validity of the underlying assumptions of PPP theory in the case of Kuwait. However, the IMF WEO data is used here instead of that of the World Bank because the latter does not provide data for Qatar's GDP per capita in constant prices.

Figure 4.3: GDP Per Capita (PPP adjusted) in GCC States and EMU



As well as the negative implications of stagnant per capita income for the welfare of GCC citizens, unemployment has also become an issue in several GCC states. In Bahrain, Oman and Saudi Arabia indigenous population pressure has outstripped the government's ability to create public sector employment. Presently official unemployment figures are unreliable and independent estimates of unemployment are likely to be more accurate. According to the UN, in Oman and Saudi Arabia for example, unemployment rates are estimated at 17.2 percent and 15 percent respectively.¹²

4.2.2 Hydrocarbon Dependence

Despite longstanding and concerted efforts to diversify economic structures to varying degrees, all GCC states remain heavily dependent on their hydrocarbon resources. This dependency has led to a host of economic problems including a high degree of exposure to energy price trends, a capital intensive economy and import dependency. On average in 1994 close to a third of the GCC's GDP was generated from hydrocarbons, more than three quarters of exports and government revenues also come from oil and gas sales (see Table 4.5). By 2004

¹² United Nations, *Arab Human Development Report 2002*, United Nations Development Programme, New York, 2002.

the contribution of oil and gas to GDP had risen to two fifths and its share of government revenues remained broadly the same, only the share of hydrocarbon exports had fallen somewhat to 69 percent of total exports.

These ratios are however, dependent on oil prices and therefore during times of high oil prices the GCC states will appear to be more dependent on hydrocarbons. For example, in 1998 when oil prices fell to extremely low levels and Dubai Light reached a nadir of \$12.17 (see Figure 4.2), oil and gas exports as a proportion of total exports fell to 67 percent, the lowest in the period examined.

Table 4.5: GCC Dependence on Oil and Gas, 2004 Compared with 1994

	1994			2004		
	Oil as % of Total GDP	Oil Exports as % of Total Exports	Oil Revenues as % of Govt Revenues	Oil as % of Total GDP	Oil Exports as % of Total Exports	Oil Revenues as % of Govt Revenues
Bahrain	14.2	62.0	54.1	23.3	73.8	72.6
Kuwait	38.4	93.4	89.8	47.6	92.8	91.4
Oman	37.0	76.3	77.6	43.8	81.3	66.2
Qatar	32.0	81.2	n.a.	62.2	83.7	55.3
SA	33.0	89.5	74.0	45.3	46.9	84.1
UAE	32.0	48.0	76.6	32.2	35.8	77.7
GCC	31.1	75.1	74.8	42.4	69.05	74.55

Source: Calculated from GCC Central Bank data and the Arab Monetary Fund, National Accounts and Commodity Structure of Trade data.

It could be argued that the presence of 'Dutch Disease' in these economies has limited the competitiveness of non-hydrocarbon exports but this is also because of the structure and comparative advantage of their economies. The GCC states have a comparative advantage in exporting energy intensive products, such as petrochemicals and aluminium and therefore they are somewhat limited as to how much they can diversify their exports and still remain competitive.

At current production rates and using data for 'proven' reserves Kuwait's oil reserves have the highest 'life time' among the GCC states at 112 years, followed by the UAE (100 years), Saudi Arabia (68 years) and Qatar (42 years). Bahrain has the lowest reserve life expectancy at just 1.3 years, followed by Oman with 20 years (see Table 4.6).¹³ Bahrain's oil reserves are now almost exhausted, it has therefore faced much greater imperative to diversify than any other GCC state.¹⁴ Bahrain also has the lowest oil and gas reserves per capita of the GCC states, at only 176 barrels of oil per capita and only 0.13 mn cubic meters of gas per capita in 2004 (see Table 4.6). In contrast, Kuwait has the highest oil reserves per capita at 36,000 barrels per head and Qatar has the greatest gas reserves per capita at 34.8 mn cubic meters per head.

Table 4.6: Oil and Gas Indicators, 2004

	Oil Reserves per Capita (1,000 bbls)	Gas Reserves per Capita (mcm)	Expected Life of Oil Reserves	Expected Life of Gas Reserves
Bahrain	0.176	0.13	1.31	9.2
Kuwait	36.00	0.57	111.89	161.9
Oman	2.33	0.42	19.54	56.8
Qatar	20.54	34.84	42.06	657.7
SA	11.59	0.30	68.00	105.5
UAE	22.64	1.40	100.47	132.3
GCC	14.30	1.2	74.54	221.7

Source: BP Statistical Review 2005 and GCC Central Bank Reports.

¹³ These figures for 2004, taken from the BP Statistical Review of World Energy 2005, are the most reliable data for comparing the reserve-production ratios (reserve 'life-times') of the World's oil-producing nations. As an indication of relative reserve 'life-times' they are useful, but they should be treated with considerable caution with respect to their absolute values. This is because the data in question ('proven' reserves) only refer to reserves for which there is a greater than 90 percent probability of their being commercially recoverable. If the 'probable' category of reserves (50-90 percent probability of recovery) and possible (greater than zero but less the 50 percent probability) are included, the total reserves picture for each country is much larger.

¹⁴ Bahrain's situation has become more acute since Saudi Arabia ceased an oil grant of 50,000bpd in late 2004, a decision widely thought to reflect Saudi displeasure at Bahrain's US FTA agreement.

Economic dependence on oil, the price of which has tended to be volatile, is reflected in the extreme swings in GCC government revenues, witnessed over the period of study. As Saudi Arabia's Minister of Finance, Dr. Ibrahim Al-Assaf noted both "Oil prices and spending on development projects control the budget".¹⁵ During times of low oil prices deficits have grown significantly and during the late 1980s have breached 20 percent of GDP. GCC governments have faced periods of successive fiscal deficits during the period under study. During the 1990s all the GCC states on average faced budget deficits greater than 6.5 percent of GDP (see Table 4.7). As we shall see in chapter six, budget dependence on oil revenues which have been very volatile in the past may potentially have serious implications for meeting fiscal policy rules set as part of the convergence criteria for CU.

Table 4.7: GCC Fiscal Surplus/Deficits as a Percentage of GDP

		Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	UAE
1980s	Average	1.1	-4.3	-8.0	-2.3	-8.3	-4.5
	Maximum Deficit	-5.4	-21.7	-22.3	-30.5	-25.3	-14.7
1990s	Average	-2.6	-6.3	-7.3	-5.1	-5.9	-9.2
	Maximum Deficit	-6.5	-27.0	-12.1	-10.7	-10.5	-16.5
2001-2005	Average	-0.1	17.9	1.0	8.0	3.3	-3.0
	Maximum Deficit	-10	5.7	-7.8	-4.8	-6.8	-15.4

Source: Economic Integration Department, Gulf Cooperation Council and GCC Central Bank reports. Note: Due to the Gulf war in 1991 data for Kuwait for the years 1990/91 are missing and for Saudi Arabia the year 1991 is also missing.

GCC government spending has been shown to be highly pro-cyclical so that during times of low oil prices governments have not been able to offset this economic decline with fiscal policy.¹⁶ As a result economic swings are much greater and the non-oil economy, which is in part determined by public sector spending, also suffers during times of low oil prices.

¹⁵ Staff writer, "Saudi Arabia to increase infrastructure spending" *Arab News*, 20 February 2005.

¹⁶ Fasano, U. and Wang, Q. "Testing the Relationship Between Government Spending and Revenue: Evidence from GCC Countries" *IMF Working Paper*, November 2002.

As a result of successive periods of government deficits some GCC states built up considerable public debts. In particular, Saudi Arabia suffered from high levels of domestic public debt which by 1999 had reached 102 percent of GDP.¹⁷ Other GCC states, such as the UAE however, have avoided issuing long term sovereign debt and instead have relied on returns from considerable overseas assets to fund consecutive budget deficits.

The ability of the hydrocarbon sector to drive the economic development of the GCC states ultimately depends upon the spending decisions and economic policies of the GCC leaders. In past decades the GCC leaders were characterized by their conspicuous consumption. On top of that, massive funds were laid out on military purchases that not only were unproductive but also often unnecessary.¹⁸ However, as we will discuss in detail in chapter five, since oil prices began their upwards trajectory in 2002 the spending priorities of the GCC leaders have been to diversify their overseas assets into non-hydrocarbon fields and to build service sector industries domestically in order to diversify domestic national income.

4.2.3 Private Sector Growth

There are a number of perceived advantages from increasing the role of the private sector. Not only should it reduce the fiscal burden on the state but it should also be 'job creating' and probably attract greater levels of FDI. As part of a wider process of increasing private sector growth, the GCC states have committed themselves to a program of privatization of state owned entities (see section 4.3.3). However, there are in-built limitations on the extent to which this can be carried out. Firstly, since the vast majority of state-owned assets fall within the hydrocarbon sector which is a strategic asset of vast importance to governments, there is naturally a

¹⁷ Since then Saudi Arabia has used some of its oil windfalls from the oil price rise of 2003-2005 to pay back some of its debt which as of the end of 2005 was estimated to stand at 47 percent of its GDP.

¹⁸ According to Looney, R.E. "Saudi Arabia: Measures of Transition from a Rentier State", in *Iran, Iraq and the Arab Gulf States* (ed. Kechichian, J.) pp.131-160, Palgrave, 2001., defense was the fastest growing sector of Saudi Arabia's major government expenditure categories between 1989 and 1999.

reluctance to reduce state control over this sector. Secondly, state ownership of the oil and gas sector enables the governments to utilize it as a means of providing a range of subsidies and welfare benefits to the population – a major political economy consideration which could be prejudiced if the state lost control of the sector.

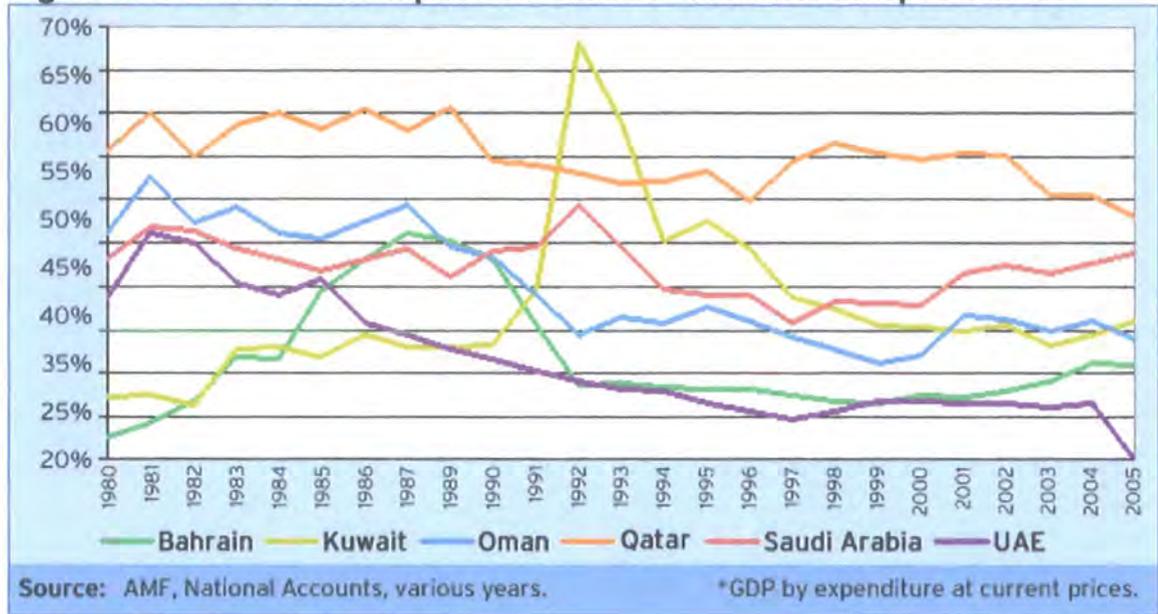
Consequently, various policies aimed at reducing the role of the government vis-à-vis the private sector, in most GCC states this has only taken place to a limited degree. In Saudi Arabia and the UAE the process has proceeded at a sluggish pace whilst in states like Bahrain, Oman and Qatar the selling off of state assets and establishment of joint public private ventures has been somewhat energetic.

During the 1990s budgetary requirements were encouraging some GCC states to privatize state assets, but following the recent years of high oil prices there is little financial imperative for GCC governments to raise revenues through selling off their corporations. In 2005, an estimated \$270bn¹⁹ worth of oil revenues accrued to the GCC states, therefore largely removing one possible objective of privatization (i.e. the need to raise cash). In addition, many GCC state owned corporations are now being streamlined and are performing reasonably well without ownership being transferred to the private sector. In recent years some partial privatizations have taken place however these are more likely to have been motivated by a desire to allow GCC citizens to share in the enormous wealth earned by many state owned companies since the oil price boom began.

Using the expenditure measure of GDP, GCC government consumption has fluctuated considerably with a small downward trend since 1980 (see Figure 4.4). In 1980 public consumption averaged 39 percent overall, ranging between 23 percent in Bahrain and 56 percent in Qatar. In 2003 the average was only slightly lower at 37 percent, ranging from 27 percent in the UAE to 51 percent in Qatar.

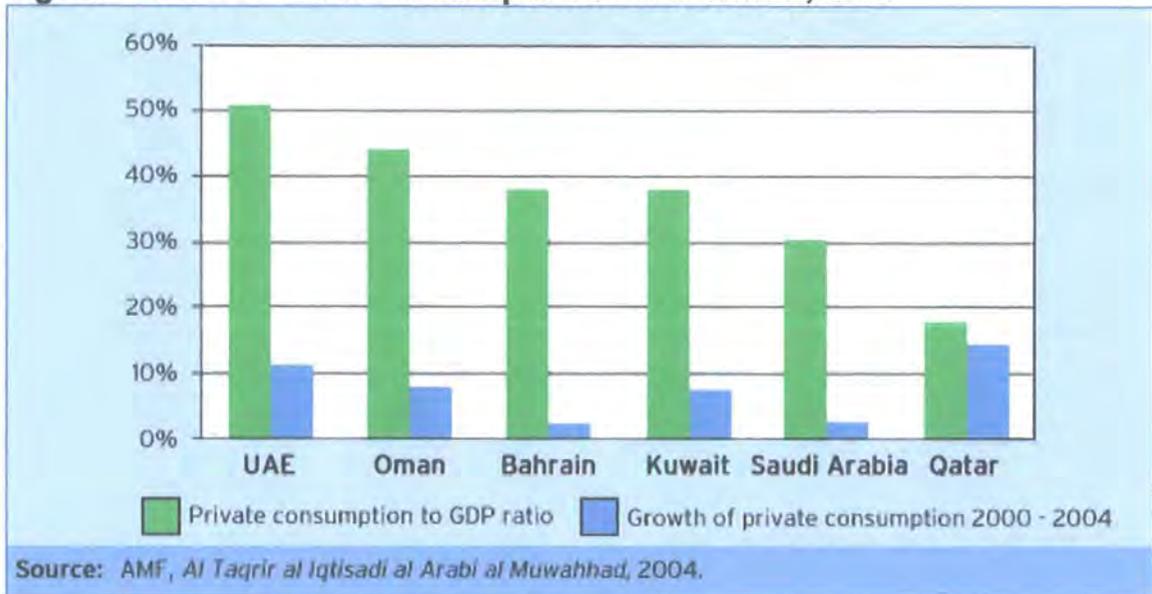
¹⁹ Rutledge, E. "GCC Economic Performance in 2005" in *Gulf Yearbook 2005-2006*, pp. 109 -129, Gulf Research Center, Dubai, 2006.

Figure 4.4: Public Consumption as Share of Total Consumption in GDP*



Private sector growth can also be stimulated by improving the business climate and reducing bureaucratic hurdles and red tape for businesses. In addition, private household consumption can be promoted through providing a greater choice of goods and services. It appears that certain GCC states have been more successful at stimulating private sector consumption than others. In 2004, the private consumption to GDP ratio varied considerably across the GCC states, for example, in Qatar the ratio was lowest at just 18 percent of GDP, however the growth rate of private consumption in Qatar between 2000 and 2004 was the highest in the GCC at 14 percent (see Figure 4.5). The private consumption to GDP ratio was at its highest in the UAE at 51 percent of GDP in 2004. The UAE is therefore the only GCC state where private consumption currently forms the majority of expenditure on GDP. The growth of the private sector in certain states, such as Qatar, has been inhibited by the lack of business opportunities and the dominance of public sector monopolies in certain economic sectors.

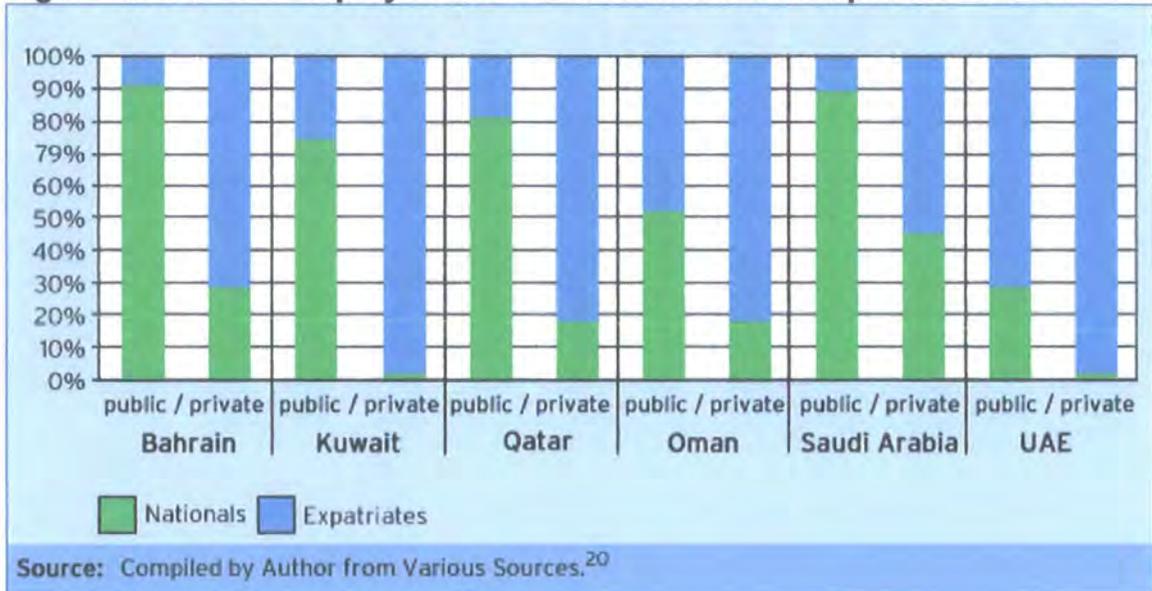
Figure 4.5: GCC Private Consumption to GDP Ratios, 2004



An important impetus behind the policy of increasing the role of the private sector and privatization in the GCC states has been to reduce dependence on the state as the main provider of employment for nationals. In light of the reality that it is unproductive and fiscally unsustainable for the GCC government's to continue creating more jobs in the public sector for nationals, they are looking to the private sector to provide employment for nationals.

States such as Bahrain, Oman and Saudi Arabia have been more successful at increasing private sector employment of nationals than others. Only in Saudi Arabia and Bahrain do nationals make up a significant share of the private sector workforce at 45 percent and 28 percent respectively (see Figure 4.6). In these economies the reality has been that the government itself has not been able to create new jobs for nationals because of severe population and budgetary pressures so that nationals have had to compete with expatriates for jobs in the private sector. Nationals have also been helped to some degree by the policy of nationalizing the workforce in certain private sector areas. In contrast, in the UAE and Kuwait nationals represent only a very small share of the private sector workforce, at just 1 percent and 2 percent respectively. These GCC states still have the luxury of relatively small populations and very large oil and gas reserves.

Figure 4.6: Sector Employment of GCC National and Expatriate Labour



4.2.4 Balance of Payments Performance

Overall, the average trade surpluses of the GCC states as a percentage of their GDP between 1980 and 2002 ranged from a minimum of 9.9 percent in the case of Bahrain to a maximum of 30.2 percent in Qatar (see Table 4.8). The balance of trade in all GCC states is heavily influenced by hydrocarbons and many have witnessed several negative trade balances over the last two decades. For instance, Bahrain stands out in this respect from the other GCC states and has experienced numerous negative trade balances. Between 1980 and 2004, Bahrain experienced eleven years of trade deficits, and a successive period of trade deficits from 1983 to 1989 as well as from 1991 to 1994.

²⁰ Data for Bahrain and Kuwait is for 2003, source EIU Country Profiles, Data for UAE is 1995 census data, Ministry of Labour, Data source for Oman is Central Bank of Oman Annual Report 2004, Data source for Qatar is Qatar Central Bank Annual Report 2004, for the year 2003 and Qatar's private sector includes Mixed Sector employees, Data for SA is SAMA Annual Report and Ministry of Labour, for the year 2002.

Table 4.8: Trade Balance as a Percentage of GDP

	Average 1980-2004	Standard deviation	Coefficient of Variation
Bahrain	9.9	0.32	3.21
Kuwait	16.9	0.14	0.85
Oman	17.8	0.07	0.41
SA	14.7	0.11	0.75
UAE	17.5	0.13	0.72
Qatar	30.2	0.14	0.48

Source: International Monetary Fund, Direction of Trade Statistics and World Bank World Development Indicators (April 2006).

The GCC states are generally considered to be open trading economies. Trade, as a percentage of GDP, ranges from 64 percent of GDP in Saudi Arabia to 146 percent of GDP for Bahrain.²¹ The direction for trade in the GCC states over this period has moved away from the US and Europe towards Asia. The volume of GCC imports from Asia increased by a compound annual growth rate (CAGR) of 9.5 percent between 1980 and 2004, whilst the volume of imports from the US grew by only 1.7 percent (see Table 4.9). Currently most GCC imports originate in Europe and Asia, accounting for 33 percent and 30 percent of total imports respectively. Intra-GCC imports constituted only 6.6 percent of total GCC imports in 2004, yet their volume has grown by a CAGR of 5.1 percent over the period of analysis (in chapter five, intra-GCC trade is analysed in detail, see section 5.2).

In terms of GCC exports, 36 percent were destined to Asia in 2004, but only 11 percent to the EU and to the US. The share of GCC exports to the US has declined slightly since 1980, while the volume of exports has only grown by a CAGR of 1.5 percent. The share of GCC exports to the European Union countries has fallen considerably over the same period and the volume of exports has fallen by a CAGR of 3 percent since 1980. In comparison the share and volume of GCC exports to Asia have increased substantially over the last 25 years (see Table 4.9).

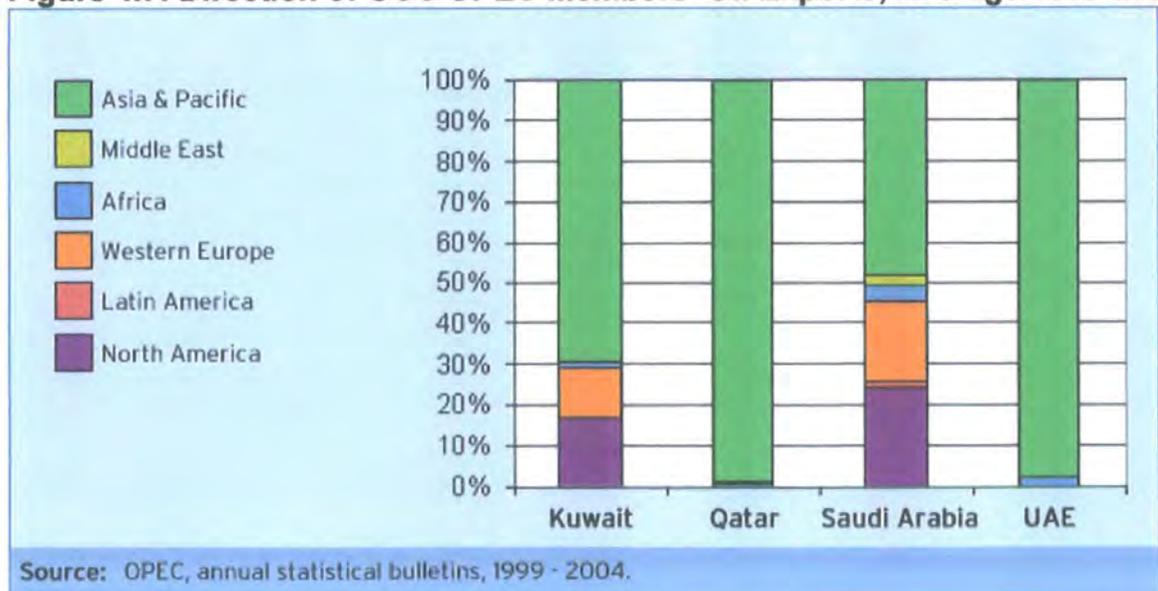
²¹ Calculated from World Bank, *World Development Indicators*, November 2004.

Table 4.9: Changing Direction of GCC Trade

Share of GCC Imports by Origin					
	1980	1990	2000	2004	Volume growth since 1980
Asia	11.2%	15.0%	21.2%	30.0%	9.5%
EU	37.2%	34.0%	32.1%	32.7%	4.5%
US	16.7%	13.0%	13.1%	7.7%	1.7%
GCC	6.6%	8.4%	8.7%	6.6%	5.1%
RoW	28.3%	29.7%	25.0%	23.0%	5.1%
Share of GCC Exports by Destination					
	1980	1990	2000	2004	Volume growth since 1980
Asia	14.8%	19.6%	33.9%	35.6%	5.7%
EU	36.7%	14.8%	11.4%	11.4%	-2.9%
US	11.7%	14.4%	10.7%	10.6%	1.5%
GCC	3.0%	8.0%	4.9%	4.6%	3.7%
RoW	33.8%	43.2%	39.2%	37.8%	1.9%

Source: International Monetary Fund, Direction of Trade Statistics (July 2005)

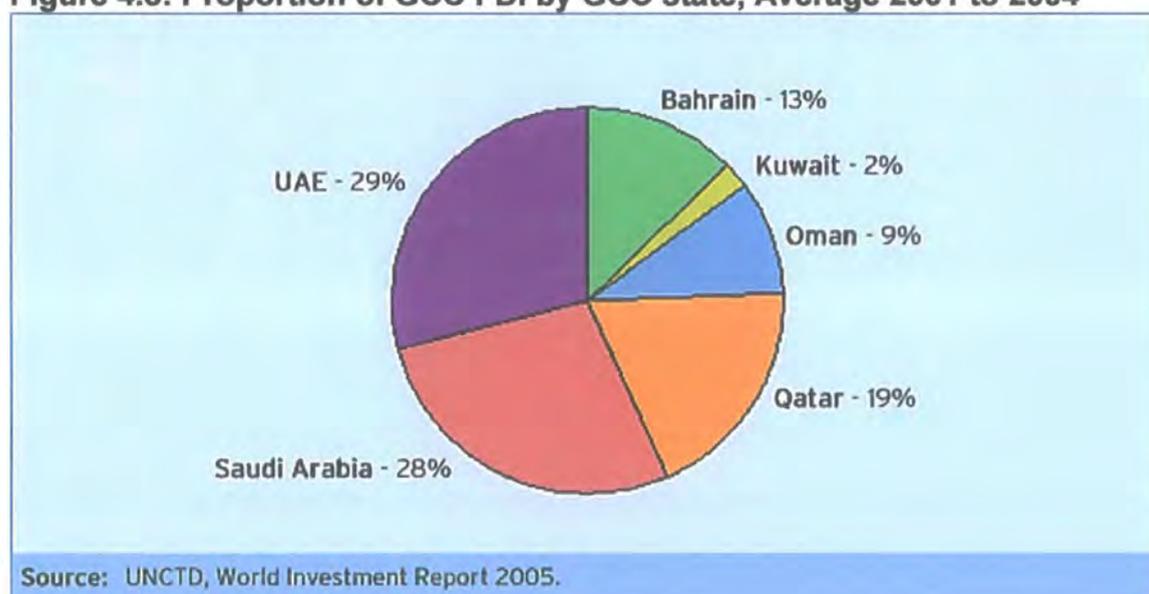
GCC exports, which as we have seen are dominated by oil exports are also predominantly destined for Asia. For the four GCC states who are members of OPEC, oil exports to Asia and the Pacific accounted for between 48 and 99 percent of total oil exports on average between 1999 and 2003 (see Figure 4.7).

Figure 4.7: Direction of GCC OPEC Members' Oil Exports, Average 1999-2004

The trade and current account surpluses of the GCC states are reflected in the capital account deficits that they have experienced as a result of their inability thus far to attract significant flows of foreign capital as portfolio or foreign direct investments. On average between 2001 and 2004 the GCC states received just 0.4 percent of global FDI.²²

Some GCC states have however, been more successful than others in terms of attracting FDI. It is not surprising to find that the two largest GCC economies attracted the greatest shares of FDI between 2001 and 2004 but perhaps unexpectedly the smallest GCC states Qatar and Bahrain also attracted significant shares of FDI, accounting for 19 percent and 13 percent of total FDI inflows between 2001 and 2004 respectively (see Figure 4.8).

Figure 4.8: Proportion of GCC FDI by GCC state, Average 2001 to 2004



Bahrain has been successful in terms of diversifying its economy particularly into service sector activities such as banking and finance while Qatar has recently attracted considerable FDI into developing its downstream natural gas sector. When FDI is measured as a percentage of GDP then Bahrain, Qatar and the UAE have attracted the most significant levels of FDI, amounting to 7.9, 2.4 and 0.8

²² According to the United Nations Conference on Trade and Development, *World Investment Report 2005*.

percent respectively. The UAE has also seen some success in its diversification into the service sector and, along with Bahrain, is generally considered to be among the most liberal of the GCC states, therefore they have been able to attract foreign companies and workers more easily.

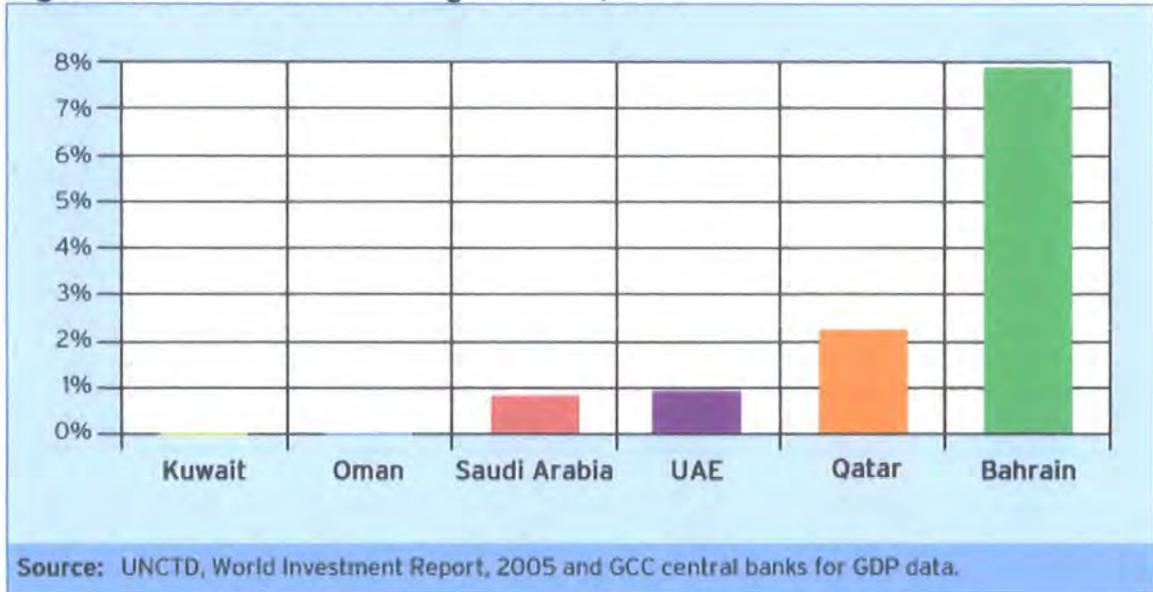
Despite being the largest economy of the group by far, in Saudi Arabia FDI as a percentage of its GDP amounted to just 0.7 percent. Furthermore, over the 2001 to 2004 period Saudi Arabia attracted less FDI as a proportion of the region's total than the UAE did at 28 percent and 29 percent of the total FDI inflows respectively. It is hoped by the Kingdom's policy makers that Saudi Arabia's 2005 accession to the WTO may in time improve this (see section 4.3.4).

Post 2004 however, Saudi Arabia has made substantial deals with foreign companies to invest in its downstream hydrocarbon sector. In a bid to increase the value-added of its oil exports Saudi Arabia has attracted FDI in large sums to its petrochemical and refining industries. In late 2004 the Kingdom signed a deal with Japan's Sumitomo Chemical to build, what is billed to be the world's largest, integrated refinery and petrochemicals complex; PetroRabigh.²³ Additionally, in May 2006 two major deals with international oil companies were signed, both for constructing multi-billion dollar refineries. One will be built on the Kingdom's east coast and one on its west coast. Total, France's major oil company, signed a deal with Aramco, estimated to be worth \$6bn, to develop one of these refineries.²⁴

²³ Rutledge, E. "Value-added across the board" Gulf in the Media Business Bulletin May 27- June 02 2006, Gulf Research Center, Dubai, 2 June 2006.

²⁴ *Ibid.*

Figure 4.9: FDI as a Percentage of GDP, 2004



4.2.5 Exchange Rate Performance

All the GCC have had *de facto* pegs against the US dollar in the period under study and the pegs have been very stable which has been beneficial for intra-GCC exchange rate stability (see Figure 4.10). Another advantage, as we have seen in section 4.2.1 is that this arrangement has provided the GCC with a low inflation environment.²⁵ The standard deviations of their exchange rates against the dollar over this period were negligible. The sustainability of the pegs against the dollar, or otherwise, have been supported by the large levels of international reserves which the GCC states hold.

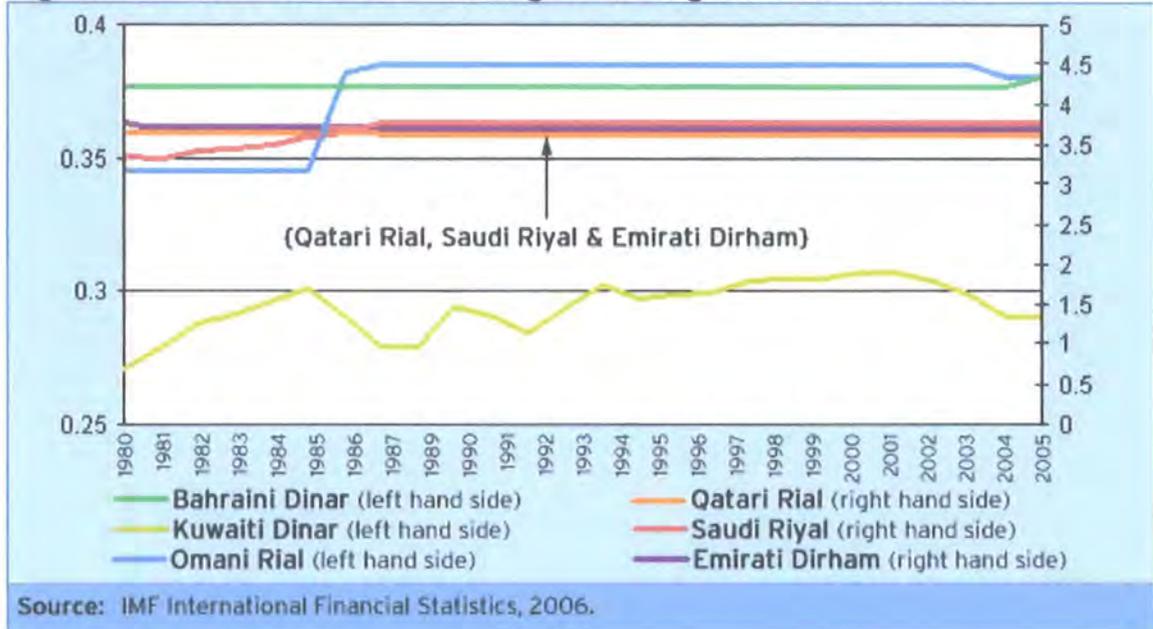
Despite this, during times of very low oil prices such as that in 1986 and 1998 there has been pressure on these pegs.²⁶ In 1986 Oman adjusted its currency the rial against the US dollar. As a result of falling oil prices it devalued its currency by 10

²⁵ Ghosh, A. R., Gulde, A. M., Ostry, J. D. and Wolf, H. C., "Does the Nominal Exchange Rate Regime Matter?" *NBER Working Paper Series*, 5874, MA, January 1997, this paper finds that pegged exchange rate regimes experience lower inflation.

²⁶ According to Karam, Philippe D., "Exchange Rate Policies in Arab Countries: Assessment and Recommendations", Economic Policy Institute, Arab Monetary Fund, Abu Dhabi, December, 2001, during the 1997-1998 Asian crisis risk premiums on the Saudi Riyal's exchange rate one year forward hit 1000 basis points intra-day at one point.

percent against the dollar.²⁷ According to Stern Saudi Arabia was also forced to make an adjustment to its currency peg in 1986 and in 1997 a small adjustment to the UAE dirham took place.²⁸

Figure 4.10: GCC Nominal Exchange Rates against the US Dollar



The GCC currencies are all freely convertible but speculative activity against the local currencies is often deterred by the GCC's huge international reserves. Research by the AMF considers the foreign reserve adequacy ratios²⁹ of the GCC states to be very healthy compared with other Arab countries.³⁰ GCC Central Banks also reportedly keep some control over the sale of local currencies against the dollar by stipulating the requirement of import/export papers.³¹

Real exchange rates over time have seen some divergence as inflation rates have varied among the members. As we have seen previously official inflation rates

²⁷ Central Bank of Oman, *25 Years of Central Bank of Oman – April 1975 to April 2000*, Muscat 2000

²⁸ Sturm, M. and Siegfried, N. "Regional Monetary Integration in the Member States of the Gulf Cooperation Council", *European Central Bank, Occasional Paper Series*, No. 31, June 2005.

²⁹ There are a number of indicators used for determining the adequate level of reserves for an economy, the paper uses several ratios including reserves to imports, reserves to short term debt and reserves to broad money.

³⁰ Bolbol, Ali, A. and Fatheldin, Ayten, M. "Analysis of Foreign Reserves in the Arab Countries, 1980-2002", *Arab Monetary Fund Economic Papers*, Number 10, Abu Dhabi, January 2005.

³¹ Interview with Manish Agrawal, Senior Dealer, Rates Markets, ABN AMRO, Dubai, 5 May 2005.

have been low and highly cyclical but on average there appear to be persistent price differentials among the GCC economies (see Table 4.2). As a result real exchange rates have correspondingly diverged. Econometric analysis by Hassanain³² has shown that there are persistent deviations from Purchasing Power Parity across the GCC economies.

Real (and Nominal) Effective Exchange Rates³³ (REER/NEER) for the GCC states, which have closely tracked those of the US, have been volatile (see Figure 4.11). The REER indicates the level of competitiveness of the given country's exports. Oil and gas form a large proportion of GCC exports, on average 70 percent in 2004 (see Table 4.5). The REER of the GCC will therefore have very little effect upon the competitiveness of the vast majority of GCC exports because oil prices are denominated in the US dollar and the price is determined in world oil markets. However, the volatility of the US REER (shown in Figure 4.11) may have hampered the growth of non-oil exports as econometric evidence has pointed to this in developing countries, it could also have been a causal factor in the low flows of FDI into the GCC states.³⁴

During the 1980s the GCC states experienced a depreciation of the REER and a gradual appreciation over the 1990s. The appreciation of the dollar in the late nineties coincided with a decline in the oil price which had adverse economic repercussions for the GCC states.³⁵ Between 2001 and 2003 there was a real depreciation of the GCC currencies this can be explained by the devaluation of the dollar against most international currencies including the euro and the yen and the increasing level of trade with the Eurozone and Asian countries.³⁶ However, since

³² Hassanain, Khalifah "Purchasing power parity: further evidence and implications" *Review of Middle East Economics and Finance*, Vol. 2, No. 1, 63-77, April 2004

³³ The NEER is a weighted average of major bilateral nominal exchange rates, with weights based on the trade shares reflecting the relative importance of each currency in the effective exchange rate basket. The REER is obtained by adjusting the NEER for inflation differentials with the countries whose currencies are included in the basket.

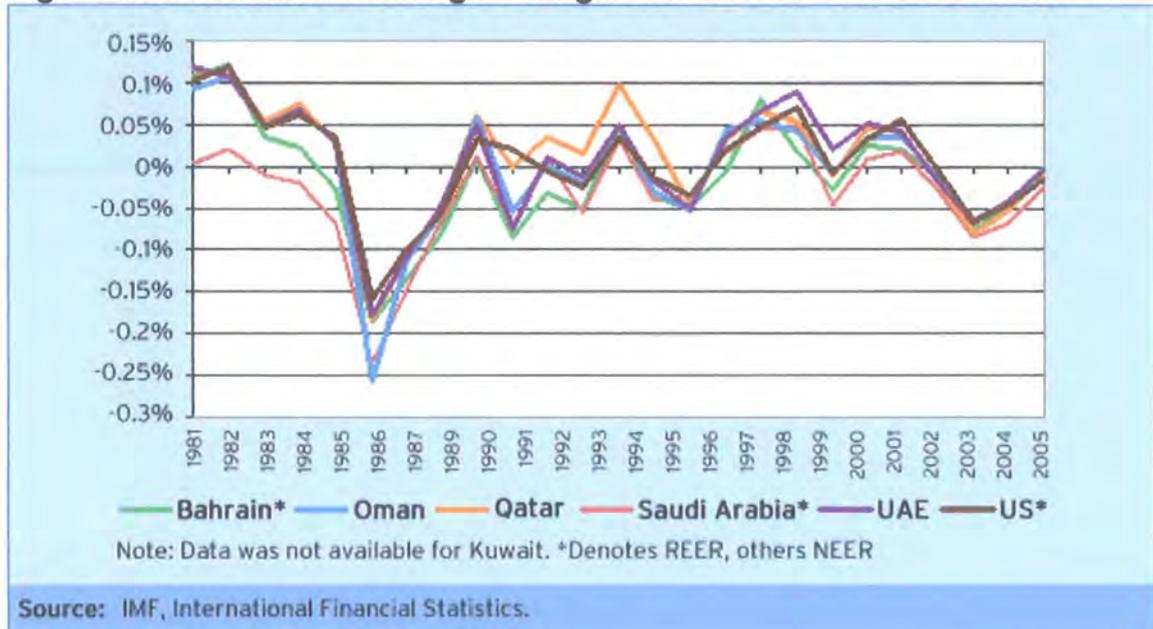
³⁴ Esquivel, Gerardo and Felipe Larrain B, "The Impact of G-3 Exchange Rate Volatility on Developing Countries" El Colegio de México, Pontificia Universidad Católica de Chile and Harvard University Revised, August 2001.

³⁵ The Economist "Oil producers' surpluses - Recycling the petrodollars", 10 November 2005.

³⁶ The calculation of the REER is weighted by the given country's bilateral volume of trade with other countries.

2003, high oil prices and increased liquidity combined with fixed nominal exchange rates in the GCC have led to a relative increase in domestic price levels compared with foreign ones and therefore a real appreciation in GCC exchange rates (see Figure 4.11).

Figure 4.11: Annual Percentage Changes in GCC and US REER/NEER



Domestic monetary policy tools, such as banking reserve ratios, Certificates of Deposit issuance and a few Open Market Operations, have to a limited degree helped to control the money supply and therefore inflation rates, during oil price booms.³⁷ But during times of dollar depreciation, such as in 1994, 2004 and 2006 the GCC central banks have been unable to protect themselves against inflation arising from the increased cost of non-dollar denominated imports. Research by Mohammed and Sakka³⁸ has shown that the GCC states have high import propensities and low price elasticities of demand for imports. Consequently a rise in import prices following a devaluation in their exchange rates has a significant impact on the general domestic price level in these countries. Using econometric

³⁷ For example, in 2005 the UAE Central Bank began issuing 5 year CDs in an attempt to soak up surplus liquidity from the economy, previously only 18 month CDs had been issues, see "Central Bank plans debt issue to control inflation", *Reuters*, 13 August 2005.

³⁸ Mohammad, Y.H.J and El-Sakka, M.I.T., "Demand for Imports in the GCC Countries" *Journal of the Gulf and Arabian Peninsula Studies*, 27 (100), 2001.

analysis Ghars El-Din *et al.* showed that a ten percent devaluation causes a 2.1–7.4 percent rise in domestic prices.³⁹ The combination of low price elasticities of demand for imports and the absence of a well established import substitution sector implies that domestic prices in the GCC states are more sensitive to a change in import prices resulting from a devaluation of their currencies than they are to domestic economic conditions.⁴⁰ Therefore, exchange rate fixing has important implications for other economic policies and the ability of the domestic authorities to control their inflation environment. Furthermore, during oil price booms the fixed pegs have prevented a nominal appreciation of the GCC currencies which has then exacerbated inflationary pressures in these economies.

Apart from causing inflation spikes during periods of dollar depreciations another major concern regarding the choice of the dollar exchange rate peg for the GCC single currency relates to the fact that whilst the dollar peg stabilizes the currency risk on their export income, on the other side of their trade balance - the cost of their imports remain highly volatile. GCC trade is increasingly being dominated by Asia and Europe and trade with the US is becoming less important. US imports constitute a significantly smaller proportion of the total than the other major trading blocs such as Asia and Europe, as was discussed in section 4.2.3 (see Table 4.9).

In Kuwait, the switch from the trade weighted basket peg in 2003 to the dollar peg in order to synchronize GCC exchange rates prior to MU was lamented by several Kuwaiti economists and Central Bank officials. They considered the basket peg to have given them more stability in terms of their import costs and greater flexibility which allowed them to minimize import related inflationary pressures during times of dollar depreciations. For example, in mid-2005 one regional expert, interviewed for this research, in Kuwait said "(The peg to the dollar) is a disaster, we tried to convince the (other GCC states) to peg to a basket. It doesn't suit these economies and back then the euro wasn't really an option, but now we are really feeling the

³⁹ Ghars El-Din, Mohamed Abdul Hafez and Mohammad, Yousuf Hasan Jawad "Exchange Rate and Domestic Prices in the GCC Countries", *Economic Research Forum*, Working Paper 0105, January 2005.

⁴⁰ *Ibid.*

pain of the dollar peg.” One Kuwaiti regional expert said “I still believe that a basket is more appropriate and related to the commercial balance.”

At times, when the US dollar has been weak there have been calls from concerned parties, particularly within the GCC business communities, to de-peg from the dollar. For example, the dollar’s weakness in 1994, 2004 and 2006 led to calls to link the currencies to a trade-weighted basket. For example, Standard and Chartered bank in the UAE in 2005 commented that the most appropriate exchange rate policy was to remove the dirham – dollar peg and to switch to a trade weighted exchange rate band, which in their opinion “would help improve the region’s resilience to external shocks, including oil prices swings (and) control inflationary pressures.....these are a compelling set of reasons to abandon the status quo as soon as practicable.”⁴¹

4.3 GCC Economic Policies and Objectives

Identifying GCC economic policies and objectives is complicated by the fact that decision making tends to be highly personalized in the Gulf States. Nevertheless, Saudi Arabia has been publishing detailed five year development plans since 1970 and Oman began doing so from 1976 onwards. Kuwait launched a five year economic planning system in 1995 and Bahrain set up an Economic Development Board (EDB) in 2001.

The formulation of economic policies has tended to be retrospective, as economic problems have emerged particularly during times of low oil prices, policies such as fiscal rationalization through diversification and privatization only then take priority. Conversely when oil prices are high the imperative to implement economic reforms is reduced. Similarities and contrasts between the GCC state’s economic policies are discussed in this section and particular attention is given to their choice of monetary policy.

⁴¹ Brice, Steve “The Case for Currency Flexibility” *Emerging Markets: Dubai*, Oxford Business Group, 2005.

As Saudi Arabia and Oman have been publishing economic development plans throughout the period of analysis it is worth briefly looking at these. In Saudi Arabia's Third Plan (1980-1985), spending on education, health, and social services increased. During these years oil production declined and the envisaged real GDP growth rate of 1.3 percent per annum was not achieved.⁴² Oman's second Five-Year Plan (1981-1985) focused on completing basic infrastructural projects that were already underway.

Oman's third Five-Year Plan (1986-1990) was intended to augment the achievements of the previous plan, but the steep decline in oil prices forced the government to tighten its fiscal budget at the expense of some investment and development projects. In Saudi Arabia's Fourth Plan (1985-1990), the focus was again on education and training but also emphasized stimulating private sector investment and increasing economic integration with members of the GCC. Over this period oil revenues declined markedly which once again meant the envisaged GDP growth rate was not met.

Oman's Fourth Five-Year Plan (1991-1995) concentrated primarily on broadening and diversifying the production base of the economy, increasing private sector involvement and developing human resources. Saudi Arabia's plan for the same period emphasized improved and more efficient government social services; and creating greater private-sector employment opportunities for Saudis by reducing the number of foreign workers.⁴³

Saudi Arabia's Sixth Plan (1995-2000) focused on lowering fiscal commitments (without actually cutting government services) and expanding educational training programs. The plan called for reducing its dependence on the petroleum sector by diversifying economic activity. Saudization policies also featured prominently. Its

⁴²Kingdom of Saudi Arabia, Ministry of Economy and Planning, online: available <http://www.planning.gov.sa/indexe.htm>

⁴³ *Ibid.*

Seventh Plan (2000-2005) again focused on economic diversification and measures to give the private sector a more prominent role.⁴⁴

In June 1995, Oman launched "Oman 2020", which intended to diversify its economy completely away from dependence on oil (at the time Oman's oil reserves were forecast to be commercially exhausted by 2020). The Fifth Plan (1996-2000) called for wider private sector participation and the use of sophisticated macro-economic modeling techniques in the planning process.

The key priority of the Sixth Plan (2001-2005) was to raise the rate of enrolment in higher education institutions and upgrade basic education. The plan also aimed at improving the provision of suitable employment opportunities for Omani's through economically feasible, labour intensive production projects. The privatization programme was also prioritized in order to reduce the national economy's dependence on public spending.⁴⁵

Between 2002 and 2005 the price of oil increased by approximately 207 percent⁴⁶ and preliminary analysis indicates that most GCC states are using these windfalls more prudently and proactively than in the past.⁴⁷ A broad range of economic diversification measures are taking place in tandem with an increased emphasis on nationalizing labor markets, and diversifying overseas assets; which can to an extent be seen as oil stabilization funds.

4.3.1 Economic Diversification and Stabilisation Funds

A broad, and long standing goal that is essentially common to all GCC economic policies has been to diversify the GCC economic bases away from dependence on hydrocarbons. The volatile nature of commodity prices and overdependence on

⁴⁴ *Ibid.*

⁴⁵ Sultanate of Oman, Ministry of National Economy online: available <http://www.moneoman.gov.om/english.htm>

⁴⁶ For Dubai Light blend between 2002 and 2005, according to the International Energy Agency, *Energy Prices and Taxes*, 2006.

⁴⁷ Khalaf, Roula "Gulf states have learnt investment lessons" *Financial Times*, 9 December 2005.

them has been reflected in the instability of the region's macroeconomic fundamentals. In addition to the complications such over reliance creates when drafting forward looking spending plans, the hydrocarbon sector is also highly capital intensive. It is therefore unable to provide many employment opportunities for nationals. This in turn has resulted in large public sectors and welfare associated spending commitments.

Economic diversification has been pursued most diligently in Bahrain, Oman and the Emirate of Dubai, all of which happen to have low oil reserves.⁴⁸ Qatar was also faced with dwindling oil reserves but its economic diversification has been a vertical one, from oil and natural gas extraction to downstream activities, primarily liquefied natural gas and petrochemicals. In the oil abundant emirate of Abu Dhabi, there has been little immediate urgency to diversify its economic base. Instead, its priority has been to encourage private sector activities and investment in the economy in order to minimize the downturn when oil prices are low and government investment and expenditure is cut back. While Saudi Arabia has ample oil reserves its main problem is its large national population and dwindling per capita incomes. Saudi's diversification is essential primarily to create sufficient jobs for its young population.

In order to insulate themselves from external oil price shocks and the volatile impact on their budgets and spending plans as well as to ensure intergenerational equity, a few GCC governments have established oil stabilization funds. Kuwait and Oman have both introduced such funds which have, to a degree, helped in stabilizing and diversifying government revenues and thus securing spending plans. The Kuwaiti government established a Reserve Fund for Future Generations (RFFG) in 1976, into which 10 percent of government revenues are deposited annually. The RFFG accumulated sizable assets reaching an estimated \$100 bn before the 1991 Gulf war, during which the government had to borrow back around \$40 bn to finance the coalition partners who fought against Iraq. The funds were also used to cover the gap in government income lost from oil production during

⁴⁸ For a historical examination of Bahrain's diversification process see Rutledge, E. *The Experience of Economic Diversification in Bahrain, 1987-1997*, The Bahrain-British Foundation, London, 1999.

the crisis and for reconstruction after the war ended.⁴⁹ Kuwait's fund has been successful in diversifying government income. The investment income from the fund's assets held mainly in overseas capital markets has become the second largest source of government revenues after oil, contributing roughly a third of total revenues.⁵⁰

In Oman, where the implementation of several economic plans had suffered as a result of low oil prices, the State General Reserve Fund (SGRF) was established in 1980 to act as a reserve for future generations, and also to act as a stabilization fund for government spending when necessary.⁵¹ Initially, government allocations to the fund were substantial but as with most spending targets, these have ebbed and flowed with world oil prices. In 1991, following successive budget deficits and net outflows from the SGRF, a second fund called the Contingency Fund, was set up specifically to act as a stabilization fund for the budget. A number of different allocation mechanisms have been used for the funds usually determined by price of oil.⁵² Reserves have thus been hard to build following years of consecutive budget deficits as a consequence of low oil prices throughout the 1980s and 1990s limiting the efficacy of the fund in achieving its stabilizing objectives.

Investment funds, such as the Abu Dhabi Investment Authority and the Kuwait Investment Authority, also act to a degree as oil stabilization funds. They invest windfall oil revenues during times of high oil prices in overseas assets which can be relied upon for income streams during times of low oil prices. During the 2002-2005 oil price boom GCC states were increasingly investing their oil funds into diversified projects overseas and in mergers and acquisitions. For example, the UAE, which is the GCC's top overseas investor, having made double the value of acquisitions compared to the second largest investor, Saudi Arabia⁵³, acquired a \$1bn stake in DaimlerChrysler, the German-US car manufacturer as well as

⁴⁹ Fasano, Ugo "Review of the experience with oil stabilization and savings funds in selected countries", *International Monetary Fund Working Paper*, June 2000.

⁵⁰ *Ibid.*

⁵¹ The Economist Intelligence Unit, Oman Country Profile 1997/1998, London.

⁵² *Ibid.*

⁵³ Staff Writer "Private Investigations" *The Banker*, 2 May 2006. Accessed at 5 May 2006.

purchasing a 5 percent stake in Ferrari, for \$137mn, and successfully bid \$6.8bn to take over P&O, Britain's largest ports and ferries group in February 2006.⁵⁴ Such investments are an important part of their diversification plan.

4.3.2 Labour Force Nationalisation Measures

A paradoxical situation has emerged in the GCC states where large numbers of expatriates are employed despite the presence of an increasing number of unemployed nationals. This is in part a result of the highly segmented labour markets where the public sector more or less guaranteed employment for nationals while the private sector predominantly employed expatriates.⁵⁵ This segmentation is attributable to several factors including shorter working hours, longer holidays, job security and a host of other benefits in public sector employment. Indeed not only do GCC nationals prefer to work in the public sector they also expect to receive a government job.⁵⁶ With high population growth rates since the 1980s (see Table 4.4) most governments however will not be able to continue creating employment for all nationals not only because it will make public sector services highly inefficient, but because it will substantially increase their fiscal burdens.

Each GCC government has attempted to address this challenge by introducing a policy of nationalizing the workforce that has generally replaced most expatriates in the public sector and has in some cases set quotas for the employment of nationals in areas of the private sector. With the exception of the UAE, the majority of GCC public sector jobs are done by nationals. The proportion of public sector jobs held by nationals ranges from 53 percent in Qatar to 91 percent in Bahrain (see Figure 4.6). After successfully nationalizing the public sector labour force the focus is increasingly turning to the private sector. Employment of nationals in the

⁵⁴ Sharif, Arif "P&O's link with parent hinders DP World move" *Gulf News*, 14 June 2006.

⁵⁵ In the first oil price boom of the seventies much of the expatriate labour in the GCC states were from other Arab countries, however these labor flows are increasingly being displaced by cheaper labour from developing countries in Asia. In Kuwait for example data shows that approximately 50 percent of expatriate labor is Asian.

⁵⁶ Bosbalt, Mohammed and Wilson, Rodney, "Education, school to work transitions and unemployment in Saudi Arabia" *Middle Eastern Studies*, Vol. 41, No. 4, pp. 533-545, July 2005.

GCC's private sector is much lower, for example, it currently only employs between 1 percent of nationals in the UAE to 45 percent in Saudi Arabia (see Figure 4.6).

In states such as Bahrain, Oman and Saudi Arabia where unemployment has become somewhat of a political issue, the respective governments have introduced quotas for the private sector. This first formal labour market policy introduced in the region was in Bahrain in 1988.⁵⁷ The policy of Bahrainisation of the workforce was introduced in an effort to replace expatriate workers, who have continuously constituted more than 50 percent of its work force. In 1994 the Human Resource Development Support Programme was initiated and in 1996 the Government of Bahrain opened the country's first job centre, which was later followed by training and business financing funds for Bahraini job seekers. In 2001 some occupations were made exclusive for Bahrainis.

The UAE is attempting to address its emerging national unemployment, which is likely to become more of an issue in the coming years, by setting quotas for certain service sector activities such as in banking and insurance, where companies employing more than fifty people must meet Emiratisation targets. In addition, in recent years the UAE has passed legislation that will require all Public Relations Officers, Human Resources Officers and Secretaries to be Emiratis.⁵⁸

In Oman the policy of Omanisation was introduced in the mid 1990s. In 1995 a large expatriate workforce existed in Oman, amounting to 82 percent of the total labour force and quotas for national employees were introduced into several economic sectors including transport, insurance and trade.⁵⁹ In the UAE such quotas exist in the banking, insurance and trade sectors.

In Saudi Arabia, the problems involved in relying on expatriate labour were first mentioned in the third five-year plan (1980-85) which warned against the

⁵⁷ IMF, Middle Eastern Department, "Financial Systems and Labor markets in the Gulf Cooperation Council Countries" 1997, Washington D.C.

⁵⁸ Staff writer "Emiratisation is top priority for UAE Government, says UAE Labour Minister" *AMEinfo* 24 July 2006.

⁵⁹ The Economist Intelligence Unit, Oman Country Profile, 1997-1998, London.

unhindered growth of the expatriate labour force.⁶⁰ Yet in 2003 the issue of national unemployment remained and was a growing concern, according to Minister of Petroleum and Mineral Resources, Ali Al-Naimi, "The underlying goal of these reforms is to ... expand and diversify the Kingdom's economy while creating job opportunities for a rapidly growing population."⁶¹ The Saudi Arabian Ministry of Planning's Seventh Development Plan (2000-2005) stated that "The Plan adopts a set of economic policies ...designed to develop human resources, raise the efficiency of manpower, and increase employment through both generation of new jobs and replacement of non-Saudi manpower".⁶²

During the 1990s various Saudisation laws were passed, which required private businesses employing more than 20 people to increase the number of Saudi nationals by five percent annually, prevented the hiring of foreigners in administrative positions and increased the fees involved in recruiting expatriates.⁶³

The policy of such private sector quotas has however, been criticized for potentially harming the efficiency and competition of private sector businesses.⁶⁴ So far it has failed to adequately address the issue of unrealistic employment expectations of nationals and the perceived mismatch between the skills of national university graduates and private sector needs. Having said this, in a similar vein most GCC states are now channeling government resources into a more market orientated strategy of providing training and education for nationals in order to equip them with the skills required by the private sector. For example, *Tanmia* the UAE's national human resource development agency, helps national job seekers improve their skills by providing specialized training. While Saudi Arabia's Eighth Plan (2005-2010), according to Saudi Arabia's Minister of Economy and Planning, Ahmed Al-Hekami, allocated funding for "the establishment of seven new

⁶⁰ Economist Intelligence Unit, Saudi Arabia Country Profile, 1997-1998, London.

⁶¹ Royal Embassy of Saudi Arabia, *Political and Economic Reform in the Kingdom of Saudi Arabia*, Washington D.C., December 2003.

⁶² *Ibid.*

⁶³ Looney, R.E. "Saudization and Sound Economic Reforms: Are the Two Compatible?" Strategic Insights, Volume III, Issue 2, February 2004.

⁶⁴ See for example, staff writer "Emirati companies struggling under strict labour laws" *Khaleej Times*, 24 October 2005.

universities and 50 technical colleges with specializations required by the job market and the private sector."⁶⁵ In chapter five of this thesis, GCC labour market challenges and policies are examined in further detail.

4.3.3 Promoting the Private Sector

Building the private sector has been a long standing key policy objective of the GCC states for reasons discussed earlier in section 4.2.4. Saudi Arabia's Sixth five year Development Plan (1995-2000) stated that one of its aims was "To rationalize government expenditure and make the national economy more dependent on private sector activities."⁶⁶ In addition to the narrow policy of selling off state assets to the private sector, a number of other policies aimed at increasing private sector activities have been adopted.

Several GCC states have improved the business environment for the private sector by investing in infrastructure and creating Free Trade Zones (FTZs) where local private sector businesses, as well as foreign companies, can locate. FTZs provide businesses with benefits such as minimal red tape and quick approval of procedures. FTZs are usually established as business clusters and therefore associated business services are also readily at hand.⁶⁷ The UAE is the regional leader in terms of establishing FTZs with more than twenty established or planned, Qatar and Bahrain also have FTZs on the drawing board. Increasingly in the region public sector contracts are offered to private sector companies and joint public-private partnerships are taking place. More and more sectors where state owned monopolies have held dominance are being gradually opened up to competition.

Several GCC governments are targeting the growth of small and medium sized enterprises (SMEs) in order to promote private sector growth and domestic

⁶⁵ Staff Writer "Seven New Universities To Be Established Under 8th Plan", *Arab News* 24 November 2005.

⁶⁶ Kingdom of Saudi Arabia, Ministry of Planning, "Socio-Economic Developments During the Sixth Plan" Chapter Two of The Seventh Development Plan, Available from: <http://www.planning.gov.sa/PLANNING/INTROe.HTM> (accessed at 20 March 2006).

⁶⁷ For example, Dubai Media, Healthcare and Internet Cities.



entrepreneurialism. Small businesses in Saudi Arabia for example, are the main source of private-sector investment and they form more than 90 percent of private enterprises across the country.⁶⁸ Consequently the Saudi Commerce and Industry Minister, Hashim Yamani, in 2006, emphasized the importance of policies to support the growth and financing of SMEs, through mechanisms such as franchising.⁶⁹ Qatar's first Industrial Area for SMEs is expected to become operational by 2008, according to Qatar's Ministry of Energy and Industry, "The project is part of the authorities' efforts to provide suitable investment opportunities to local and foreign investors, as well as encouraging the local private sector."⁷⁰

Privatization – or the selling off of state owned assets – has been taken up as a policy objective throughout the GCC, but despite a commitment to the privatization in principal, the process has encountered a number of obstacles as was discussed in section 4.2.3. In some GCC states, such as Kuwait, there has been political opposition to the process. Concerns over increasing national unemployment are likely to hinder the transfer of state owned companies to the private sector which may well result in cost cutting and job losses.

In Kuwait the policy of privatization has faced social and political obstacles and continuous objections from members of the National Assembly who fear that selling off state assets could eventually erode Kuwait's generous welfare state. Privatization has so far been limited to the Kuwait Investment Authority (KIA) selling small stakes in companies listed on the Kuwait Stock Exchange. Its \$12 bn divestment programme began in 1994, following consultations with the World Bank,⁷¹ but was suspended between 1997 and 2000 due to low levels of liquidity on the Kuwaiti Stock Exchange. It resumed in 2001 with the sale of KIA shares in the Mobile Telecommunications Company, and by 2002 KIA's divestiture program had sold holdings in 31 companies.

⁶⁸ Staff Writer "Remove Obstacles to SMEs: Yamani - KSA" *Arab News*, 18 June 2006.

⁶⁹ *Ibid.*

⁷⁰ Bibbo, Barbara "Qatar to build 1b-riyal-facility for small and medium units" *Gulf News*, 6 May 2005.

⁷¹ Robins, Phillip "Can Gulf Monarchies Survive the Oil Bust?" *The Middle East Quarterly*, Volume 1, Number 4, December 1994.

In Bahrain, in 2003, the decision was taken by the Cabinet to privatize the power sector in full. The Government has commissioned a study to investigate options for privatizing the power sector over the next five years. The government has also approved a plan to create a new company, worth \$663mn, to acquire its stakes in a number of major tourism projects. The plan calls for a 60 percent equity stake of the new company to be sold to private investors in an IPO.⁷²

In Oman there has been little privatisation to note. In July 2005 Oman sold a 30 percent stake in its national telecommunications company, the shares were initially sold only to Omani citizens but once listed on the Muscat Securities Market, were available for anyone to purchase.

In Qatar, the privatisation process has seen relatively more progress. The first major sale of Qatari state assets took place in December 1998, when the government sold 45 percent of its shares in Qatar Public Telecommunications Corporation. In 2001 port services were also privatized. The Government of Qatar considers privatization as one of the key ways of reducing pressure on the state's fiscal budget. In February 1998 the Ministry of Electricity and Water transferred some of its responsibilities to the majority privately owned Qatar Electricity and Water Company (QEWC).

As well as partial privatisations of public companies, some GCC states have created quasi-private corporations to take over control of certain services. In early 2002 the Qatari government established Qatar Fuel Company (QFC), which took over the operation and maintenance of multi-product pipelines, storage facilities and liquefied petroleum gas filling stations from state-owned Qatar Petroleum.⁷³ A new regulatory body, the Qatar General Electricity and Water Corporation, was created in April 2000 to replace the Electricity and Water Ministry. The corporation is planning to reduce the ministry's workforce by two-thirds as part of a strategy to become more efficient. It is also tasked with privatizing the generation,

⁷² *Ibid.*

⁷³ UNDP Programme on Governance in the Arab Region, online available: <http://www.pogar.org>

transmission and distribution of utilities, which will gradually lead to the abolition of subsidies for expatriates and commercial establishments over time.⁷⁴

The Supreme Economic Council in Saudi Arabia initially approved a set of objectives for a privatization plan in 1997 and the strategy was approved again in 2002.⁷⁵ During its Seventh Plan (2000-2005) there have been only a few significant privatisations such as the \$4bn floatation of Saudi Telecom Company (STC) in January 2003 and the National Company for Cooperative Insurance was floated at the end of 2004. But there are plans for a number of privatisations in the pipeline. The Supreme Economic Council has legislated for the partial privatization of the National Saudi Arabian Mining Company, *Maaden*. Plans were announced to sell off 50 percent of the company in an IPO at the end of 2006.⁷⁶ Additionally at the end of 2005 it was announced that an IPO of a 35 percent equity stake of Yanbu National Petrochemicals Company (YANSAB), a subsidiary of Saudi Basic Industries (SABIC), was being planned. In 2006 the Saudi government announced that its Tadawul stock market would be turned into a share holding company, of which some shares would be offered to the private sector.⁷⁷ The Supreme Economic Council has also identified a further twenty sectors for possible privatization.⁷⁸

The UAE's federal government has encouraged privatization of the economy. Few privatization plans have emerged in Dubai which is focusing instead on encouraging foreign investment, while Abu Dhabi is concentrating on the privatization of some of its utilities and other industries, apparently to bring in modern technology and management techniques and reduce costs. The Abu Dhabi government has established a public joint stock company, the General Holding

⁷⁴ *Ibid.*

⁷⁵ Luciani, Giacomo "The Pace and Problems with GCC Privatizations" in *Gulf Yearbook 2005-2006*, pp. 147-155, Gulf Research Center, Dubai, 2006.

⁷⁶ *Ibid.*

⁷⁷ Staff writer "Saudi to privatise bourse" *Gulf Daily News*, 10 May 2006.

⁷⁸ The list identified 20 sectors, including: postal services; water desalination; air transport, airport and seaport services; municipal construction; and educational, health and social services. The plan also proposed private management of highways, railways, oil refineries, grain silos, flour mills, state-owned hotels and sports clubs. (20 May 2004 - Saudi Embassy, Washing D.C.)

Company, which will be charged with privatizing a number of state-owned factories including fodder, cement, steel and pipe plants and flour mills.⁷⁹

Abu Dhabi's most ambitious privatization plans concern water desalination and producing and distributing electricity. Eleven companies have been created in Abu Dhabi to manage the different aspects of producing, operating, scheduling, dispatching and distributing of water and electricity. But considerations such as the elimination of government subsidies of water and electricity as well as a plan to trim the 14,000 strong staff in the industry in order to lower costs and increase profitability may well delay implementation.

4.3.4 Attracting FDI

FDI brings with it technical and managerial expertise which is transferred to associated indigenous companies. According to endogenous growth models such technology transfer can be extremely important in fostering growth. A paradox exists in the GCC economies, where despite the high level of GCC investment abroad (estimated at around \$740 bn⁸⁰) the region has in the past suffered from a lack of inward investment itself. In section 4.2.4 it was established that the GCC states have been mostly marginalized from such FDI flows, receiving only 0.7 percent of global FDI flows in 2004.⁸¹ FDI has been restricted by a number of factors. A survey of the obstacles to the inflow of FDI into the UAE found that the most significant barriers were the limits on foreign ownership of companies, real estate laws, the Agency law and government red tape.⁸²

Despite this, the UAE in particular, has been proactive in implementing policies to attract foreign investors, enacting laws to allow foreign investment in real estate for example and running successful marketing campaigns advertising themselves as an ideal location for business. In 2003 Saudi Arabia also began to make serious

⁷⁹ Luciani, *op.cit.*

⁸⁰ Staff writer, "Gulf offering limited investment avenues for high oil revenue", *Khaleej Times*, 20 December 2004

⁸¹ United Nations Conference on Trade and Development, *World Investment Report 2004*.

⁸² Qasrawi, Sophia, "Foreign Direct Investment in the UAE: Determinants and Recommendations" *Emirates Occasional Papers*, 2004.

efforts to attract increased investment and in 2003 cut taxes on foreign investors from 45 percent to 20 percent.⁸³ Mobilising investment is considered a priority and as being key to the GCC's economic growth. Bahrain and Oman have allowed for the complete foreign ownership of companies operating domestically and opened up their banking sectors to foreign competition. The UAE, in particular Dubai, has been active in establishing several Free Trade Zones (FTZs) which also provide incentives for foreign companies to establish themselves, such as allowing 100 percent foreign ownership and profit repatriation, this policy has attracted many multinational companies to Dubai and has spurred FDI.

Membership of the World Trade Organisation (WTO) has also been an important policy for the GCC states, as well as providing greater access to international markets it is generally accepted that membership of the WTO encourages foreign investment.⁸⁴ All the GCC states are now members of the WTO. Oman joined in 2002 and the other four GCC states were contracting parties to the General Agreement on Tariffs and Trade (GATT) and became members of the WTO from its launch in January 1995, with the exception of Saudi Arabia. The Kingdom gained entry in 2005, after twelve years of negotiations. The sticking point for Saudi Arabia's membership has been the subsidies it provides on certain goods and the slow pace of economic liberalization in the Kingdom. Following its accession Saudi Arabia announced that it would give licenses to ten foreign banks to operate in its domestic market.

Several GCC states have also signed or are negotiating Free Trade Agreements (FTAs) with the US, which is seen by national policy makers as a key instrument for increasing FDI from US companies. The FTA being negotiated multilaterally between the GCC states and the EU is also expected to increase FDI flows between the two economic blocs.

There are few opportunities for FDI in the GCC upstream hydrocarbon sector at present, as it remains firmly in the hands of the State in most GCC economies due

⁸³Staff Writer "S. Arabia cuts tax rates on foreign investors" *Arab News*, Jeddah. January 13 2004.

⁸⁴ Baghat, Gawdat, *Middle East Economic Survey*, Vol. XLVII, No. 34, 23 August 2004.

to political considerations but also the inherent need to control the rate of resource depletion as well as to adhere to OPEC quotas (of which four of the GCC states are members). Saudi Aramco is the state oil company responsible for investing in the Saudi upstream oil industry and in Kuwait a decision on 'Project Kuwait' a proposal put to parliament to allow foreign involvement in the upstream oil sector has been continuously deferred since 1998. The prospects for International Oil Companies (IOCs) are unlikely to improve in the region any time soon with high oil prices there is little need for GCC countries to ramp up oil field production to increase their revenues and there is ample domestic capital available for investment in the hydrocarbon sector.

However, FDI in the downstream hydrocarbon sector is being actively encouraged. For example, Oman's current Five-year Plan (2001–2006) makes clear that private investment in a number of gas-based projects is essential if its objectives are to be met. The plan hopes to attract a total of \$11.4bn in private sector investment compared to the estimated \$4.9bn it received between 1996 and 2000.⁸⁵ With increasing population pressures, the utilities sector, in particular water and electricity, is also a key sector where FDI has been sought. For example, as part of the plan to privatize the electricity and water sector, Qatar established in November 2004 the first private electricity and water company in the industrial town of Ras Lafaan and AEC, of the US, owns a 55 percent stake in this project.⁸⁶ Furthermore, recent legislative developments in some GCC states⁸⁷, allowing foreigners to purchase property, are also improving the business climate for FDI.

4.3.5 Monetary Policies

The GCC states all have very similar exchange rate policies, and have all officially pegged their currencies since the early 1980s. As a result their monetary policies are directed towards exchange rate targeting. The Omani Riyal has been officially

⁸⁵ United Nations Development Programme, Programme on Governance in the Arab Region, Financial Management: Qatar, (Accessed at <http://www.pogar.org/countries/finances.asp?cid=15>)

⁸⁶ *Ibid.*

⁸⁷ In terms of purchasing property some GCC states, with the exception of Kuwait and Saudi Arabia, allow foreigners to purchase property in designated areas.

pegged to the US dollar since the 1970s, the other GCC states were pegged to the IMF's Special Drawing Rights (SDR) with the exception of the Kuwaiti Dinar which was pegged (with an adjustable relationship) to an undisclosed weighted basket of currencies of its main trading partners.⁸⁸ The basket was made up of five currencies and was heavily dollar weighted.

In 2003 all the GCC states officially pegged their currencies to the US dollar which was chosen as the common interim peg prior to CU. Because the Kuwaiti dinar peg is the only currency previously pegged to a basket of currencies it was allowed a band of adjustment at +/-3.5 percent until the scheduled monetary unification. The value of the pegs was based on historical currency rates against the dollar. The choice of the dollar peg was perhaps a natural one for most GCC states early on in their economic development considering the price of oil has been denominated in dollars since the early 1970s.

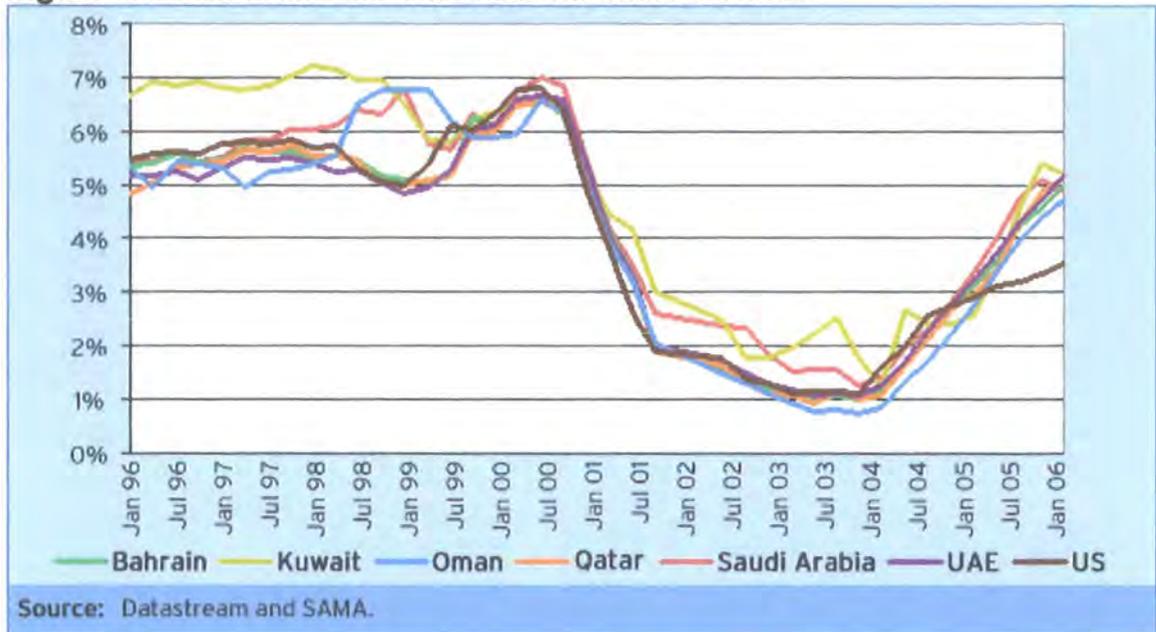
Following the monetary decisions of the Federal Reserve bank has provided the GCC's monetary institutions with instant credibility and furthermore it has simplified monetary policy making. However, the peg to the dollar has meant that interest rate setting as a monetary policy tool has not been available for use. As a consequence, nominal interest rates have had to track US interest rates and therefore interest rates have been similar across the GCC. However, the GCC central banks have at times chosen to allow a gap to emerge between their interest rates and those of the US depending on their domestic economic circumstances. Therefore they can exert control over monetary policy in the short term. For example, in the first half of 2006 Saudi Arabia chose not to follow two US interest rate rises due to concerns over falls in the Tadawul stock market.⁸⁹ In fact, since 1996 the maximum interest rate differential between GCC interest rates and those of the US ranged from of -91 and 205 basis points⁹⁰ (see Figure 4.12).

⁸⁸ Saudi Arabia pegged its currency to the SDR in 1986, the UAE in 1980, Qatar since 1979. Oman pegged to the dollar in 1986 and Kuwait to a trade weighted basket of currencies in 1990.

⁸⁹ Staff writer "Saudi has no plan to revalue riyal: Official" *The Peninsular*, Qatar, 26 June, 2006.

⁹⁰ Data could only be obtained from 1996 onwards.

Figure 4.12: GCC and US Three Month Interest Rates



The monetary policies and Central Bank mandates in the GCC countries have been directed primarily towards maintaining a stable international value for their respective currencies, as well as issuing currency, providing financial assistance to the government and supervising the financial system.⁹¹

GCC Central Banks monitor banking and monetary variables in the economy and use a variety of monetary instruments, other than interest rate setting, to manage domestic liquidity. Bahrain, for example, uses relatively sophisticated techniques like Open Market Operations for the sale of Government paper and secondary markets to manage its money supply, other states such as the UAE use simple reserve requirements, loan to deposit ratios and Certificates of Deposit (CDs) to control money growth in the economy. As well as bills and repos, Saudi Arabia also uses the sale of bonds to control domestic liquidity and inflation. However, the use of Open Market Operations in Saudi Arabia to control the supply of money in the economy has been exercised merely as a means for government borrowing. Saudi Arabia has a relatively high level of domestic debt, owed to local banks, as it has borrowed to finance budgets during times of low oil prices. While these monetary policy tools are undoubtedly less effective than having the ability to set

⁹¹ GCC Central Bank websites

independent interest rates to manage economic cycles they do provide the GCC states with some ability to manage liquidity in their economies in the short term. For example, in 2005 the UAE central bank increased the maturity of its CDs to five years in order to help absorb the increase in liquidity in the domestic economy caused by high oil prices.⁹²

As GCC Central Banks lack experience of interest rate setting and utilizing sophisticated money market tools it has been argued that delegating monetary policy to the Federal Reserve in the GCC's early stages of institutional development was prudent. This may have been the case in the past but it is becoming increasingly apparent that the GCC states would undoubtedly now benefit from building their own independent institutional capabilities to participate fully in their future economic development.

4.3.6 GCC Economic Integration Policies

The GCC's 'Unified Economic Agreement' was ratified and came into force in January of 1982 and was effective up until 2001. The Unified Economic Agreement set out was far reaching and set out policies for the free movement of GCC citizens within the bloc along with recommendations for the coordination of banking, financial and monetary policies. In terms of GCC-wide economic integration the members established a Free Trade Area in 1983, under which tariffs on goods of national origins are eliminated.

However, for much of the 1980's and 1990's concrete progress on many of the integration objectives stagnated. In 1986 the first service sectors were opened up to GCC citizens. By 2000, and after a sustained period characterised by low economic growth rates, the GCC integration as a means to economic diversification was again on the agenda. In 2001 a revised Economic Agreement was agreed upon by GCC leaders at the annual GCC Summit held in Muscat,

⁹² Staff writer "Central Bank plans debt issue to control inflation" Reuters, 13 August 2005.

Oman. It set out a detailed and ambitious plan for a fully integrated common market as a precursor to MU.

In 2001 the GCC's Supreme Council agreed on a timetable for implementing the various stages of integration. This called for the creation of a Customs Union in 2003, the establishment of convergence criteria for monetary union to be set out by 2005⁹³ and the completion of a Common Market by 2007.

With regard to the movement of capital the GCC leaders have agreed in principal to completely integrate financial markets and harmonize all financial regulations. GCC citizens will have the same rights and investment opportunities in all GCC States and be able to own businesses and properties throughout the bloc. The GCC Pensions and Social Security authorities recommended in 2003⁹⁴ that full social security coverage should be extended to all GCC citizens working within member countries. Sultan Al Ghaith, head of the UAE delegation, said that "as of January 2006 implementation for the complete coverage of all GCC citizens will become compulsory."⁹⁵

Central Bank cooperation in the GCC takes place within the Central Bank Governors Committee, which meets twice a year and reports to various GCC subcommittees including the Committee for Financial and Economic Cooperation. In 2002 the GCC Supreme Council, Meeting in Doha, Qatar, set up a Monetary Union Unit which would focus solely on issues pertaining to CU.

In January 2003, the GCC Customs Union came into effect with the enactment of a single external tariff at five percent, a unified customs code and the single point of entry principle. Given that national tariff levels differed substantially, in 1999 Saudi

⁹³ The publication of GCC CU convergence criteria has been postponed until 2006, GCC Central Bankers had apparently agreed on the criteria amongst themselves but differences amongst Finance Ministers resulted in no decision being announced at the 2005 GCC Summit.

⁹⁴ GCC Pensions and Social Security Meeting Manama, Bahrain 10 December 2005.

⁹⁵ AMEinfo, "Gulf Pensions and Social Security authorities recommend full coverage of GCC expatriate workers" 14 December, 2003, available at <http://www.ameinfo.com/32307.html>

Arabia's average tariff was 12.6 percent while Oman's was only 4.8 percent, the agreement was a notable and encouraging development.

The GCC are also negotiating as a single economic bloc with the EU for the establishment of a EU-GCC Free Trade Agreement. Unlike some of the bilateral agreements signed between various GCC States and the US, it is widely felt that collectively the GCC will be able to strike a better deal.

4.4 Conclusion

All the GCC states faced similar economic challenges over the 1980 to 2005 period, namely a need to diversify their economies away from an overdependence on hydrocarbons, increasing the role of the private sector, attracting more FDI and reforming labour markets in order to create more jobs opportunities. These challenges are made harder by the pro-cyclical nature of these economies resulting from a disproportionate reliance on income from oil – an inherently volatile commodity.

There are of course differences, Bahrain and Oman face a greater imperative to diversify away from oil in the short term as their commercial reserves are close to depletion, Saudi Arabia has by far the largest population but has the second lowest GCC per capita income; job creation is the Kingdom's primary challenge. Qatar, Kuwait and the UAE have small populations compared to their hydrocarbon reserves and thus have less need to diversify but are in a better financial position to do so.

Despite the various economic policies introduced over this period, many of the same challenges remain today. Qatar's main economic objectives for example in 2005 were: diversifying the economy, creating the right investment climate and strengthening the private sector and increasing its overall role in the economy.⁹⁶

⁹⁶ World Trade Organization, Trade Policy Review, Report by Qatar, 24 January 2005, online http://www.wto.org/english/tratop_e/tpr_e/g144_e.doc

The assumed economic benefits of a Common Market and the CU in promoting intra-regional trade and thus economic diversification may well explain why GCC leaders recently renewed their commitment to their Unified Economic Agreement and embarked on a Customs Union.

The degree to which the GCC's choice of monetary policy has influenced their ability to overcome their economic challenges is difficult to determine. But while the *de facto* peg to the US dollar may have helped create a low inflationary environment it has arguably been at the expense of being able to use monetary tools, such as independent interest rate setting to encourage growth, especially during periods of low oil prices.

Being tied to US interest rates is not an optimal policy choice for the GCC states as monetary policy set by the US Federal Reserve is tailored for the needs of the US economy, not those of the GCC. Furthermore, by outsourcing monetary policy the GCC has to rely much more on fiscal policy to control the economy. Thus there are problems in projecting and managing fiscal budgets arising from the fact that GCC government revenues remain intimately linked with the price of oil.

The GCC's monetary policy choices between 1980 and 2005 have effectively sacrificed flexibility for 'credibility' yet the US dollar peg has not discernibly helped the region in terms of attracting significant FDI inflows. The peg has also become less appropriate as trade with Eurozone and Asian countries has become increasingly important over the period of analysis. During periods of dollar depreciation GCC states suffer from import price inflation which adversely affects import-export businesses as well as consumers. Many of the issues addressed in this chapter will have a direct bearing on the appropriateness of the GCC economies for CU, therefore many of these issues are returned to in subsequent chapters of this thesis and discussed in greater detail.

Chapter 5 : Assessing the Suitability of the GCC States for Currency Union

5.1 Introduction

The aim of this chapter is to assess the GCC states against various OCA criteria. By doing this we should be able to highlight areas where transitional 'costs' will be higher and reform more difficult. More generally it will help to determine the economic costs and benefits that will be incurred from forming the CU, which will be examined in more detail in chapter seven of this thesis.

This chapter first discusses the economic criteria established as the benchmark for forming a successful CU using the OCA theory. It then looks at the degree to which the GCC economies meet the following criteria: the level and importance of intra-GCC trade, factor market mobility – including labour and capital, economic structures and diversification and finally, economic synchronicity. The degree to which the GCC states meet each of the core criteria is assessed, in part by, employing the primary research undertaken in the GCC states.

This primary research provides first hand evidence and insights into the unique economic and political circumstances of the GCC. The findings of a GCC wide business survey and semi-structured interviews with regional experts are drawn upon, in order to make a comprehensive assessment of the appropriateness of CU for the GCC economies. Empirical analysis using regional and international data sources throughout compliments this primary research. In order to assess the degree of economic synchronicity econometric analysis is also employed.

It should be noted from the outset that even if the GCC states do not meet some of the aforementioned criteria adequately, this alone will not necessarily prevent them from forming a viable CU. The case of EMU is illustrative of circumstances where political will overrides economic concerns. It is conceivable and indeed quite possible that if there is adequate political will among Gulf leaders then a joint

currency may well be entered into, regardless of whether or not all OCA criteria are met.

However, the credibility of the new single currency and sustainability of the CU will be considerably influenced by both the suitability of the GCC economies vis-à-vis the OCA criteria and the degree to which the necessary preparations are dealt with in the lead up to 2010. An assessment of the range of prerequisite policies, generally considered necessary in forming a successful CU, will be covered in the following chapter.

5.1.1 The Main OCA Criteria

The main economic criteria employed to assess the appropriateness of CU for any given region originates from the OCA theory.¹ According to the OCA theory the presence of certain economic conditions among a group of countries will help to minimise certain 'costs' that are incurred when forming a CU. The key economic one being the loss of national autonomy over monetary policy setting (for a more detailed assessment of OCA criteria refer to chapter two).

In order for full economic integration and a single monetary policy to be appropriate for a given economic region, they must have significant levels of intra-regional trade; flexible labour markets and mobile intra-regional capital flows; diversified economies and synchronised economic cycles.²

This section proceeds as follows; firstly it examines the level and significance of intra-GCC trade. CU is considered optimal for countries with strong trading links, in this case the benefits from reduced transaction costs and exchange rate risks will be highest. Next, we examine the flexibility of GCC labour and capital markets. OCA theory asserts that if labour and capital are sufficiently mobile between the

¹ Mundell, R. A. "A Theory of Optimum Currency Areas" *The American Economic Review*, Vol. 51, No. 4, pp. 657-665, September 1961.

² Kenen, P. B. "The Theory of Optimum Currency Areas: An Eclectic View", in *Monetary Problems of the International Economy*, (eds. R.A. Mundell and A.K. Swoboda) pp.41-60, University of Chicago Press, Chicago, 1969.

member states it will be possible to adjust to an economic shock in one member state without facing any major difficulties or having to employ a bespoke monetary policy.

The chapter then moves on to look at two other areas: the degree of diversification prevalent in the GCC economies and the level of synchronisation between them. Firstly, the theory suggests that if a group of countries are diversified and not highly dependent on specific industries or commodities they will be less likely to experience asymmetric shocks which would require the use of the national exchange rate or monetary policy to mitigate the effects. Secondly, the greater the similarity of economic structures and synchronisation between the member economies, the less likely the possibility of them experiencing asymmetric economic shocks. In the final section of this chapter we assess quantitatively the level of economic synchronisation between the GCC economies. When member economies are synchronised and suffer from, and react to, the same economic shocks then a single monetary policy for the entire region will not cause problems for any one national economy and a common monetary policy will be appropriate for the group.

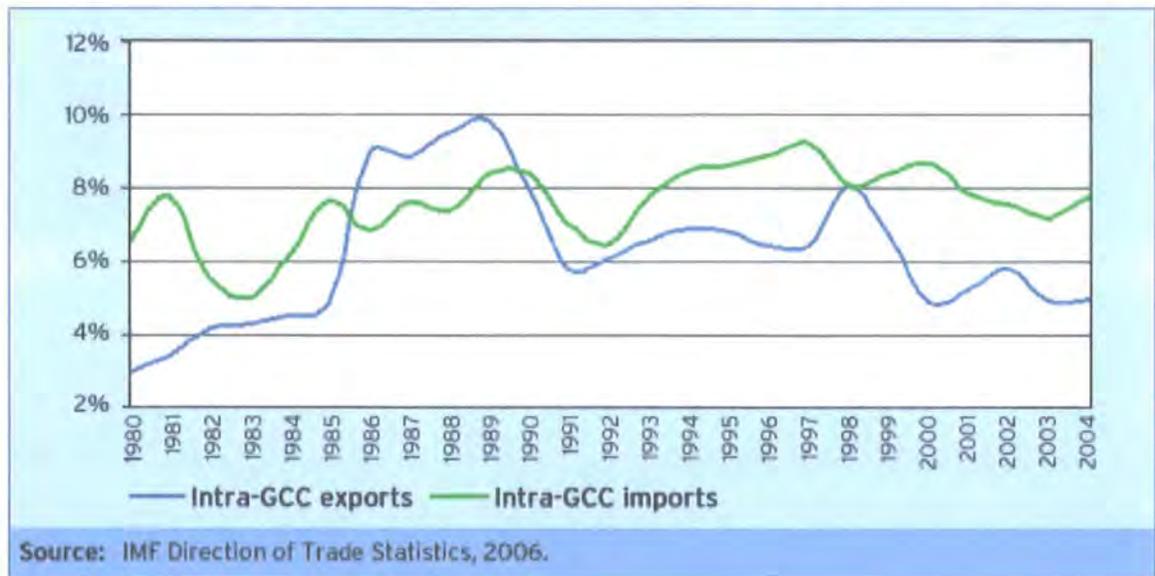
5.2. Intra-Regional Trade

The conventional analysis of intra-GCC trade levels and ratios shows that intra-GCC trade is weak, particularly when compared with the Eurozone countries prior to forming a monetary union. However, evidence from an empirical analysis of non crude oil intra-regional trade data and trade intensity ratios, as well as new evidence provided by the GCC wide business survey, suggest that GCC trade linkages are somewhat stronger than may have previously been considered. Indeed, the survey findings indicate that intra-GCC trade is important for a significant proportion of the GCC business community.

5.2.1 Conventional Trade Analysis

Most literature on GCC economic integration refers to levels of intra-GCC trade as being low, for example Laabas and Limam note that despite signing a FTA, intra-GCC exports in 1999 amounted to only 6.8 percent of total GCC exports, much lower than other regional blocs such as the EU where intra-EU exports amounted to 63 percent of total EU exports.³ In 1981 GCC intra-regional exports constituted only 3.4 percent of their total exports and 7.8 percent of their total imports. In 2004 this figure had risen only marginally on the export side to 5 percent of total exports and had remained stagnant on the import side forming 7.8 percent of total imports. Between 1980 and 2004 the average share of regional trade as a proportion of their total trade was 6.2 percent but during times of low oil prices intra-regional trade has risen higher than this average and vice versa (see Figure 5.1).

Figure 5.1: Intra-GCC Trade as a Percentage of Total GCC Trade



Compared with the Eurozone countries prior to them forming a CU, the share of intra-GCC trade is also relatively low as a proportion of the region's GDP. The ratio of intra-regional exports to GDP in the Eurozone countries in 1998 was approximately 13 percent whereas in the GCC in 2004 the ratio was just 2.6 percent (see Table 5.1).

³ Laabas, B. and Limam, I. *Are GCC Countries Ready for Currency Union?* Arab Planning Institute, Kuwait, April 2002.

Table 5.1: GCC and Eurozone Trade as a Percentage of Regional GDP

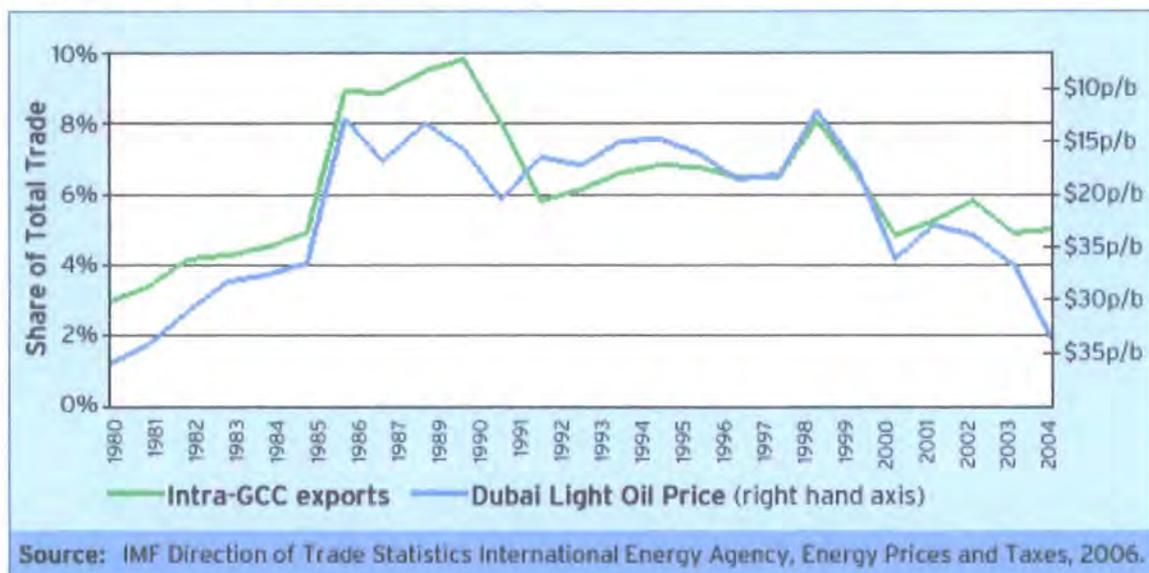
GCC			Eurozone		
1980	Exports	1.9	1980	Exports	11.4
	Imports	1.4		Imports	11.3
1985	Exports	1.8	1985	Exports	12.5
	Imports	1.9		Imports	12.3
1990	Exports	3.6	1990	Exports	12.6
	Imports	2.1		Imports	12.4
1995	Exports	2.8	1995	Exports	12.4
	Imports	2.4		Imports	11.4
2004	Exports	2.6	1998	Exports	12.8
	Imports	2.5		Imports	12.0

Source: IMF World Economic Outlook Database and IMF Direction of Trade Statistics. Eurozone data from Bayoumi, Tamim and Mauro, Paulo "The suitability of ASEAN for a regional currency arrangement", *International Monetary Fund Working Paper 162*, December 1999.

Most of the GCC states are large oil exporters, with adequate supplies for domestic needs and therefore little of their intra-regional trade is crude oil. Their similar trade structures has meant that there are few trading complementarities between them and consequently absolute trade flows between GCC states have not been significant.

Having said this, the share of intra-GCC trade as a proportion of total trade is very much dependent on the price of oil and during times of high oil prices the proportion of intra-GCC trade (which is predominantly non-crude oil trade) will inevitably fall and visa-versa. The strong inverse relationship between intra-GCC trade and the oil price is illustrated in Figure 5.2.

Figure 5.2: Intra-GCC Exports and Crude Oil Price (Inverted)



Therefore, we must be careful in drawing conclusions from the intra-GCC trade data as a share of total trade (including crude oil) which can be misleading because of the distorting effect of oil prices. It is therefore much more meaningful, to examine the share of intra-GCC non-crude oil trade as a proportion of the GCC's total non-crude oil trade.

5.2.2 Analysis of Non-Crude Oil Trade

In fact, intra-GCC *non-crude* exports calculated as a share of GCC total *non-crude* exports, is triple the intra-GCC share of total exports including crude oil. In 2002 intra-GCC non-crude oil exports as a share of total non-crude oil exports constituted 18.1 percent (see Table 5.2). Intra-GCC non-crude oil exports therefore form a significant proportion at close to a fifth of their total non-crude oil trade. Furthermore, Jadresic calculates intra-GCC exports as a share of the GCC's total exports excluding crude oil *and* refined oil products, in this case intra-GCC share increases even further to reach more than a third of their total exports.⁴

⁴ Intra-GCC exports stood at 34.1 percent of total non-crude oil and non-crude oil product exports in 1998, see Jadresic, E. "On a Common Currency for the GCC Countries", *IMF Policy Discussion Paper*, December 2002, p.10.

Table 5.2: Oil and Non-Oil Intra-GCC Trade, 2002

		All Exports		Non-Crude Oil Exports		All Imports		Non-Crude Oil Imports	
		USD Mn	%	USD Mn	%	USD Mn	%	USD Mn	%
Bahrain	Within GCC	489.97	5.8	545.10	29.7	1,395.60	34.5	498.30	15.0
	Total Exports	8,481.60		1,838.00		4,045.53		3,331.00	
Kuwait	Within GCC	251.73	1.6	393.90	5.4	974.46	11.1	989.50	11.0
	Total Exports	16,005.10		7,234.30		8,767.28		9,007.40	
Oman	Within GCC	1,290.55	11.6	1,271.90	49.5	1,992.96	33.2	1,991.70	33.2
	Total Exports	11,126.70		2,570.30		6,005.26		6,002.50	
Qatar	Within GCC	699.15	6.4%	699.00	13.1	625.42	15.4	625.20	15.4
	Total Exports	10,976.50		5,349.50		4,050.87		4,052.10	
SA	Within GCC	3,542.87	5.3	3,029.30	17.4	1,239.87	2.6	1,484.20	4.6
	Total Exports	67,002.10		17,422.8		48,282.10		32,333.0	
UAE	Within GCC	2,624.96	6.7	2,738.80	20.2	1,458.50	4.8	1,815.80	5.4
	Total Exports	39,281.10		13,552.9		30,352.60		33,377.6	
GCC	Within GCC	8,899.23	5.8	8,678.00	18.1	7,686.80	7.6	7,404.70	8.4
	Total Exports	152,873.1		47,967.8		101,503.6		88,103.6	

Source: Non-crude oil trade data from External Trade Bulletin of the ESCWA Region, United Nations, 13th Issue, Total trade data from IMF Direction of Trade database (February 2006)

Notes: UAE 2002 data includes re-exports.

Turning to the trend in intra-GCC trade, since 1990, non-crude intra-GCC exports as a share of the total have fluctuated between a peak of 22.3 percent in 1991 and

a low of 10.3 percent in 1996 (see Table 5.3). The intra-GCC share of non-crude oil imports has been much lower however than intra-GCC exports varying between a low of 4.8 percent in 1991 and high of 8.4 percent in 2002. In absolute terms, intra-GCC non-crude oil exports grew strongly between 1990 and 2002, by a Compound Annual Growth Rate (CAGR) of 10.4 percent. However as a proportion of total non-crude oil exports, in 2002 the figure (18.1 percent) was only slightly higher than in 1990 (16.9 percent) (see Table 5.3).

Table 5.3: Share of Intra-GCC Non-Crude Oil Trade, 1990-2002

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Bahrain A	28.8%	28.0%	30.8%	27.8%	29.2%	21.4%	25.0%	23.5%	27.4%	33.5%	25.0%	27.5%	29.7%
B	9.5%	8.8%	8.8%	9.8%	11.6%	13.3%	12.1%	12.4%	11.6%	14.5%	14.7%	14.4%	15.0%
Kuwait A	28.3%	28.7%	9.2%	8.1%	5.3%	3.8%	3.9%	4.2%	5.6%	4.6%	3.7%	5.5%	5.4%
B	6.8%	7.4%	8.9%	8.0%	9.1%	9.7%	9.6%	10.4%	9.4%	10.4%	11.5%	11.2%	11.0%
Oman A	56.8%	58.4%	57.0%	49.6%	48.2%	50.4%	48.8%	47.0%	49.8%	51.8%	51.7%	47.0%	49.5%
B	27.0%	29.0%	31.0%	32.3%	32.3%	28.7%	28.0%	29.0%	28.9%	32.7%	33.2%	33.2%	33.2%
Qatar A	29.6%	24.5%	21.7%	25.9%	25.3%	18.1%	28.3%	22.7%	12.7%	19.5%	13.2%	8.3%	13.1%
B	8.6%	10.0%	10.7%	14.4%	14.4%	10.2%	12.5%	13.2%	15.4%	17.1%	14.9%	12.2%	15.4%
Saudi Arabia A	11.6%	17.4%	11.8%	15.3%	16.1%	25.5%	9.5%	33.3%	29.0%	25.5%	16.5%	15.0%	17.4%
B	1.8%	1.4%	1.2%	2.2%	2.8%	2.7%	3.2%	3.1%	3.4%	3.9%	3.6%	3.9%	4.6%
UAE A	34.7%	39.2%	38.8%	39.8%	39.2%	32.2%	25.2%	17.2%	12.7%	16.0%	21.9%	19.9%	20.2%
B	6.3%	4.4%	6.5%	4.1%	4.4%	5.0%	4.7%	5.0%	5.1%	5.1%	4.5%	4.8%	5.4%
GCC A	16.9%	22.3%	17.6%	19.8%	15.0%	17.9%	10.3%	19.8%	18.3%	17.7%	16.8%	16.1%	18.1%
B	5.4%	4.8%	5.5%	6.1%	6.8%	6.6%	6.8%	7.2%	7.4%	7.8%	7.5%	7.7%	8.4%

Source: Calculated from Economic and Social Commission for Western Asia, External Trade Bulletin of the ESCWA Region, 4th, 6th, 8th, 9th, 11th and 13th issues.

A: Intra-GCC non crude exports as share of total GCC non crude exports

B: Intra-GCC non crude imports as share of total GCC non crude imports

5.2.3 Trade Intensity Ratios

Another way to assess the levels of trade amongst the GCC states is to look at Trade Intensity Ratios (TIRs). The trade intensity ratio measures the strength of bilateral trade and helps to determine whether the value of trade between two countries is larger, or smaller, than would be expected given each country's share of world trade.⁵ Table 5.4 shows the trade intensity ratios for the GCC states for four periods. A trade intensity ratio greater than one implies a bilateral trade flow greater than what would be expected.

While it is hard to discern any trends over the periods examined, the data reveals the relative strengths and weaknesses of intra-GCC trading relationships. The data in Table 5.4 show that the trade relationship between Oman and the UAE is particularly strong with Oman's UAE-TIR the highest among the other GCC states in every period of analysis since 1980. This is consistent with the following analysis of the survey results which found that Oman and the UAE had strong intra-GCC trade linkages.

An analysis of the TIRs indicates that Saudi Arabia, the UAE and Bahrain are significant exporters within the region and therefore often have the highest TIR. As is consistent with the previous analysis of non-crude oil exports Qatar and to a lesser extent Kuwait have relatively weak intra-GCC trade linkages and frequently have the lowest TIRs in the grouping. However, it is interesting to note that the TIR between the GCC's largest economies, Saudi Arabia and the UAE is often the weakest for both partners compared to that with other GCC states. Given the undoubted importance to the GCC of these two economies this is potentially a rather troubling finding.

⁵ The TIR is defined as the share of one country's exports going to a partner divided by the share of world exports going to the partner. It is calculated as: $T_{ij} = (x_{ij}/X_{it})/(x_{wj}/X_{wt})$ Where x_{ij} and x_{wj} are the values of country i 's exports and of world exports to country j and where X_{it} and X_{wt} are country i 's total exports and total world exports respectively.

Table 5.4: GCC Trade Intensity Ratios, 1980-2004

1980-1989						
Exporter	Bahrain	Kuwait	Oman	Qatar	SA	UAE
Bahrain	..	3.67	15.64	20.29	2.72	35.29
Kuwait	0.65	..	0.56	2.04	1.88	3.02
Oman	3.41	2.06	..	7.21	1.76	11.88
Qatar	0.33	3.25	0.65	..	1.22	1.00
SA	21.84	0.99	0.33	1.21	..	0.83
UAE	1.90	1.52	11.83	9.25	3.19	..
1990-1999						
Exporter	Bahrain	Kuwait	Oman	Qatar	SA	UAE
Bahrain	..	4.46	13.40	11.06	2.68	3.01
Kuwait	1.15	..	1.00	1.95	0.99	1.18
Oman	3.33	2.18	..	4.43	2.16	22.74
Qatar	2.18	2.00	2.66	..	2.27	5.33
SA	38.33	6.54	2.41	5.67	..	4.71
UAE	3.76	2.84	44.98	9.70	1.80	..
2000-2004						
Exporter	Bahrain	Kuwait	Oman	Qatar	SA	UAE
Bahrain	..	5.21	15.10	8.68	3.70	2.38
Kuwait	1.45	..	1.98	1.52	1.01	0.77
Oman	2.76	2.63	..	3.79	3.34	11.88
Qatar	3.77	1.67	1.06	..	2.63	4.54
SA	35.15	5.72	2.92	4.25	..	1.81
UAE	4.40	5.07	38.72	8.24	1.72	..
2004						
Exporter	Bahrain	Kuwait	Oman	Qatar	SA	UAE
Bahrain	...	4.93	15.30	6.67	3.94	2.12
Kuwait	1.47	...	1.86	0.99	0.93	0.64
Oman	3.27	3.17	...	3.17	3.73	9.80
Qatar	3.85	1.66	1.17	...	2.64	3.18
SA	34.89	4.60	2.74	3.19	...	1.46
UAE	4.30	4.01	29.63	6.12	2.00	...

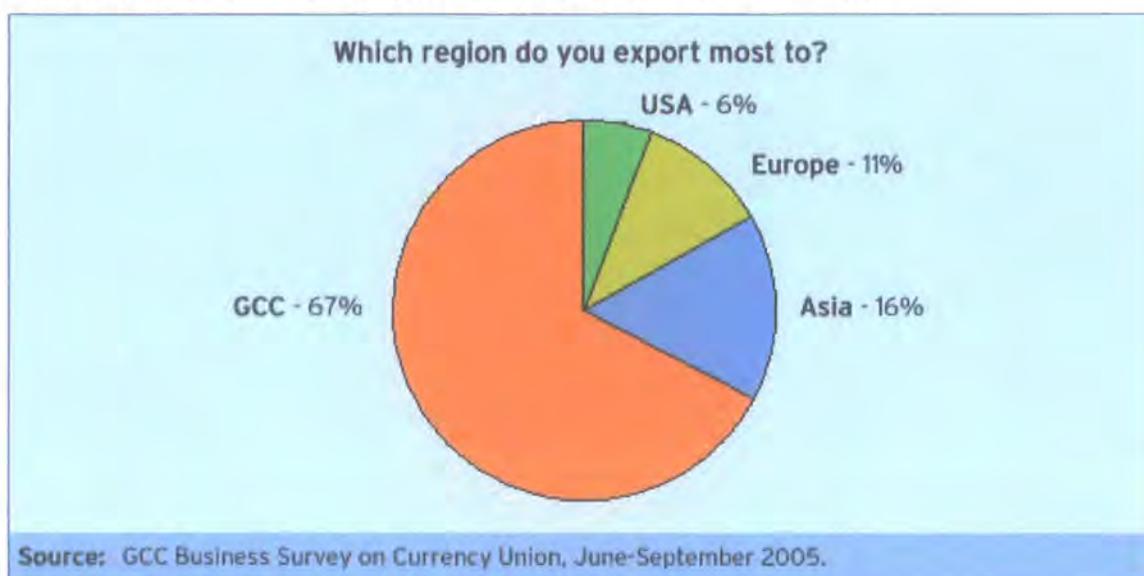
Source: Calculated from IMF, Direction of Trade Statistics, July 2005.

Note: Exporters are in left hand column in the table, importers across the top of each table.

5.2.4 Evidence from the GCC Business Survey

The responses to the business survey confirms the picture presented by the previous analysis of non-crude oil trade that intra-GCC trade is perhaps more important than often thought.⁶ Of our respondents, 59 percent stated that they had some involvement in foreign trade. When asked about the extent of their involvement in intra-GCC trade, two thirds said that the region they exported to most was the GCC, followed by Asia (see Figure 5.3).

Figure 5.3: Business Responses to Survey Question Four



One would expect that those GCC states that are least economically diversified, such as Qatar and Kuwait, would also be least integrated into regional trade. The results however revealed a slightly more complex picture. Those businesses that said the GCC was the region they exported to most were most frequently based in the UAE and Saudi Arabia, and to a lesser extent, in Oman (see Table 5.5). A sizable 56 percent of Omani business respondents saw the GCC as their most important export market again indicating that Oman has strong regional trade links. This finding was also strongly supported by the previous analysis of trade data (see Table 5.2). However, a large proportion (48 percent) of Kuwaiti businesses

⁶ Our survey questions did not distinguish between non-crude trade and total trade (including crude) however since only 8 percent of respondents were in the oil, gas or petrochemical sectors we can assume that virtually all survey references to intra-GCC trade signify non-crude trade.

also said that the GCC was the region they exported most to. This is somewhat surprising considering the fact that the majority of Kuwait's exports are crude oil and oil products which other GCC states, with the exception of Bahrain, do not import.⁷ In fact, as is consistent with our findings from the empirical trade analysis, the survey indicates that it is only Qatar which is currently not particularly well integrated in regional trade, with the lowest proportion of business respondents saying that they exported mainly to the GCC. However, as we shall discuss later in the thesis (in chapter eight), developments are taking place in the economy of Qatar which may substantially change this pattern and facilitate a much greater participation in intra-GCC trade for Qatari enterprises.⁸

The cross tabulation of the characteristics of those businesses that said they exported most to the GCC also shows that the majority were SMEs, with 84 percent of those businesses having less than 250 employees and 81 percent less than \$50mn annual turnover (see Table 5.5). There is no common definition for SMEs in the Gulf or the wider Middle East for that matter. As a reference point, SMEs in Europe are defined as businesses with up to 250 employees and an annual turnover of less than 50mn euros.⁹ It is generally considered to be the case that SMEs form the greatest part of the GCC community and therefore it is important that these businesses, which contribute significantly to private sector activities in the region, are also significantly involved in intra-regional trade.¹⁰

⁷ In 2004 93 percent of Kuwait's exports were crude oil, (see table 4.5, chapter 4)

⁸ It should be noted that Qatar may soon be exporting considerable amounts of its natural gas to Oman and Dubai via the Dolphin Project. Dubai alone will be supplied up to 700mn standard cubic feet of gas per day of Qatari natural gas for 25 years.

⁹ Calculated to be equivalent to approximately \$64mn on 17 May 2006.

¹⁰ According to one estimate, Small businesses in Saudi Arabia represented almost 93 percent of the total enterprises, and accounted for about 25 percent of total employment. See Sajini, Ismail I. "Effects of WTO on Small & Medium Enterprises" *Arab News*, 19 January 2004.

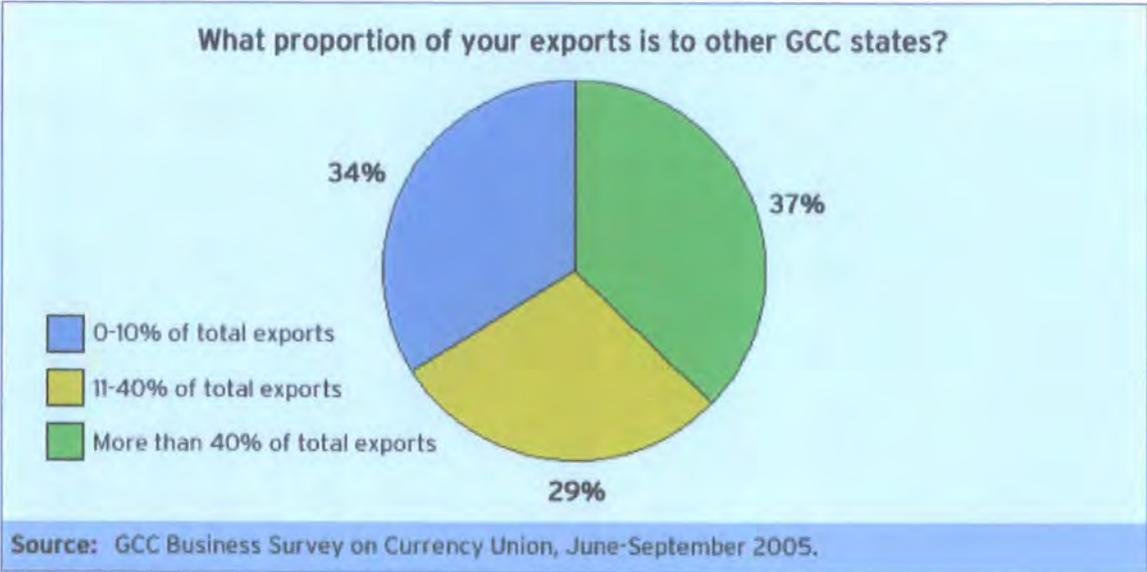
Table 5.5: Characteristics of Business Respondents Who Said They Exported Most to the GCC States

In which GCC state are you based?						
Bahrain	Kuwait	Oman	Qatar	SA	UAE	
6.8%	11.4%	15.2%	1.5%	31.8%	33.3%	
Approximately how many people does your company employ?						
Less than 10	11-50	51-100	101-250	251-500	501-1000	More than 1000
6.1%	39.4%	12.9%	25.8%	6.8%	3.0%	6.1%
Approximately what is the annual turnover of your business?						
Less than US\$ 1 mn	US\$1-10 mn	US\$ 11-50 mn	More than US\$ 50 mn		Unable to disclose	
9.1%	52.3%	19.7%	11.4%		7.6%	

Source: GCC Business Survey on Currency Union, June-September 2005.

When asked what proportion of their total exports were to other GCC states, 63 percent of respondents stated that this was greater than 10 percent and 34 percent stated that it was greater than 40 percent (see Figure 5.4).

Figure 5.4: Business Responses to Survey Question Five



The business respondents who said they exported most to other GCC states, (i.e. more than 40 percent of their total exports) were located most frequently in Saudi Arabia and the UAE (see Table 5.6). The proportion of business respondents that said they exported more than 10 percent to the GCC states was the lowest in Qatar. This was the case in the previous question and further indicates that businesses in Qatar are currently the least involved in intra-GCC trade.

Cross tabulating the responses to the question with the number of company employees showed that the companies with intra-GCC exports greater than 40 percent of total fell predominantly in the 101-250 employees size group (44 percent of respondents) (see Table 5.6). i.e. at the top end of the SME category. On the other hand, of the largest companies (more than 500 employees) only 13 percent sold more than 40 percent of their exports to other GCC countries. Similarly, examining those companies which exported between 11 and 40 percent to the GCC, here again, it is the 'larger' SMEs which are most likely to fall into this category (39 percent).

Table 5.6: Characteristics of Business Respondents to Survey Question Five

		In which GCC State are you based?					
		Bahrain	Kuwait	Oman	Qatar	SA	UAE
What proportion do you export to the GCC?	0-10%	14%	14%	11%	3%	32%	26%
	11% - 40%	6%	12%	13%	1%	39%	29%
	> 40%	5%	14%	12%	2%	42%	25%

		Approximately how many people does your company employ?						
		less than 10	11-50	51-100	101-250	251-500	501-1000	> 1000
What proportion do you export to the GCC?	0-10%	11%	52%	17%	6%	8%	3%	3%
	11% - 40%	4%	22%	11%	39%	12%	6%	6%
	> 40%	5%	17%	5%	44%	15%	5%	8%

		Approximately what is the annual turnover of your business?				
		Less than US\$ 1 mn	US\$1-10 mn	US\$ 11-50 mn	> US\$ 50 mn	Unable to disclose
What proportion do you export to the GCC?	0-10%	15.4%	64.6%	7.7%	9.2%	3.1%
	11% - 40%	4.6%	35.8%	40.4%	11.0%	8.3%
	> 40%	3.4%	22.0%	52.5%	13.6%	8.5%

Source: GCC Business Survey on Currency Union, June-September 2005.

This analysis of intra-regional trade, combining the responses to a GCC-wide business survey with empirical analysis of intra-regional trade data has revealed that intra-GCC trade is perhaps more significant and important for the GCC business community than originally thought. The survey results also indicate that for the GCC as a whole intra-GCC trade is particularly important for the larger SMEs in the region.

The balance of evidence presented above indicates that Intra-GCC trade is, however, more important for some GCC states e.g. Oman, UAE, and Bahrain, than for others, which will have implications for the distribution of costs and benefits arising from the scheduled CU. It is perhaps not surprising that trade linkages are particularly intense between two of the more diversified GCC states (UAE and Oman) because this is where complementarities for trade have arisen. However, the weakness of trade linkages between Saudi Arabia and the UAE, the two largest GCC economies, is an issue of concern which we will return to later on in this chapter (see section 5.6).

5.3 Labour Market Mobility

In a step towards creating a common GCC market, the GCC governments have enacted legislative reforms to facilitate the free movement of national labour regionally. But despite this, the degree of intra-GCC labour mobility is not particularly high. This is due to a combination of factors including structural, institutional and socio-economic constraints inhibiting the national labour force.

The GCC labour market is unusual in that 60 percent of the labour force are expatriates. Expatriate labour is highly elastic responding to economic shocks through inter-regional flows. However, the national labour force is much less mobile, not only within the region but within sectors of the GCC national economies, with nationals preferring public sector employment. As a result of rigidities in the national labour market, unemployment has emerged and is a serious concern for GCC leaders because of its political implications. However, policy measures introduced to address emerging national unemployment, such as

mandatory quotas for nationals in the private sector might potentially inhibit labour market mobility if they are enforced without concomitant improvements in the competitiveness of the national labour force.

In this section we will begin by examining the characteristics of the GCC labour force and its segmented nature. We will then discuss the socio-economic and institutional factors that are impeding the flexibility and mobility of the national labour force and have led to the emergence of national unemployment in most GCC states. Following this we will consider the legislative framework of the GCC labour market and the policy of nationalizing the workforce which is present in most GCC states. Finally we will attempt to assess the degree of intra-GCC labour mobility using the limited available data.

5.3.1 Characteristics of the GCC Labour Market

The GCC labour market is characterized by its segmented nature. The majority of workers in the GCC states are expatriates; non-nationals form the largest proportion of the total GCC labour force. Expatriates currently comprise between approximately 50 to 64 percent of the total labour force in Saudi Arabia, Qatar and Bahrain and between 70 and 90 percent in Oman, Kuwait and the UAE (see Table 5.7). Expatriate labour began to flow into the GCC states following the oil price boom in the seventies when national labour was scarce. Substantial low cost inflows of labour from the wider Middle East and Asia supported the GCC's rapid economic growth and transformation.¹¹

¹¹ For further details see Yousef, Tarik , "The Changing Role of Labor Migration in Arab Economic Integration" Georgetown University, February 2005, (Available at SSRN: <http://ssrn.com/abstract=793804>)

Table 5.7: Segmentation of GCC Labour Force

	National Workforce ('000)			Expatriate Workforce ('000)			Total Labour Force ('000)
	Public Sector	Private Sector	Sub Total	Public Sector	Private Sector	Sub Total	
Bahrain	32.24	63.27	95.52	3.3	166.14	169.43	264.94
%	33.8%	66.2%	36.1%	1.9%	98.1%	63.9%	
Kuwait	246	17	263	85	1,053	1,138	1,401
%	93.5%	6.5%	18.8%	7.5%	92.5%	81.2%	
Oman	104.14	87.1	191.2	22.89	424.32	447.21	638.41
%	54.5%	45.5%	30.0%	5.1%	94.9%	70.0%	
Qatar	32.74	3.11	35.85	* 29.3	14.9	44.19	80.04
%	91.3%	8.7%	44.8%	66.3%	33.7%	55.2%	
SA	652.94	2,495.79	3,148.72	75.05	3,017.88	3,092.93	6,241.6
%	20.7%	79.3%	50.4%	2.4%	97.6%	49.6%	
UAE	102	9.0	111	* 270	684	954	1,065.
%	91.9%	8.1%	10.4%	28.3%	71.7%	89.6%	
GCC	1,170.1	2,675.24	3,845.29	485.5	5,360.25	5,845.76	9,691.1
%	30.4%	69.6%	39.7%	8.3%	91.7%	60.3%	

Source: Compiled by author from various sources¹²

The labour market is segmented in several ways, between national and expatriate workers, public and private sector employees and high-skilled and low skilled labour. The private sector employs the majority of expatriates in the economy, of the total expatriate labour force, 92 percent are employed in the private sector (see Table 5.7). Traditionally, the GCC public sector has been the principal employer of nationals and in some GCC states as much as 94 percent of the national labour force holds public sector jobs (see Table 5.7). There are, however, considerable differences between GCC states with three countries – Bahrain, Oman and Saudi

¹² Data for Bahrain and Kuwait is 2003, source EIU Country Profiles. Data for UAE is 1995 census data. Data source for Oman is Central Bank of Oman Annual Report 2004, data for 2004. Data source for Qatar is Qatar Central Bank Annual Report 2004, data for 2003 and data for Qatar's private sector includes Mixed Sector employees. Data for SA is SAMA Annual Report and Ministry of Labour, 2002.

Arabia – having a much larger participation of the national (i.e. indigenous) workforce in the private sector.

The expatriate labour force is, in contrast to that of the national work force, inherently flexible. A pool of abundant labour exists in Asia, in particular from populous countries such as India, Pakistan and the Philippines from where at least 55 percent of expatriate workers in the GCC arrive.¹³ This migrant labour is relatively cheap as it is available at international prices and forms a highly elastic supply of labour. Work in the private sector is characterised by less secure employment, fixed term contracts, longer working hours, and is relatively easy for businesses to hire and fire. Therefore, following an economic shock, such as an oil price collapse, immigrant labour flows respond quickly and therefore cyclical unemployment in the private sector has not been a problem for the GCC states. During the ongoing oil price boom (2002 to present) wages in the private sector have not risen at anywhere near the rate of inflation in the goods and asset markets. This is particularly the case in Dubai and Qatar, and indicates that labour is very flexible in that an influx of expatriates – seeking new job openings resulting from the economic boom – has resulted in downward wage pressure.¹⁴

It is generally considered that the public sector provides salaries and other benefits at a premium to that on offer in the private sector.¹⁵ As 'rentier' states the distribution of oil wealth through the provision of inflated public sector salaries unrelated to productivity for all nationals came to be expected as a basic right by GCC citizens. In several GCC states the right to employment was enshrined in legislation and translated into guaranteed public sector jobs for nationals.¹⁶ In fact, extensive under-employment of nationals in the economy, particularly in the public sector, has caused labour productivity growth by some calculations to be negative

¹³ Girgis, M. "National Versus Migrant Workers in the GCC: Coping with Change" Mediterranean Development Forum Labor Workshop, Cairo, 5-8 March 2000.

¹⁴ In fact, in Dubai, there have been some concerns that the cost of living is outpacing wages and may make the UAE less attractive for expatriate labour, see Constantine, Zoi, "Dubai ranks 25th among world's expensive metros" *Gulf News*, 27 June 2006.

¹⁵ Sassanpour, *op. cit.*

¹⁶ *Ibid.* p.33

in the GCC economies.¹⁷ The dominance of the public sector in these economies has previously created strong preferences among nationals for public sector work but expectations about obtaining a public sector position have become unrealistic.

During the 1990s the public sector wage bill was consuming more than 50 percent of annual oil revenues in some GCC countries.¹⁸ Today the share of the public sector wage bill in total government expenditure is likely to be much less due to the rise in the oil price, however it still constitutes a significant share and there remain serious doubts as to whether the large number of nationals 'employed' in the public sector is sustainable.

The high levels of GCC national population growth¹⁹ have generated a population pyramid profile with a high proportion of the GCC population, an estimated average of 29 percent, currently under the age of fifteen compared with just 17 percent in the EMU countries (see Figure 5.5). In Saudi Arabia and Oman the proportion is higher than the average, with 38 percent and 35 percent respectively. In recent years new entrants to the labour market have been estimated at 210,000 annually.²⁰ Fiscal consolidation throughout the late nineties led to efforts to streamline public sector employment and improve efficiency which eventually translated into reduced employment opportunities for nationals. With nationals unable to compete successfully with expatriate labour however unemployment among GCC nationals has become a major concern in most GCC states and is estimated to have reached an aggregate 17.8 percent of the GCC national labour force.²¹

¹⁷ Dasgupta, D., Keller, J. and Srinivasan, T.G. "Reform and Elusive Growth in the Middle-East - What Has Happened in the 1990s." Paper for MEEA Conference on Global Change and Regional Integration: The Redrawing of the Economic Boundaries in the Middle East and North Africa, London, 20-22 July 2001.

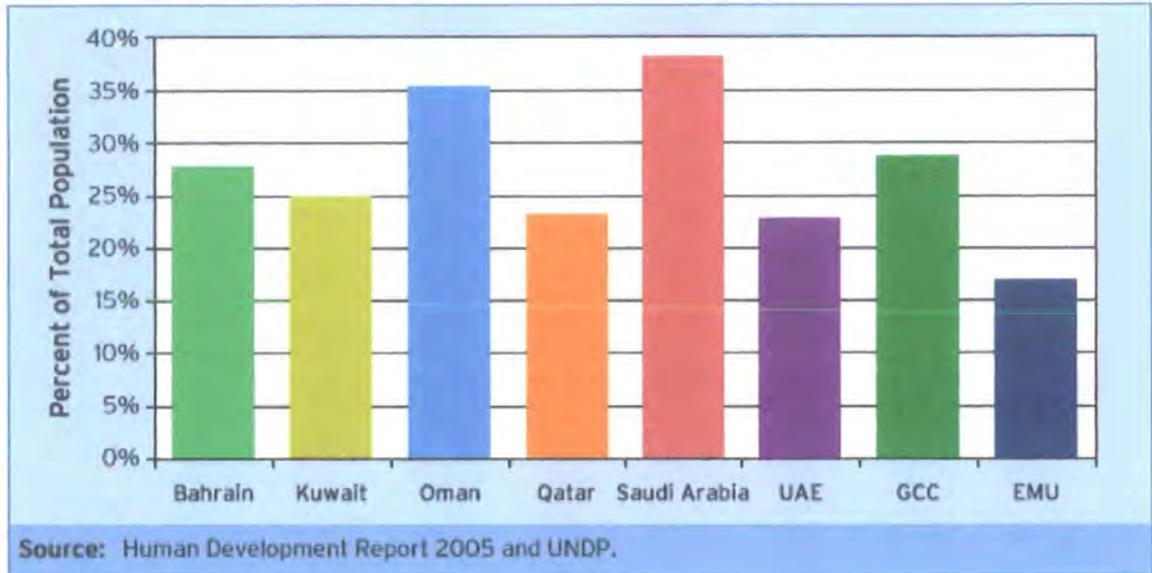
¹⁸ Girgis, Maurice "National Versus Migrant Workers in the GCC: Coping with Change" Mediterranean Development Forum Labor Workshop, Cairo, Egypt, p.4, 5-8 March 2000,

¹⁹ With each GCC state's annual population growth averaging above 3 percent between 1980 and 1999, see chapter 4, table 4.4.

²⁰ Girgis, Maurice "The GCC Factor in Future Arab Labour Migration" Fourth Mediterranean Development Forum, Amman, p.35, October 2002.

²¹ Girgis, Maurice "National Versus Migrant Workers in the GCC:Coping with Change" Mediterranean Development Forum Labor Workshop, Cairo, Egypt, 5-8 March, 2000.

Figure 5.5: Share of GCC Populations below Age of Fifteen, 2003



National unemployment data for the GCC states is scarce and due to its political nature official estimates cannot be relied upon.²² In Saudi Arabia for example, the level of unemployment varies considerably depending on the source.²³ The extent of national unemployment undoubtedly varies across the GCC states. For example, it is highest in Bahrain, Saudi Arabia and Oman where population pressures have outpaced the growth of national income until recently. Independent estimates put unemployment at 17.2 percent in Oman, 15.2 percent in Saudi Arabia²⁴ and between 12-15 percent in Bahrain.²⁵ In Qatar however, there is very little, if any, open employment²⁶ and in Kuwait and the UAE the problem is still an emerging one.

²²In 2005 there were demonstrations in Bahrain about unemployment where citizens and police clashed. See Staff Writer "Bahrain king warns against politicising unemployment", *Reuters*, 4 July 2005.

²³ Estimates of unemployment in Saudi Arabia for example have ranged from 10 percent to 30 percent of the national working age population, see staff Writer "Tackling Unemployment In Saudi Arabia Is National Priority, Says Qusaibi" *Middle East Economic Survey*, Volume 48, Issue 5, 31 January 2005.

²⁴United Nations, 2002, *Arab Human Development Report 2002*, United Nations Development Programme, New York.

²⁵Sassanpour, *Op.Cit.*

²⁶*Ibid.*

5.3.2 Socio-Economic and Institutional Factors

A number of socio-economic and institutional factors have created rigidities in the national workforce that cannot be easily changed in the short term. As a result of the incentives biasing nationals towards work in the public sector, great esteem is placed on these jobs which are now in short supply. The attractiveness of public sector jobs was illustrated when, in April 2006, more than ten thousand Saudi nationals from all across the Kingdom descended on Riyadh to apply for the five hundred job vacancies in the Passport Department in Riyadh, and caused riots when they became frustrated with the application process.²⁷

In addition to the general unwillingness to work in the private sector on the part of nationals, they are also less attractive for private sector businesses to employ. For example, the Emiratization process set quotas for the minimum level of nationals a banking institution must employ. However, according to a *Tanmia* report in 2005, the UAE's National Human Resource Development and Employment Authority, almost three quarters of all banks had not met the quotas; and the insurance sector was doing even worse in this regard. However, as yet the Government has not penalized any private companies for non-compliance.²⁸

Tanmia also found that 27 percent of nationals that were given a job in a private bank left within six months and on average Emiratis spent only 19 months with the bank compared to more than 60 months for the average expatriate.²⁹ Banks reported a range of problems including their policy of a six day week, escalating salary demands and insufficiently qualified and motivated applicants. The absence of quota enforcement and lack of incentives for private sector businesses to hire nationals has meant so far that labour force nationalization policies are not meeting their targets.³⁰

²⁷Staff Writer "10,000 Turn Up for 500 Job Vacancies" *Arab News*, 21 April 2006.

²⁸Rutledge, E. "Are the GCC's labor nationalisation policies working?" *Araa Magazine*, Gulf Research Center, Dubai, July 2005.

²⁹Tanmia, UAE Human Resources Report 2005, Dubai, UAE.

³⁰Staff Writer "80,000 companies flouting emiratization laws" *Gulf News*, 21 August 2005

Expatriate labour has tended to fill both the unskilled and highly skilled jobs in the GCC economies, with GCC nationals often filling administrative and clerical positions. Unless nationalization policies are to substantially downgrade the economic welfare of nationals, replacement of expatriates will need to take place at higher skill levels. However, GCC educational institutions have often produced graduates with knowledge and skills unable to meet private sector needs and consequently there is a mismatch between the demand and supply of skills. Educational institutions have also neglected to provide sufficient technical and vocational training courses. The number of university students studying business and science degrees is only 5 and 10 percent of total GCC students respectively, while the proportion studying Art subjects, including Islamic Studies, is substantially higher at 49 percent of total students.³¹ Therefore, most graduates lack the educational and vocational skills needed to compete for jobs in the private sector.

Saudi Arabia will need more than 20,000 engineers and 300,000 technical and trades people by the year 2010, according to Mohammad A-Ba'thi, Vice-President of Corporate Human Resources at the Saudi Basic Industries Corporation (SABIC). According to the SABIC Vice-President, students graduating in engineering in the Kingdom account for less than 10 percent of the annual university crop. Al-Ba'thi went on to say that of the total 100,000 national students graduating from colleges and universities in the country and abroad, only about 20,000 graduate from technical and vocational institutes.³²

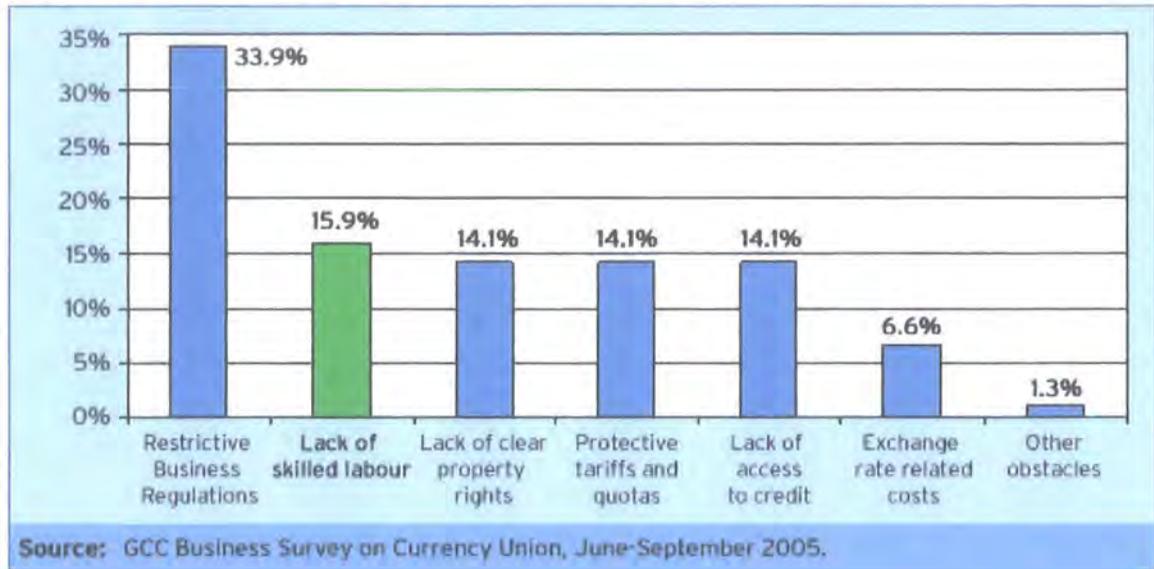
A suitable supply of appropriately skilled labour is essential to raise private sector income relative to the public sector and achieve the common GCC policy objective of increasing the role of the private sector. In addition, only with a significant improvement in the national skill levels will many private sector economic activities become viable and further the policy aim of economic diversification. With the policy of quotas in place across the GCC the national workforce will have to obtain relevant transferable skills that are matched to the demand of the private sector. In

³¹ Figures are for 1998/1999, ESCWA "Responding to Globalization: Skill Formation and Unemployment Reduction Policies" United Nations, New York, p. 47, 2003.

³² Staff writer "Saudi needs professionals" *Khaleej Times*, 24 May 2006

fact, when the views of GCC businesses were surveyed as to the main obstacle to the future growth of their business, the second largest proportion, 16 percent, considered a 'Lack of skilled labour' to be most important (see Figure 5.6).

Figure 5.6: Business Views on the Obstacles to the Growth of their Business



Having identified skills accumulation as a potential obstacle to increasing national employment in the private sector, the GCC governments are in the process of reforming their educational curricula. Technical and vocational colleges are also being established providing courses with a practical approach suited to service sector economy where an average of 74 percent of the GCC labour force is employed.³³ For example, in Saudi Arabia's 2006 budget plan funds were allocated for the establishment of three new technical colleges and 15 vocational training centres.³⁴ But it will take at least a generation for the appropriately skilled nationals to replace high-skilled expatriates and in the short term there will be little alternative but continued reliance upon expatriate labour in certain fields and professions.

³³ AMF, *Al-Taqrir al-Iqtisadi al-Arabi al-Muwahhad*, The Unified Arab Economic Report, September 2003.

³⁴ SAMBA, *Saudi Arabia's 2006 Budget, 2005 Economic Performance*, 16 December 2005 (Accessed at: <http://www.saudi-us-relations.org/articles/2005/loi/051216-budget-samba.html>)

5.3.3 Legislative Framework

The GCC leaders have already gone a long way to removing barriers to intra-GCC labour mobility and have enacted legislation to facilitate this. In the GCC Economic Agreement of 1981, Articles Eight and Nine allowed for the equal treatment of GCC citizens with regard to freedom of work, residence, ownership, inheritance and undertaking economic activities across the member states.³⁵ The 2001 Economic Agreement went much further and Article 3 stipulated that equal treatment of GCC citizens would be allowed across the GCC states in both the private and public sectors as well as in terms of pensions, social security, and health and education provision.³⁶

Several steps have been taken to implement these policies. At its 24th summit in 2004 the GCC leaders agreed to extend social security and civil service retirement to those GCC nationals working in other GCC states, irrespective of whether they work in the public sector or the private sector. A deadline for 2010 was set for completing a unified system which would guarantee all GCC nationals their pension and social security.³⁷ At present there is no social security or pension provision for GCC nationals working in the private sector and no legislation to ensure private sector employers provide pensions.

In time GCC citizens will be able to move and work in other GCC states without foregoing important benefits such as social security and pensions, which will remove a significant disincentive to labour mobility. However, there are currently no plans to extend benefits such as land grants, subsidized building loans and marriage grants which are only available to nationals residing in their own country.³⁸ Other efforts to increase intra-GCC mobility include allowing the use of

³⁵GCC Secretariat General "Unified Economic Agreement", (Available at: www.gcc-sg.org), GCC, Kingdom of Saudi Arabia, Riyadh, 1981.

³⁶GCC Secretariat General "The Economic Agreement", (Available at: www.gcc-sg.org), GCC, Kingdom of Saudi Arabia, Riyadh, 2001.

³⁷Badr-El-Din A. Ibrahim "Intra-National Labor Mobility Between Arab Gulf Cooperation Council (AGCC) States –Towards Activating AGCC Economic Integration Process and Optimizing Human Resources Exploitation." Economic Research Forum, 12th Annual Conference, Cairo, December 2005. P.16.

³⁸Interview with Dr. Belkacem Laabas, Economist, Arab Planning Institute, Kuwait, 19/06/05.

civil identification (ID) cards for movement between GCC states rather than passports. Adopting the use of ID cards has been agreed in principle but implementation of the system in some GCC states has been delayed due to failure to complete the technical requirements.³⁹

5.3.4 Labour Nationalisation Policies

GCC leaders have adopted a mixture of policies to deal with unemployment. But the main approach has been to implement a mandatory policy of nationalising the workforce which, having been applied to the public sector, is now focused on the private sector. At the 21st GCC summit, all the GCC leaders agreed to a policy of reducing foreign workers gradually and setting quotas for national employment in the private sector as well as increase taxes on expatriate recruitment.⁴⁰ At a GCC Labour and Social Affairs Ministers Council meeting in 2005, the Bahraini labour minister Dr. Majeed Al Alawi stressed the need for the GCC states to work collectively on reducing national unemployment, he said "There is also an urgent need for a unified approach to solving unemployment and other labour issues facing the region" and went on to say that "we will discuss ways of making it easier for GCC nationals to find jobs in other countries in the region".⁴¹

In chapter four (section 4.3.2) the labour nationalization policies in place in Bahrain, Oman, Saudi Arabia and the UAE were discussed. In these GCC states nationalization quotas are imposed on private sector establishments and expatriates are banned from working in certain professions and sectors. For example, in Saudi Arabia the 2006 Labour Law raised the rate of Saudization of jobs in certain companies to 75 percent,⁴² employment of expatriates in 25 sectors and professions, for example in gold and jewelry shops, grocery stores and the travel industry has also been banned.⁴³ In Oman, Omanisation quotas are imposed

³⁹Staff Writer "GCC smart card deadline looms" *Khaleej Times*, 13 July, 2005

⁴⁰ESCWA "Responding to Globalization: Skill Formation and Unemployment Reduction Policies" United Nations, New York, 2003.

⁴¹Staff Writer "GCC labour reforms call" *Gulf Daily News*, 23 November 2005.

⁴²Abdul Ghafour P.K. "Saudization Quotas Eased for Some Job Categories" *Arab News*, 2 April 2006.

⁴³Staff Writer "Saudiisation begins to pinch expats" *Reuters*, 12 March 2004.

across six sectors and also in several occupations such as cashiers, drivers, and security officers.⁴⁴

In the UAE, quotas are in place in the banking and insurance sectors, in addition expatriates are banned from working in certain administrative positions including Public Representative Officers, Human Resource Officers and Secretaries.⁴⁵ In Kuwait, a ceiling of 35 percent of expatriates is in place in the public sector and several professions are closed to expatriates.⁴⁶ In Qatar there are currently no labour quotas in place, although priority is given to nationals in public sector employment.

In addition to the mandatory policy of setting quotas across the GCC states other market based measures are being implemented, such as increasing the recruitment fees for expatriates to addressing attitudes to work and productivity through public media campaigns.

However, through replacing expatriate labour in the private sector with nationals, the GCC governments have been criticized for jeopardising the GCC's economic competitiveness.⁴⁷ Furthermore, if the nationalisation policies achieve some success then the GCC labour markets are likely to become less flexible and mobile, unless considerable socio-economic transformations occur at the same time.

Mandatory policies such as labour quotas create market distortions and inhibit the existing flexibility of the GCC labour force. The alternative is a market based approach which realigns the incentives for working in the public sector with that of the private sector. Such policies limit constraints on the labour market and are

⁴⁴ Staff Writer "Breathing space – Oman Economy", *Middle East Economic Digest*, 28 May 2004.

⁴⁵ Janardhan, Meena "UAE: Required hometown hiring knocks Expats out of key jobs" 9 March 2006 (Accessed at <http://www.globalinfo.org>)

⁴⁶ Shah, Nasra M. "Restrictive Labour Immigration Policies in the Oil-Rich Gulf: Effectiveness and Implications for Sending Asian Countries" United Nations Expert Group Meeting on International Migration and Development in the Arab Region, Beirut, p.10, 15-17 May 2006.

⁴⁷ Looney, R.E. "Saudization and Sound Economic Reforms: Are the Two Compatible?" *Strategic Insights*, Volume III, Issue 2, February 2004.

likely to be more successful in dealing with long standing structural rigidities and institutional failures that to date have impeded the mobility of the GCC labour force. Measures such as the expansion of social security and pension coverage to nationals in the private sector should be beneficial in this respect, but will need to be implemented as soon as possible to begin to take effect. In addition, encouraging and supporting the growth of SMEs will create employment and can provide nationals with managerial and professional opportunities.⁴⁸ Educational reforms will also be key to improving the competitiveness of GCC nationals but will take time to be felt.⁴⁹

5.3.5 Evidence on Intra-GCC Labour Mobility

So far, however, it appears from the incomplete data that intra-GCC labour mobility has been very limited. Figures on intra-GCC labour flows have not been systematically collected in the past, possibly because of the limited movements. It appears though that a comprehensive process for collecting this data is now underway. The GCC Public Social Insurance Authorities have begun collecting information about all nationals working in the GCC states in preparation for the move towards extending social security and pension provision to those GCC nationals working in other member states.⁵⁰

To collect reliable data however will, to a certain extent, depend on active engagement on the part of GCC nationals working in states other than their own. For instance, in 2005 the Public Authority of Social Insurance in Oman circulated notices to alert all non-Omanis to contact them as part of this process. The initial response was almost unbelievably low with only four people working in the private sector registering.⁵¹ This lackluster response is likely to change once GCC citizens become aware of their pension rights and entitlements. Some GCC states have also set up employment offices in other member states to facilitate the employment

⁴⁸Girgis, Maurice "National Versus Migrant Workers in the GCC: Coping with Change" Mediterranean Development Forum Labor Workshop, Cairo, Egypt, 5-8 March, 2000.

⁴⁹ Rutledge, E. "Education, Not Quotas" in *Emerging Dubai 2006*, Oxford Business Group, 2006.

⁵⁰Badr-El-Din *Op.Cit.* P.17.

⁵¹*Ibid.* P. 17

of their nationals. For example, Oman has established a labour office in Qatar to facilitate the recruitment of Omani nationals there.⁵²

In addition to this, figures on the number of licenses granted to GCC citizens for setting up economic enterprises in other member states are also currently negligible (see Table 5.8). Furthermore, since 1992 the number has grown only by a CAGR of 3 percent on average across all the GCC states.

Table 5.8: Licenses Granted to GCC Citizens to Practice Economic Activities in Other Member States

	1992	2003	% Change
Bahrain	233	260	0.9%
Kuwait	372	1157	9.9%
Oman	107	159	3.4%
Qatar	208	215	0.3%
SA	740	936	2.0%
UAE	2531	3384	2.4%
GCC	4191	6111	3.2%

Source: GCC Secretariat, GCC Achievements in figures 2003 (Available at: www.gcc-sg.org/)

Overall, employment legislation in the GCC states is considered to be relaxed, in particular with regard to the expatriate work force. Trade Unions are illegal in most GCC states,⁵³ there is no minimum wage and the hiring and firing of expatriates is considered relatively easy.⁵⁴ This is reflected in the World Bank Rigidity of Employment Index, which illustrates that the GCC states have an average employment rigidity index of 25 significantly less than that of the Eurozone countries at 48 (see Table 5.9).

⁵² *Ibid.* P.18 Bahrain has also inaugurated two employment units to help secure employment for Bahrainis in other GCC states.

⁵³ Although following pressure from the US Bahrain and the UAE have recently agreed to allow expatriate workers to set up trade unions as this was a key US condition for a bilateral FTA. See Staff Writer "UAE to allow unions for expats" *Saudi Gazette*, 23 January 2005.

⁵⁴ Except in Oman where there are minimum wages for Omanis with certain skills. Sassanpour, C., Joharhi, G. Kireyev, A. and Petri, M "Labour Market Challenges and Policies in the Gulf Cooperation Council Countries" IMF, Washington D.C, November 1997, p. 33.

Table 5.9: Labour Regulation Flexibility

Hiring and firing workers	Kuwait	Oman	SA	UAE	GCC	EMU
Difficulty of hiring index (0–100)	0	44	0	0	11	40
Rigidity of hours index (0–100)	60	60	40	80	60	65
Difficulty of firing index (0–100)	0	0	0	20	5	38
Rigidity of employment index (0–100)	20	35	13	33	25.2	48
Hiring cost (% of salary)	11	9	11	13	11	28
Firing cost (weeks of salary)	42	13	79	96	57.5	45
Ease of hiring and firing (rank)	26	33	28	73	40	n.a.

Source: World Bank, *Doing Business in 2006: Creating Jobs*, Country Data Profile

Note: Data for Bahrain and Qatar are not available. Higher values in the table indicate more rigid regulations.

Yet while the hiring and firing of expatriate labour is straightforward for businesses, there are many restrictions on the intra-GCC movement of non-nationals. For example, expatriate labour is often not allowed to transfer between employers even within the same state. In order to move between jobs expatriates, in some cases, have to return to their home country first and then re-enter the GCC state after a period of time, in others there are complete bans on job transfers. However, following reflection on these draconian labour restrictions, there have been some improvements by certain GCC states to facilitate expatriate mobility regionally.⁵⁵

The UAE, Oman and Saudi Arabia have somewhat eased constraints on expatriate labour mobility by removing bans and allowing transfer of sponsorship either for a fee or after a period of time, and other mobility improvements for high-skilled expatriates.⁵⁶ In 2004 Saudi Arabia passed a law allowing certain expatriates to become nationals.⁵⁷ Reforms are also being considered involving the lifting of travel restrictions between GCC states for expatriates. This measure is however,

⁵⁵ In order to become more consistent with ILO standards, see staff writer "ILO concerned about Gulf working conditions" *Arab Times*, 6 November 2005.

⁵⁶ Saudi Arabia allows transfer of sponsorship subject to certain conditions, as does Oman subject to sponsor approval. In the UAE all categories of workers can transfer sponsorship, subject to original sponsor approval but only under certain conditions.

⁵⁷ Staff Writer "Expatriates Welcome New Citizenship Law" *Arab News*, 20 October 2004.

aimed at increasing intra-GCC tourism rather than any meaningful attempt to increase expatriate labour mobility within the region and is likely to apply only to professionals.⁵⁸

These rather weak moves towards intra-GCC labour mobility are despite the fact that following CU the GCC economies would benefit from a flexible regional pool of labour particularly in the face of asymmetric shocks. Furthermore, skilled labour may be more inclined to migrate to the region if they were allowed to move between jobs regionally and the issuance of a single GCC work permit would also streamline GCC bureaucracy.⁵⁹ However, at present, the GCC states can source their labour directly from South Asia without any difficulty and this will be the case for the foreseeable future.⁶⁰

5.4 Capital Market Integration

Initially OCA criteria did not specifically cover or consider the role of risk sharing, portfolio diversification or capital market integration, but a decade after the original theories were conceived they were broadened to factor in these considerations.⁶¹ Mundell argued that a high degree of capital market integration would allow CU members to hold claims on each other's output⁶² and insure against asymmetric shocks. If one member was hit by an economic downturn the income from capital assets held in other member states not suffering from the negative shock, would offset the decline in domestic income, allowing for consumption smoothing and providing a form of insurance. Thus a pivotal role for financial market integration exists in adjusting to macroeconomic disturbances and the smooth functioning of an OCA.

⁵⁸ Staff Writer "GCC to facilitate travel of expatriate workers" *Arab News*, 26 June 2005.

⁵⁹ If and when this process was established it would mean that the same rules and procedures would apply across the GCC states, thus improving efficiency of the process.

⁶⁰ In the long term, with economic development in India and China the factor cost of labour will eventually increase and Asian labour may be less inclined to migrate, at such a time the GCC states may have to offer more attractive terms of employment for expatriate labour.

⁶¹ Mundell, R. A., Uncommon Arguments for Common Currencies, In *The Economics of Common Currencies*, eds. H.G. Johnson and A.K. Swoboda, pp114-132, 1973.

⁶² For instance equity shares, dividends, interest payments and rental revenues.

In this section we will discuss the degree of capital market integration within the GCC focusing in particular on the region's equity markets, corporate bond markets and intra-regional FDI. GCC stock markets have seen rapid growth over the past five years; which to no small degree has been correlated with the higher oil prices. At present, other asset markets in the GCC states, such as debt markets, are comparatively underdeveloped but the growing trend of *sukuk* (Islamic security) issuance and the trading of *sukuks* in secondary markets is a noteworthy development that we shall discuss in detail in the second part of this section. Finally in this section we will examine intra-GCC FDI which up until 2003 had been rather weak, but more recently, there has been an increasing number of large intra-GCC FDI projects, a trend which is not yet reflected in available data.

However, before we embark on this subject it will be useful to briefly outline the legislative background of intra-GCC capital market mobility. Article five of the GCC Economic Agreement of 2001 stipulated for the allowance of cross border investments without barriers. The GCC states agreed to:

- Unify all their investment-related laws and regulations.
- Accord national treatment to all investments owned by GCC natural and legal citizens.
- Integrate financial markets in member states, and unify all related legislation and policies.
- Adopt unified standards and specifications for all products, according to the Charter of the GCC Standardization and Metrology Organization.⁶³

At the 23rd GCC summit in Doha in 2002 the GCC leaders agreed to establish a GCC common market as soon as possible⁶⁴, and ensure the equal treatment of GCC citizens in all economic activities, including investments. The Doha summit resolution has taken several years to be implemented in some GCC states and

⁶³ GCC Secretariat General, 2001, "The Economic Agreement" (Available at: www.gcc-sg.org), GCC, Kingdom of Saudi Arabia, Riyadh.

⁶⁴ GCC leaders are reportedly committed to forming a Common Market by the end of 2007, see Staff writer "GCC delays approval for currency union plan" *Saudi Gazette*, 20 October 2005.

progress on fulfilling Article Five has been mixed. In particular, as we shall see, advancement in harmonising stock market rules and regulations across the GCC states has been rather limited. We examine the degree of integration between the region's stock markets by looking at legislative reforms governing GCC investors which have removed the legal barriers to regional portfolio diversification, as well as actual integration indicators such as the number and growth of cross listings.

5.4.1 Stock Markets

In the past the vast share of GCC capital had been held outside of the region, particularly in US assets and the region's markets were not seen as attractive to GCC nationals. For instance, throughout the nineties, the performance of the GCC markets was poor with the market capitalisation of Saudi Arabia's Tadawul Index growing just 30 percent between 1989 and 1999.⁶⁵ Apart from the preference of placing surplus capital outside of the region (in mature markets which conventionally were seen as safe havens) the experiences of Kuwait's *Souk Al Manakh* crash had also deterred locals from investing regionally.

However, between 2000 and 2005 GCC stock market capitalisation increased ten fold⁶⁶ fuelled mainly by excess liquidity due to high oil prices and a home bias for investments following the terrorist attacks of 9/11 and the freezing of some Arab investments in the US. The stock market boom has significantly increased the role of capital markets in the region and therefore the potential macroeconomic benefits of intra-regional portfolio diversification. Indeed the GCC represented the largest emerging market in 2005.⁶⁷ The stellar performance of the GCC stock markets between 2004 and early 2006 encouraged wide spread participation of GCC citizens in stock trading and increased the number of partial floatations of previously family owned and public sector organisations. Regional investors have

⁶⁵ Neaime, Simon "Liberalization and Financial Integration of MENA Stock Markets" A paper prepared for presentation at the Economic Research Forum's 9th Annual Conference on "Finance & Banking" held in Sharjah, United Arab Emirates, 26-28 October 2002.

⁶⁶ Combined market capitalization was \$119bn at the end of 2000 and \$1.1 trillion at the end of 2005, according to AMF, Kai'da Bayanat Aswaq Al-Awraq Al Malia Al Arabia Al Nasrat Al Faslia, Q4 2005.

⁶⁷ In terms of market capitalization.

developed a strong preference for equity based investments which have undoubtedly outperformed other asset classes such as bonds in the last few years.

In 2005 each GCC stock market recorded excellent year on year growth, average stock market growth in the region was 79 percent and the best performers were the Dubai Financial Market (DFM) and the Saudi Tadawul Index (see Table 5.10). The increasing numbers of Initial Public Offerings (IPOs) in 2005 also helped to attract wide spread interest from national investors.⁶⁸ Participation in the gains of the stock market by small scale retail investors was readily encouraged and banks were allowed to leverage investors for the purpose of buying stocks. It was estimated that in Saudi Arabia more than 50 percent of the entire population were investing in the Tadawul market in 2005.⁶⁹ In contrast to developed western stock markets, institutional investors play a very minor role in the GCC markets compared with small retail investors.

⁶⁸ In 2005 regional IPO's raised over \$5.5bn compared to \$3.9bn raised in 2004.

⁶⁹ Ahmad, Mahmoud "Stock Mania Adds to Delays in Government Office" *Arab News*, 11 May 2005.

Table 5.10: GCC Stock Market Indicators, End of 2005

	YoY Index Growth	Market Cap (\$bn)	Market Cap as % GDP	Number of Shares Traded (Min)	Listed Companies	YoY Listings Growth
Bahrain Stock Exchange (BSE)	24.9%	17.567	164%	458	45	0%
Kuwait Stock Exchange (KSE)	78.3%	133.056	261%	52,201	159	27%
Muscat Securities Market (MSM)	41.2%	10.786	48%	452	125	2%
Doha Securities Market (DSM)	77.7%	89.643	298%	1,033	30	0%
Tadawul Stock Market	107.0%	653.157	246%	12,281	77	5%
Dubai Financial Market (DFM)	149.4%	113.776	106%	25,541	60	71%
Abu Dhabi Securities Market (ADSM)	71.0%	123.29	114%	8,316	30	67%
GCC	78.5%	1,141.28	234%	100,283	526	17%

Source: Kai'da Bayanat Aswaq Al-Awraq Al Malia Al Arabiya Al Nasrat Al Faslia, Q4 2005, No. 44, Arab Monetary Fund, Abu Dhabi.

In most GCC states up until very recently, GCC nationals were only allowed to trade and own shares in other member states in specified stocks. In 1985 the proportion of GCC shares permitted for GCC nationals to trade and own was only 25 percent of the total number of GCC stock companies listed, however by 2003 this had risen to almost two thirds of the total (see Table 5.11). Only in Kuwait, the longest established GCC stock market, and Bahrain, have GCC nationals been permitted to invest in any stock on the national bourse for several years. In 1999, the Bahraini government lifted restrictions on foreign ownership, allowing GCC nationals to own up to 100 percent of the shares of listed Bahraini companies (up from 49 percent previously), giving them full access to the Bahraini market.⁷⁰ In order to meet the Doha summit resolution, in 2005 Saudi Arabia granted equal treatment of GCC citizens in trading Saudi stocks, including those in banking,

⁷⁰ Information from Bahrain Stock Exchange (Accessed at <http://www.bahrainstock.com>)

insurance and real estate sectors.⁷¹ In late December 2005 the UAE's Financial Regulator, the Emirates Securities and Commodities Authority (ESCA), also ratified a decision to treat GCC nationals as locals on Emirati stock markets. The advent of the Dubai International Financial Exchange (DIFX) has however allowed all nationalities to invest in any listed company. In Qatar and Oman GCC nationals are permitted to own and trade shares in approximately 36 percent and 62 percent of the total number of stocks listed respectively (see Table 5.11).

Table 5.11: Stock Companies Permitted for GCC Nationals to Trade and Own

	1985			1995			2003		
	No. Stock companies	No. Stock Companies open to GCC nationals	% Share	No. Stock companies	No. Stock Companies open to GCC nationals	% Share	No. Stock companies	No. Stock Companies open to GCC nationals	% Share
Bahrain	23	16	70%	34	34	100%	35	35	100%
Kuwait	33	1	3%	41	41	100%	40*	40*	100%
Oman	24	6	25%	75	66	88%	173	108**	62%
Qatar	10	-	-	29	3	10%	28	10	36%
SA	43	3	7%	88	76	86%	105	94**	90%
UAE	37	16	43%	76	34	45%	97**	19**	20%
GCC	170	42	25%	343	254	74%	478	290	64%

Source: Adapted from GCC Secretariat, Achievements in Figures 2004, Riyadh (Available at: http://www.gcc-sg.org/achievement_stat2004/start.html)

Notes: *1998 **2001

Despite legislating to permit nationals from other GCC states to invest in their secondary national markets, there are obstacles in the primary markets that currently reduce intra-regional capital market investments. To date, applications for IPOs have had to be processed in person which is hugely inefficient. This has meant that GCC nationals wishing to participate in an IPO in another GCC state have had to physically travel to that state in order to do so. There is clearly much regional investor interest in IPOs in other GCC states, for example, in 2005

⁷¹ Abdul Ghafour, P.K. "Saudi Arabia gives equal treatment for share trading" *Arab News*, 5 April 2005.

newspapers reported plane loads of Saudis descended on the UAE for the IPO of Dana Gas, "Tens of hundreds of investors continue to rush into the UAE from Saudi Arabia, Qatar and Bahrain mainly to apply for the shares, creating a virtual stampede in receiving banks."⁷² Electronically linking the GCC bourses would allow for better accessibility for intra-regional investors and be much more efficient. In early 2006 the first electronic linkages in the region were expected, between the MSM and ADSM and between the ADSM and DFM. Such electronic link ups should increase liquidity on the markets involved as well as improve transparency and create a larger, more efficient and integrated market overall.

By 2005 there were a number of warning signs that an equity bubble was emerging in the GCC markets. Market capitalisation as a proportion of GDP had reached more than 200 percent of GDP in several GCC states (see Table 5.10) and price to earnings ratios had been distorted in several GCC states, in Saudi Arabia the 2005 average P/E ratio was 66.⁷³ In the past few years a number of cases of insider trading have occurred on the GCC markets that were not sufficiently penalised.⁷⁴ Also excessive leveraging of investors by banks took place during the stock market boom that posed considerable potential risks to the financial system.⁷⁵ A lack of market transparency and accurate company reporting has, for example, contributed towards creating an environment for speculative behaviour. It is not clear to what degree financial audits of many GCC companies comply with international standards. Subsequently, in the first half of 2006 severe market corrections took place that, by the end of the second quarter, had wiped approximately 30 percent, or a collective \$349bn, off the value of GCC markets, with the Tadawul market being worse hit. Many small scale Saudi investors were left in financial ruin with social as well as economic implications for the Kingdom.⁷⁶

⁷² Carvalho, S. "Dana Gas public offer heading for record oversubscription" *Gulf News*, 25 September 2005.

⁷³ Fadlallah, Tarek "The GCC Bear Trap, Prospects for Diminishing Returns" Nomura Bank, Bahrain, 22 August 2005.

⁷⁴ GCC Market Review, Global Investment House, Kuwait, December 2004.

⁷⁵ Staff Writer "CMA, SAMA Act to Curb Stock Market Speculation" *Arab News*, 2 March 2006.

⁷⁶ Staff Writer "Stock crash shatters Saudi dreams" *Reuters*, 3 May 2006.

The GCC stock market corrections highlighted the necessity of a number of reforms in creating a stable investment climate that would enhance national as well as intra-GCC investment levels. There have been calls for urgent improvements in compliance and a strengthening of regulations in order to support confidence in the markets. Speaking at a conference on GCC stock markets, former Qatari Minister of Economy and Commerce, Sheikh Mohammed Bin Ahmed bin Jassim Al Thani said, "Co-operation among the Gulf stock markets is essential to overcoming the present and future challenges (to these markets)."⁷⁷ Indeed common reforms are required in order to develop a stable and integrated regional equity market with sufficient depth and breadth of investment opportunities to be able to attract (and retain) regional capital, while also encouraging international capital.

As well as opening up the markets to GCC nationals, allowing the large GCC expatriate populations to participate fully in the region's stock markets would also attract greater levels of capital and potentially improve market performance that would make regional portfolio diversification more attractive. Non-GCC foreign investment in the GCC bourses has however, been limited and the majority of investment turnover in these markets, an estimated 90 percent, is from locals. Dependence on local investors however has restricted the bourses' liquidity levels which potentially could be much deeper. Yet there is a trend in the region towards the gradual opening up of markets to foreign nationals that is likely to attract greater levels of capital to the markets. Opening up to foreign investors is generally considered to have improved the performance of other MENA markets⁷⁸ and with this in mind, following the GCC stock market corrections in the first half of 2006 more GCC leaders seemed willing to consider doing so.

In early 2006 Saudi Arabia allowed non-GCC national participation in its market, for the first time, allowing foreign residents to purchase shares with no restrictions on companies or the number of shares they can own.⁷⁹ Previously foreign residents in the Kingdom were only allowed to purchase shares through mutual funds which

⁷⁷ Staff Writer "GCC stock markets facing challenges, says minister" *The Peninsula*, 25 April 2005.

⁷⁸ Neaime, *op.cit.*

⁷⁹ Akeel, Maha and Saleh Al-Hamamy "Bourse Opened to Expats" *Arab News*, 21 March 2006.

remains the case in Kuwait. Qatar also opened its market partially to foreigners in April 2005 allowing them to trade shares and own up to 25 percent of the equity in listed firms.⁸⁰ In Bahrain non-GCC nationals are now allowed to own up to 49 percent of a listed company's capital (up from a previous 24 percent), with the exception of two companies which are subsidised by the government. There are also seven companies that are 100 percent open to foreign investors. In Oman and the UAE non-GCC nationals are only allowed to invest in certain stocks. In the UAE at present, only about a dozen or so of the listed companies currently allow foreigners to buy their shares and the share of foreign ownership permitted varies from 15 percent to 49 percent in different companies.⁸¹ However, foreign investor activity is currently estimated to account for 20-30 percent of the turnover on the DFM and just 10 percent on the ADSM.⁸²

Another indicator of capital market integration within the region is the number of cross listings on the markets. There are several incentives for a company to engage in a cross border listing on a second exchange, including access to a bigger pool of investors, increased regional visibility, and the opportunity to raise new capital.⁸³ A substantial and increasing number of cross border listings within the GCC would be indicative of significant integration between the region's bourses and the regional orientation of GCC companies. However, cross border listings of companies on GCC stock markets remains relatively low at just four percent of the total companies listed on the GCC bourses. Only four GCC stock markets so far have permitted cross listings from other GCC markets (see Table 5.12). The Bahrain Stock Exchange (BSE) to date has eight GCC companies that are cross listed, Abu Dhabi Securities Market (ADSM) has six, Dubai Financial Market (DFM) has four and Kuwait Stock Exchange (KSE) has two.⁸⁴ Despite this, the number of cross listings has grown substantially. At the beginning of 2006, 20 companies had cross listings on four of the GCC bourses, compared to just two cross listings as of

⁸⁰ Staff Writer "Qatar opens DSM door to foreigners" *The Peninsula*, 4 April 2005.

⁸¹ Staff Writer "Move to allow foreigners to buy shares 'will boost stock market'" *Gulf News*, 24 October 2005.

⁸² *Ibid.*

⁸³ Issa, Nadim "Integration of GCC Stock Markets: To Cross List or Not to Cross List?" *Arab Press Digest*, 18 January 2006 (Accessed at: www.zawya.com).

⁸⁴ *Ibid.*

the beginning of 2000, a compound annual growth rate of 47 percent over the period.

Table 5.12: GCC Stock Market Cross Listings

Market	2000	2001	2002	2003	2004	2005
BSE	2	3	4	4	6	8
KSE	0	0	0	1	1	2
ADSM	0	0	1	3	3	6
DFM	0	0	1	1	2	4
Total	2	3	6	9	13	20
Annual Growth		50%	100%	50%	44%	54%

Source: Data adapted from Issa, *op.cit.*

Integration between the region's markets in the form of removing barriers to entry for GCC investors and harmonizing regulatory frameworks can be expected to increase the levels of regional portfolio diversification. However, too much integration between the returns of the markets will diminish their ability to diversify the risk-return profile of regional portfolios. Econometric research into the degree of stock market integration between the GCC states provides somewhat contradictory evidence. Using a Vector Error Correction Model for three of the GCC markets (Bahrain, Kuwait and Saudi Arabia) in 2002 Neaime⁸⁵ found evidence of a cointegrating relationship suggesting that the markets move together over the long run, but he did not go any further to explore its exact nature in the short run.

A later paper by Hammoudeh and Choi⁸⁶ found little correlation between the returns of the GCC markets and that country idiosyncrasies and oil price returns influence the stock returns. Using an autoregressive conditional heteroskedasticity model the authors found only weak correlations between GCC stock market returns. The degree of correlation between the stock returns of the various markets and the oil price was also found to vary considerably, with Saudi Arabia

⁸⁵ Neaime, *op.cit*

⁸⁶ Hammoudeh, Shawkat and Kyongwook Choi "Volatility Regime-Switching and Linkage among GCC Stock Markets" *Economic Research Forum*, Cairo, 16-18 December, 2004.

experiencing the strongest correlation and the lowest correlation for the UAE, which is one of the most diversified of the GCC economies. Their research therefore suggests that there are potential gains from regional portfolio diversification that could be beneficial for the GCC economies following CU in terms of diversifying their income sources following an idiosyncratic country shock.

One area where there has been little progress to date in terms of integrating the region's markets is in institutional and regulatory coordination. Stock exchange representatives themselves have criticized the lack of coordination and exchange of information between the region's markets.⁸⁷ The head of the Dubai stock market Essa Kazim reported that "In four years of working at DSM we have had one meeting with other GCC exchanges, so there is very little contact or coordination across GCC stock exchanges and it is very important to have GCC stock market consolidation and integration."⁸⁸ In addition to this the GCC states have different regulatory framework imposing transaction costs and hindering the flow of funds between markets.

Harmonization of the regulatory and supervisory frameworks is essential for greater integration and would be most cost effective if undertaken by a regional regulatory authority. The establishment of a common supervisory and regulatory body to monitor and oversee the GCC markets would be a significant step in stabilising the GCC markets and retaining and attracting new regional investments. This is a major objective of building a GCC Common Market but as yet it appears few steps have been taken to achieve a harmonization of GCC financial market regulations and supervision.

In summary it appears that capital market integration is beginning to take place in the GCC and the pace has accelerated in recent years. Individual investors and GCC corporations are increasingly exploring opportunities in other Gulf markets.

⁸⁷ Staff Writer "Gulf bourses seek independent monitor" *Gulf News*, 29 April 2005.

⁸⁸ Interview with Mr. Essa Kazim, Director General of Dubai Stock Exchange, World Trade Centre, Dubai, 14 February 2005.

However, even though some legislative steps have been taken by the individual GCC states to allow all GCC nationals to invest unhindered in their markets, actual linkages between the GCC stock markets are relatively low at present. Indicators such as cross listings and electronic linkages between the markets are few and far between.

Furthermore there is no evidence of progress on coordination between the region's financial market institutions or in harmonizing regulatory and supervisory frameworks. Considerably more progress is required on this front if the GCC states are to achieve their desired objective of capital market integration as they set out back in 2001.

5.4.2 Bonds and *Sukuks*

Although the GCC bond market is arguably underdeveloped⁸⁹ and there is ample room for expansion, the GCC debt market is quite well integrated. Interest in Islamic finance – in particular Islamic bonds, also known as *sukuks* – has increased markedly in the past few years and the GCC is becoming the global centre for issuance and also secondary trading. GCC companies and governments have issued over \$11bn in Islamic bonds since 2001 and there is increasing integration and cooperation on issuance between institutions across the GCC states.⁹⁰

High oil revenues mean that most GCC governments do not actually need to issue debt in order to finance their fiscal budgets at present (see chapter six, section 6.2), and this may be one factor slowing this sector's growth, but it is a different story for corporate bonds (see Table 5.13). Some GCC states do however issue sovereign bonds that would be accessible to GCC investors most notably Bahrain and Qatar.⁹¹

⁸⁹ Woertz, Eckart "Towards a GCC Bond Market: Lessons from Asia" *Gulf in the Media*, Dubai, 15 April 2006.

⁹⁰ McSheehy, W. "Investors set up market to handle Islamic bonds" *International Herald Tribune*, 7 June 2006.

⁹¹ Most of Saudi Arabia's public debt is issued to domestic banks.

When issued in 2003 Qatar's \$700mn sovereign *sukuk* was the largest of its kind in a civil law jurisdiction.⁹² Yet this was surpassed in 2004 by the Dubai Civil Aviation Authority *sukuk* of \$1bn, and again by Dubai in 2006 with DP World's \$3.5bn *sukuk* currently the world's largest *sukuk* issue (see Table 5.13).⁹³

Bahrain's central bank, the Bahrain Monetary Agency (BMA), is at the forefront of developing and issuing Islamic securities and has pioneered the short term, tradable *sukuk Al-Ijara*.⁹⁴ Bahrain also hosts the Liquidity Management Centre (LMC) which has created a secondary market for trading these securities.

One sign of increasing GCC capital market integration is borne out by a consortium of GCC investors who plan to set up – in Bahrain – a marketplace for Islamic Bonds in late 2006. Ahmed Abdel-Rahman, vice president for investment at 'Sokouk Holding Company', which is based in Kuwait, said it and its partners, including Kuwait Investment and Qatar Islamic Bank, planned to spend \$200mn setting up a *sukuk* Exchange Centre in Bahrain.⁹⁵

⁹² Bennett, J. "The finance finder" *Arabian Business*, 6 June 2006.

⁹³ The world's largest *sukuk* - \$3.5bn – was issued on behalf of Dubai-government owned Ports & Customs and Free Zones Corporation the holding company for Dubai Ports World and is listed on the Dubai International Financial Exchange.

⁹⁴ Bahrain Monetary Agency "Capital Markets Review" Issue 7, December 2005.

⁹⁵ McSheehy, Will "Investors set up market to handle Islamic bonds" *International Herald Tribune*, 7 June 2006.

Table 5.13: A Selection of Recent GCC Sukuks

Issuer	Issue date	Type	Issue amount	Country
Solidarity (Islamic Bank)	August 2003	Corporate	US\$400m	Saudi Arabia
Kingdom of Bahrain	September 2003	Sovereign	US\$250	Bahrain
State of Qatar	October 2003	Sovereign	US\$700m	Qatar
National Cooling Company (Tabreed)	January 2004	Corporate	US\$100m	UAE
Kingdom of Bahrain	November 2004	Sovereign	US\$250m	Bahrain
Durrat al-Bahrain	January 2005	Corporate	US\$152.5m	Bahrain
Dubai Metals & Commodities Centre	April 2005	Corporate	US\$200m	UAE
Bahrain Financial Harbour	May 2005	Sovereign	US\$134m	Bahrain
Emirates Airline	June 2005	Corporate	US\$550m	UAE
Islamic Development Bank	June 2005	Corporate	US\$500m	Saudi Arabia

Source: *Islamic Banking and Finance*, Issue 7, New Millennium Publishing Ltd, Autumn 2005. (Available at www.islamicbankingandfinance.com)

Even though, to a certain extent, opportunities for regional integration of the GCC's bond markets is limited by factors such as the lack of benchmarks, poor liquidity and a limited variety of bond issues this is changing. The recent oil price rises have coincided and possibly fuelled, an interest in Islamic finance and Islamic debt. As the region strives to become recognized as a financial centre it is likely that between now and 2010 the nascent GCC bond market will grow and deepen considerably.

5.4.3 Foreign Direct Investment

Up until fairly recently, intra-GCC FDI flows have been weak. According to available estimates, between 1990 and 2003, total intra-GCC FDI amounted to \$3.6bn, whereas aggregate GCC outflows reached approximately \$125bn over the same period, thus intra-GCC FDI formed only 2.9 percent of total FDI attributable to GCC nationals.⁹⁶ The region's two largest economies, the UAE and Saudi Arabia, received the major shares of intra-GCC FDI, at 54.2 percent and 23.4 percent respectively, while Kuwait's share was negligible and Oman's only amounted to 1.7 percent of the total (see Table 5.14). The fact that the UAE attracted the majority of intra-regional FDI suggests that regional investors are confident in doing business in the Emirates and that significant business opportunities have emerged through relative economic diversification.

Table 5.14: Intra-GCC FDI, 1990-2003*

Source	To						Total (\$mn)
	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	UAE	
Bahrain	*	0.1	9.7	0.4	160.8	37.4	208.4
Kuwait	336.8	*	1.2	107.4	153.8	756.5	1355.7
Oman	0.3	0.2	*	0	0	98.5	99
Qatar	1.9	0	3.1	*	65.1	245.9	316
Saudi Arabia	134.7	0.6	15	60.2	*	798.6	1009.1
UAE	11.8	0	30.6	88.1	456.5	*	587
Total (\$mn)	485.5	0.9	59.6	256.1	836.2	1936.9	3575.2
%	13.6%	0.0%	1.7%	7.2%	23.4%	54.2%	100.0%

Source: Ali A. Bolbol and Ayten M. Fatheldin, "Foreign and Intra-Arab Capital Flows in the Arab Countries, 1990-2003", Arab Monetary Fund. *Excluding data for 1994.

Although large amounts of surplus oil revenues have been invested abroad, since 2003 a far larger amount than previous has been retained and reinvested within the region. Not only has this resulted in high levels of GDP growth across the Gulf and boosted private sector confidence, but it has also led to increasing levels of

⁹⁶ Bolbol, Ali A. and Fatheldin, Ayten M. "Foreign and Intra-Arab Capital Flows in the Arab Countries, 1990-2003", *The World Economy* (Forthcoming).

intra-GCC FDI flows. Much of the evidence is anecdotal and has yet to feed into national or regional statistics but the phenomenon is wide spread and well documented in the regional press. For example, in 2004 the UAE's state-owned telecommunications company, Etisalat, was the lead member of a consortium – 'Ettihad Etisalat' – which won the license to operate Saudi Arabia's second GSM network, in a bid estimated to be worth \$3.2bn.⁹⁷ When the consortium later floated a \$267mn stake on the Saudi stock exchange the issue was oversubscribed by a factor of fifty.

More recently, and by far the most noteworthy instance of intra-regional investment to date, was Emaar's \$26bn investment in the recently launched Saudi Arabian "King Abdullah Economic City".⁹⁸ As a result of investments by Etisalat and Emaar, the UAE has overtaken Japan and is now the main source of FDI into Saudi Arabia, according to statistics released by the Saudi Arabian General Investment Authority (SAGIA).⁹⁹

In mid 2006 SAGIA announced that another 'Economic City' was to be built, close to the Saudi city of Hail. Supervised by SAGIA and headed by the Saudi Rakisa Holding Company it is envisaged that the \$8bn "Prince Abdul Aziz Bin Musaid Economic City" (PABMEC) will be fully funded by the region's private sector. Many GCC entities have already committed to invest in PABMEC, including the UAE's Abu Dhabi Investment Authority, Abu Dhabi Investment House, and the National Investment Co., Bahrain's Gulf Finance House and Kuwaiti firms: Kuwaiti Investment Co., and General Warehousing Company.¹⁰⁰

Saudi Arabia is reciprocating and investing considerable sums into the UAE. For instance, Al Hanoo Holding Company, is developing two major projects, the tourist-orientated \$4.9bn 'Nujoom Islands' and the \$800mn 'Emirates Industrial City'; both

⁹⁷ Staff writer "Saudi mobile phone IPO 50 times oversubscribed" *Reuters News Service*, 31 October 2004.

⁹⁸ Although Emaar is partially owned by the government of Dubai, it is a publicly listed company and is traded on the Dubai Financial Market.

⁹⁹ Staff writer "UAE becomes top investor in Saudi Arabia", *Gulf News*, 18 June 2006.

¹⁰⁰ Carvalho, Stanley, "GCC investors to pump 1.5b riyals into new Saudi economic city" *Gulf News*, 4 July 2006.

in the Emirate of Sharjah,¹⁰¹ and Saudi Oger is funding a \$500mn real estate project 'Saraya Islands' in the Emirate of Ras Al Khaimah. Yet another Saudi company, Al Rajhi Group, has a 38.5 percent stake in the \$8.2bn 'Al Salam City' megaproject, taking shape in the Emirate of Umm Al Quwain.¹⁰² Saudi Arabia's Savola Group plans to open six HyperPanda retail outlets in the UAE at an estimated cost of \$82bn; the group's first foreign retail expansion.¹⁰³

There are many other examples of recent intra-GCC FDI including the \$805mn tourist development, 'The Wave' in Oman which is a joint venture by the UAE's, Majid Al Futtaim Investments (MAFI) and the Omani Pension Fund. MAFI is also investing \$531mn in a retail development in Bahrain; the 'Bahrain City Center'. The Kuwaiti property firm, Grand Real Estate, is investing \$2bn in various developments across Dubai, and is in the process of establishing a regional bank (with a paid up capital of almost \$1bn) specifically geared to financing hotel and tourism projects in the Gulf region.¹⁰⁴

5.5 Degree of Economic Diversification

This section begins by discussing some of the conceptual issues regarding the type of economic diversification required for CU to be appropriate for a given group of countries. We make a conceptual distinction and argue that for CU to be appropriate for a given group of countries, 'within country' rather than 'within region' diversification is required. The second part of this section examines the degree of hydrocarbon dependence among the GCC economies and critically whether this makes them less than ideal candidates for forming a CU. Following this, we examine the extent to which diversification is occurring in the GCC and whether this is the type of diversification (i.e. 'within country' diversification) required for CU. Finally, this section analyses the views of expert interviewees on

¹⁰¹ Nujoom Islands, <http://www.nujoomislands.com/alhanoo.html>

¹⁰² AMEInfo, "UAQ, \$8.2bn Tameer city project" 26 July 2005 (Accessed on 20 July, 2006 <http://www.ameinfo.com/64854.html>)

¹⁰³ AMEInfo, "Six HyperPandas for UAE" 12 April 2006 (Accessed on 20 July, 2006 <http://www.ameinfo.com/82832.html>)

¹⁰⁴ GoWealthy "Kuwaiti group set to invest \$2bn in Dubai projects" 22 July, 2006 (accessed at <http://www.gowealthy.com/>)

the cohesion of the GCC economic structures, whether their economic structures are compatible for CU as well as the importance of economic diversification in forming a CU.

5.5.1 Conceptual Issues

The idea that the more economically diversified potential member economies are, the more suited they will be for CU, was developed by Kenen.¹⁰⁵ He argued that if prospective members had diversified economic structures they would be less likely to suffer from asymmetric shocks. However, it is important to be clear about the meaning of 'diversification' when discussing its relationship to the formation of a CU. Kenen is referring to what we might call '*within country*' diversification as opposed to '*within region*' diversification. 'Within country' is where each country in a regional grouping contemplating CU becomes internally diversified (i.e. has a wide range of different industries and services). Clearly, where all the countries in the potential CU are diversified in this manner then the problem of an asymmetric shock – one which (by definition) impacts upon only one particular worldwide industrial or service sector – will not be particularly problematic for the CU. Each of the countries in the region with a diversified portfolio of industries will experience the specific shock in a similar manner and to a similar degree. Therefore a CU and a common monetary policy will be appropriate for all of them, or to put it the other way round, none of them will feel obliged to break away and adopt an independent monetary policy to deal with that particular asymmetric shock.

It has been argued by Sturm¹⁰⁶ that with greater economic diversification the GCC economies will become more heterogeneous and consequently an aggregate monetary policy based on the economic circumstances of the entire region will be less likely to be optimal for each member state. However this particular argument would only apply where the diversification in question is what we have called '*within region*' diversification i.e. where the different countries in the potential CU

¹⁰⁵ Kenen, P. B., "The Theory of Optimum Currency Areas: An Eclectic View", in *Monetary Problems of the International Economy* (eds. R.A. Mundell and A.K. Swoboda) pp 41-60, University of Chicago Press, Chicago, 1969.

¹⁰⁶ See Sturm, M. and Siegfried, N. 'Regional Monetary Integration in the Member States of the Gulf Cooperation Council', European Central Bank, *Occasional Paper Series*, No. 31, June 2005.

diversify away from a common, predominant industry (in the GCC case, oil), but do so by each country becoming specialised in a different industry. In other words if one country 'diversifies' by becoming *specialised* in e.g. aluminium production, another in tourism, another in financial services etc. then this kind of heterogeneity would certainly leave them vulnerable to asymmetric shocks and make a CU and common monetary policy inappropriate for them as a group.

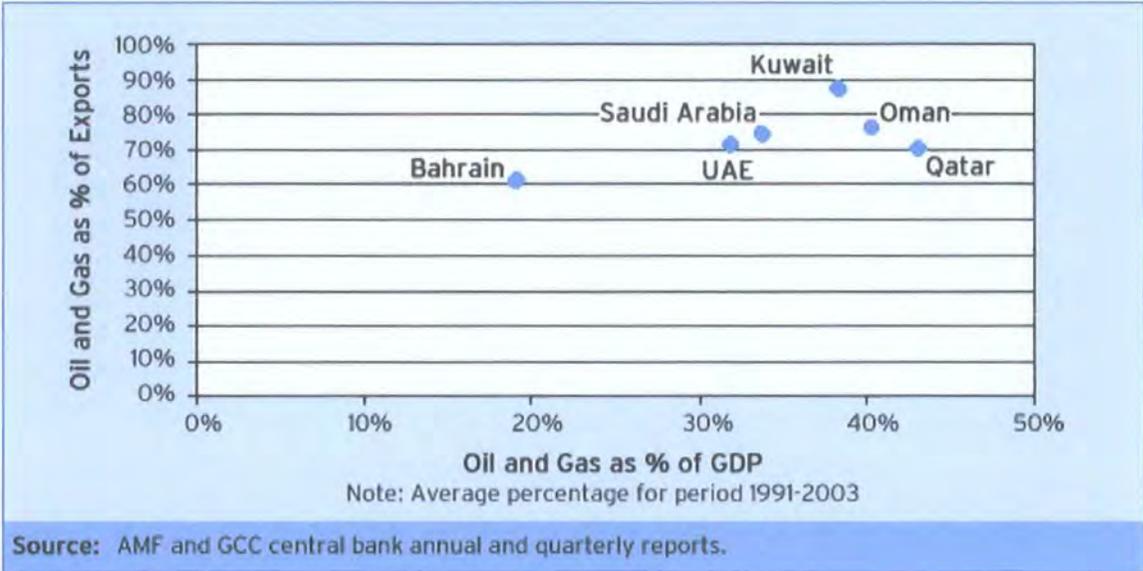
5.5.2 Does Oil Dependence Necessarily Matter for CU?

The GCC states have a fundamental common economic dependency on hydrocarbon resources. On average, oil and gas sector activities constitute 42 percent of GDP, oil and gas exports account for 69 percent of exports and oil and gas revenues constitute almost 75 percent of government revenues.¹⁰⁷ Few, if any other, regional grouping of countries shares such a common fundamental economic character. In chapter four (section 4.2.2) the GCC's economic dependency on hydrocarbons and its associated drawbacks were discussed in some detail. It was shown that the composition of the GCC economies has remained relatively unchanged over the last decade with oil and gas continuing to form the largest share of economic activity.

There are however, varying degrees of oil dependency among the GCC states. In the case of GDP the share of oil and gas ranges from 23 percent in Bahrain to 62 percent in Qatar, in the case of exports, from 36 percent in the UAE to 93 percent in Kuwait and in terms of government revenues the range is from 55 percent in Qatar to 91 percent in Kuwait (see chapter four, section 4.2.2, table 4.5). Nevertheless, even those countries with relatively lower oil dependency indices remain unquestionably dominated the hydrocarbon sector compared with any other grouping of World countries (see Figure 5.7).

¹⁰⁷ See chapter four, table 4.5.

Figure 5.7: GCC Hydrocarbon Dependence



However this failure to significantly diversify away from oil and gas does not in itself mean that CU would be inappropriate. Diversification away from oil and gas may be desirable for a number of reasons, in particular employment creation, but it is not necessarily an obstacle to CU. This is because an oil price shock affects *all the GCC states*, albeit to varying degrees. This similarity of economic structures and shared oil dependence implies that the GCC economies are likely to suffer from the same exogenous shock and as such, it could be addressed with a common monetary policy without causing problems for any individual member state. In short, as long as the GCC states remain undiversified – but *undiversified in the same manner* - this does not necessarily mean they are unsuitable for a CU. What is really important is that, as they diversify away from oil and gas they do so without becoming overly specialised in any one particular industry into which they diversify.

Using the conceptual distinction made above, CU requires that they move towards greater 'within country' diversification rather than just 'within region' diversification'. This also means that some of those regional commentators who have expressed concern about the different GCC countries diversifying into the same industries and services and therefore competing with each other, may be failing to realise that a

diversification strategy which involves some replication of new industries and services around the Gulf is probably beneficial to the CU project.¹⁰⁸

5.5.3 The Extent of 'Within Country' Diversification

It remains to examine empirically (a) the extent to which the GCC states are diversifying away from oil and gas and (b) the extent to which they are moving towards the desired ('within country') type of diversification.

Clearly, from the evidence provided above and in chapter four, the GCC economies have not been able to achieve significant economic diversification away from oil and gas and remain heavily dependent on these commodities. Despite professing a policy of economic diversification, in the past, during times of high oil prices, many of the GCC states have been unwilling to invest surplus petrodollars into an economic diversification. Only a few GCC states have seen some success in this respect. Bahrain has been motivated to diversify by the limited life expectancy of its meager oil reserves as has the resource poor Emirate of Dubai in the UAE.¹⁰⁹ However until very recently other states, for example, Kuwait and Qatar have shown little progress in this respect.

There are some signs of change however. Kuwait and Qatar have plans to invest substantial amounts in real estate and non-oil associated projects. Kuwait's ambitious 'Silk City' project could cost as much as \$86bn and includes a 1001 meter high tower bloc, which if built will be by far the world's tallest structure.¹¹⁰ Qatar is not only investing heavily in its natural gas industry and its downstream value added liquefied natural gas production, but also in a range of service sectors. The \$2.5bn 'Doha Pearl' real estate project, is one example of such diversification

¹⁰⁸ For example, the issue of regional competition was considered to be of such importance that it was the topic of a Bahrain Economic Society conference, entitled "GCC 2010: From Competition to Integration", held in Bahrain on 23-24 November 2004. In addition, a number of regional experts also felt that increasing intra-regional competition might be detrimental to the region's integration efforts.

¹⁰⁹ For an early study of the process of diversification in Bahrain, see Rutledge, E. *The Experience of Economic Diversification in Bahrain, 1987-1997*, The Bahrain-British Foundation, 1999.

¹¹⁰ Evans-Pritchard, Ambrose "Trillion dollar gamble on future of Gulf", *The Daily Telegraph*, 9 May, 2006.

(future owners of property on the island will automatically receive Qatari residency visas) as is its ambitious 'Energy City'¹¹¹ and the Qatar Financial Centre.¹¹²

As was mentioned earlier, events in the past few years (since the start of the current oil boom), particularly substantial current account surpluses, have radically altered the pattern of lackluster economic performance that has characterized much of the period of analysis. The GCC saw its highest ever current account surplus in 2004 at \$105.7bn but this was surpassed in 2005 when it climbed to \$152bn.¹¹³ In 2006, the surplus is projected by the World Bank to come in at \$172.7bn.¹¹⁴ The situation is in sharp contrast to the late 1980s and most of the 1990s when many GCC states experienced successive fiscal deficits and saw declining or stagnant GDP per capita incomes. Yet the extent to which these extra financial resources will be spent in such a way to foster economic diversification is still too early to assess.

Research by MEED Projects¹¹⁵ indicates that the total value of projects within the Gulf Region had risen by \$250bn in the first three months of 2006 and that the project market in the region is now the biggest globally on a per capita basis. The total value of projects in the GCC – at the time of writing – was \$881bn. While more than half of these projects are construction related, there are also \$228bn worth of upstream oil and gas projects and \$106bn worth of petrochemical projects.¹¹⁶ Clearly there is no intention to move away from hydrocarbons and given the anticipated growth in World demand for these commodities it would be foolish for the GCC to neglect investment in this sector.

¹¹¹ Energy City Qatar (ECQ) is billed as a pioneering development that will be the Gulf's first hydrocarbon industry business centre. ECQ forms part of the \$5bn Qatari construction megaproject, 'Lusail'.

¹¹² The Qatar Financial Center was set up by the Government of Qatar and aims to establish Qatar as a hub for project finance and by providing an attractive environment (tax-free) for a wide range of financial services activities in the Gulf region.

¹¹³ The World Bank, *2006 Economic Developments and Prospects: Financial Markets in a New Age of Oil*, 2006.

¹¹⁴ *Ibid.*

¹¹⁵ AEC Info "Projects in the Gulf region have now reached more than \$1 trillion." 25 April 2006, (available at http://www.aecinfo.com/1/pdcnewsitem/00/65/45/index_1.html)

¹¹⁶ MEED projects tracks all projects worth more than \$50mn in the GCC.

However, where diversification away from hydrocarbons *is* occurring there are some hopeful signs that the dangers of specialisation i.e. 'within region' diversification, are being avoided and that 'within country' diversification is, indeed, beginning to take place. The fact that the GCC states have similar comparative advantages means that economic diversification is taking place in the same sectors and industries which should lessen the potential for them to be hit by asymmetric shocks.

Bahrain has a well established banking and finance industry that forms a major part of its economic activity, according to the IMF's latest Bahrain Country Report in 2004 the total contribution to GDP from all financial corporations in the Bahrain was 24.2 percent.¹¹⁷ Offshore banking took off in Bahrain in the early 1980s¹¹⁸ and since then the Bahrain Monetary Agency (BMA) has provided a well regulated financial environment which is now fostering a growing Islamic banking market.

The BMA has been at the forefront of the government of Bahrain's efforts to establish Manama as the GCC's hub for Islamic finance. In particular, the BMA has been instrumental in deepening the Islamic financing market through the development of its short term *sukuk* issuance programme and through the introduction of standardised contracts for its dealings with Islamic banks. In an effort to keep ahead of increasing regional competition from Dubai and Qatar's emerging financial centres Bahrain is constructing a new \$1.3bn financial centre – the 'Bahrain Financial Harbor'.

The UAE, in particular Dubai, has also diversified into service sector activities such as banking and finance, the re-export trade and tourism and Abu Dhabi has established itself as the manufacturing hub of the UAE. As of 2004, Dubai had 272 hotels, 30 shopping malls and almost 5 million foreign visitors.¹¹⁹ Since then more hotels have been built and many more are under construction. The \$19bn

¹¹⁷ IMF, *Kingdom of Bahrain: Financial System Stability Assessment*, March 2006, Country Report No. 06/91.

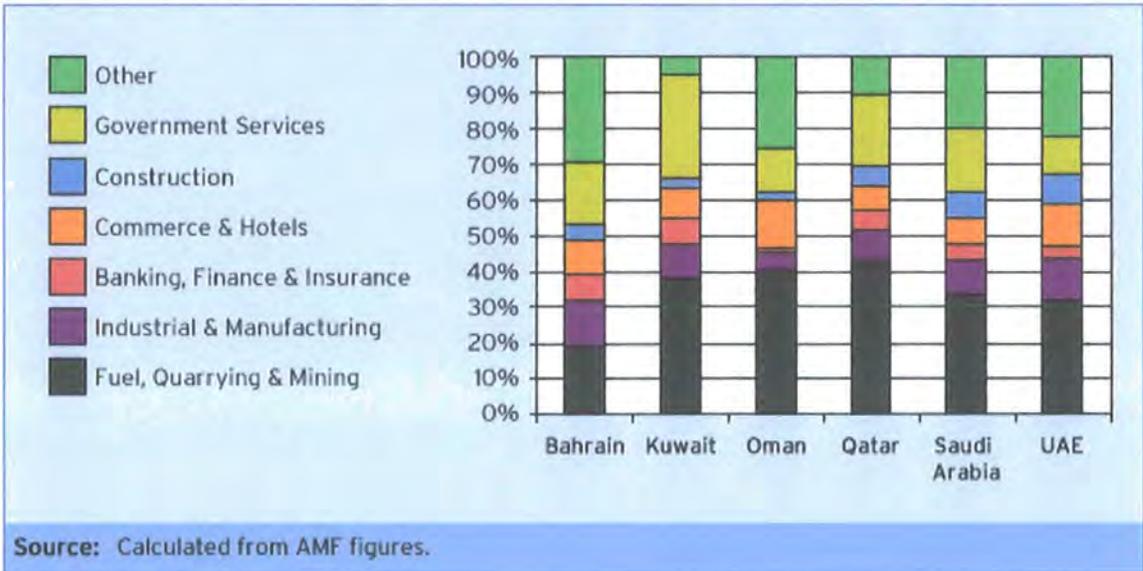
¹¹⁸ When Israel invaded Lebanon in the early 1980's Bahrain assumed Beirut's role as the Middle East's off-shore banking centre.

¹¹⁹ Staff writer "Arabia's field of dreams", *The Economist*, 27 May 2004.

Dubailand theme park, once completed will be twice the size of Disneyworld in Florida, and by 2015, Dubai alone hopes to attract 15 million tourists annually.¹²⁰

Oman is also focusing on tourism (see Figure 5.8), but in a different niche of the market, optimising its comparative advantage in a great variety of ecological zones, wildlife and scenery. The \$15bn Blue City megaproject is one such initiative being promoted by Oman’s Ministry of Tourism – which itself was only established in 2004 and it aims to provide a ‘first class tourism facility’ over an area of 34 square kilometres. Other tourist related projects include the \$805mn ‘The Wave’ development, which has successfully attracted significant levels of FDI.

Figure 5.8: Composition of Economic Structure, Average 1991-2003



In both Saudi Arabia and the UAE the manufacturing sector has also been prioritized. Saudi Arabia is understandably concentrating on the petrochemicals sector (a significant diversification away from traditional upstream oil and gas activities) with multibillion dollar projects currently underway in Jubail and Yanbu. The planned ‘Jubail Industrial City-II’ is expected to see as much as \$56bn worth of investment and authorities hope it will create as many as 55,000 jobs. Industrial development is also being pursued within the UAE by Abu Dhabi. The government

¹²⁰ Wallis, William “Tourism: Growing appeal leaves observers baffled” *Financial Times*, 12 July 2005.

of Abu Dhabi's Higher Corporation for Specialized Economic Zones is currently developing the Industrial City of Abu Dhabi which is expected to attract \$4.62bn in investments. Similarly, Dubai is also developing an industrial zone, the 'Dubai Industrial City'.

In summary, although the movement away from oil and gas dependence has been sluggish, it should first be recognised that there may be sensible reasons why this should be so – most oil experts do not expect any return to low oil prices in the foreseeable future.¹²¹ Where diversification away from hydrocarbons is taking place there are small, but encouraging signs that those states which are diversifying are avoiding simply becoming dependent on some alternative 'mono-industry' but are developing a number of sectors in conjunction – even where this involves some competition with other GCC states (e.g. Dubai and Oman competing in the tourist industry, or Bahrain, Dubai and Qatar competing in financial services, or Saudi Arabia and the Abu Dhabi competing in manufacturing) As such this trend must be regarded as a positive one from the perspective of the CU project.

5.5.4 View of Regional Experts on GCC Economic Diversification

Currently, regional experts appear to be split in their views as to whether the GCC economic structures are suited to monetary union and will be able to form a cohesive bloc. Whilst many experts thought that the GCC economic structures were very similar and thus suited to monetary union, several felt that there was not sufficient diversification or complementarities among the GCC economies in order to have a high level of integration.

Several interviewees felt that the GCC economies weren't diversified enough to be able to form a cohesive economic bloc. One Emirati government official said "The prerequisites for forming monetary union aren't present as the economies are too similar and lack of diversification is the problem. The production bases are too

¹²¹ For instance, according to Goldman Sachs, "this is the second year of a five year spike, and during this time, barring any geopolitical events that may send prices even higher, the average will be \$68", see Gulf Research Center, *GCC Economic Report*, Issue 12, Dubai, July 2006.

narrow and the chance of success is slim without diversification.” One Omani academic felt that whilst the GCC states had similar structures there were few complementarities to make them a cohesive bloc “A cohesive economic bloc is different to that suited to monetary union. There are no complementarities unlike in the EU and so there is no capacity to exchange and this is a problem.”

A few interviewees felt that there were important differences between the GCC economies; an AMF official said “All GCC states look the same from outside but there are various degrees of difference.” One Saudi government official agreed and thought that greater economic diversification in the future would allow the GCC economies to integrate further through trade, he said “Yes in terms of potential and not as the GCC economies stand now. The rationale of monetary union is to reduce transactions costs associated with intra-regional trade among members which is already negligible but the reason trade is low is not because of the transactions costs but because of the similarities of economic structures and other institutional impediments to trade.”

Finally, a number of experts felt that it was not the current GCC economic structures that mattered as much as their cohesion in the future. One Saudi government official felt “It is not what we have today that matters, but what we want to have in the future”.

5.6 Economic Synchronization

The synchronisation of the GCC economies and the economic shocks facing them is an important issue in establishing the appropriateness of CU for these economies. According to OCA theory, if the shocks affecting the prospective members of the CU are asymmetric then they are less likely to be suited to CU because the member economies will be on diverging economic paths that would be best dealt with by independent monetary policies rather than a common approach. The similar structure of the GCC economies has led many experts to assume that their economies are synchronised and experience symmetric economic shocks, mainly stemming from changes in the oil price. As we have seen from our previous

analysis in chapter four however, the GCC economies are not homogenous and have achieved various degrees of diversification depending on their diverging resource allocations. Another factor that will have a bearing on the degree of economic synchronisation is the degree to which the countries are integrated through trade and capital markets, issues which we have examined previously in this chapter.

To date, there are two notable papers which have undertaken econometric analysis in order to assess the synchronicity of the GCC economies. Laabas and Limam¹²² analyse the synchronicity of the GCC economies by examining their real exchange rates which are considered to reflect underlying macroeconomic variables as per the Generalised Purchasing Power theory developed by Enders and Hurn.¹²³ They employ a cointegration model and conclude that the GCC real exchange rates share the same stochastic trend. However, it may be revealing that they find that the results for Oman and the UAE indicate a slower pace of adjustment towards the long run relationship; furthermore, they find that "UAE growth correlation with other GCC (states) is very weak".¹²⁴ In conclusion, Laabas and Limam argue that "there does not seem to be evidence of convergence in (the GCC's) main macroeconomic fundamentals nor synchronisation of their business cycles".¹²⁵

An econometric study by Darrat and Al-Shamsi finds evidence of integration between the GCC's GDP and financial and monetary indicators.¹²⁶ Darrat and Al-Shamsi used cointegration techniques to explore the long term relationships between five economic variables in the GCC states, including real GDP, inflation rates, exchange rates, money stock and the money base. The authors established the presence of a cointegrating relationship between each of the five variables

¹²² Laabas, B. and Limam, I. *Are GCC Countries Ready for Currency Union?* Arab Planning Institute, Kuwait, April 2002.

¹²³ Enders, W. and S. Hurn "Theory and Tests of Generalised Purchasing-Power Parity: Common Trends and Real Exchange Rates in the Pacific Rim" *Review of International Economics*, Vol.2, No.2, pp. 179-190, 1994.

¹²⁴ Laabas, B. and Limam, I, *op.cit.* p.30

¹²⁵ *Ibid.* p.32

¹²⁶ Darrat. A. F and Al-Shamsi, F., "On the Path of Integration in the Gulf Region" *Applied Economics*, 37, pp. 1055 – 1062, 2005.

across the GCC states. They conclude that there are no economic obstacles to further GCC economic integration and that the impediments that have stalled the process in the past must be socio-economic factors.

However, Darrat and Al-Shamsi acknowledge that their analysis is limited in that it does not examine the role of regional players in driving the process of integration and whether Saudi Arabia is the main driving force behind the process. Neither do the authors examine the underlying Vector Error Correction Model (VECM) processes of the cointegrating relationships nor the impulse response functions, which are frequently used to provide further information on cointegrating series.

In this section we employ these techniques to shed light on the appropriateness of the GCC economies for CU both collectively and individually. In testing for GCC cointegration on a collective basis more than one cointegrating equation can often be present however this makes it very difficult to identify the long term cointegrating equation and the dynamics of the relationship. We address this issue by investigating further the long run relationship between each of the GCC economies and the regional economic powerhouse, Saudi Arabia. Saudi Arabia accounts for 54 percent of the region's GDP, has 67 percent of the population and its stock market capitalization accounts for 52 percent of the total GCC bourses. The relationship with Saudi Arabia is examined on a country by country basis and the results of each GCC economy are contrasted. The underlying cointegrating equations are examined as are the impulse response functions which indicate the adjustment time in returning to the long term relationship following an economic shock.

5.6.1 Estimating the Model

In order to carry out our investigation we employ annual GCC real GDP data based on 2000 prices from between 1981 and 2004.¹²⁷ The start date is chosen because it is the year the GCC as a regional bloc came into existence. However, the data

¹²⁷ Sourced from IMF IFS database. Data for Kuwait during the Iraq invasion is omitted from the data set therefore the series was extrapolated for the missing two years.

for Qatar is limited to a much shorter period between 1992 and 2001 and is therefore too short to use in our cointegration analysis. While the number of observations in each series is relatively small, previous research¹²⁸ suggests that it is the time span of the data rather than the frequency which is of importance when modeling cointegrated series.

The following econometric model was used for testing cointegration and Granger Causality between Saudi real GDP and the other respective GCC economies. The Johansen cointegration test was carried out and involved setting up a Vector Auto Regression. The VAR model is shown in equation 5.1 where $y_t = (y_t^g, y_t^s)'$, where y_t^s is real GDP in Saudi Arabia and y_t^g is real GDP in one of the other respective GCC states, y_t is a 2 by 1 vector, as is A_0 . Γ is a 2 by i matrix, where i is the number of lagged variables and Π is a matrix of the form $\Pi = \alpha\beta'$.

$$\text{Equation 5.1. } \Delta y_t = A_0 - \Pi y_{t-1} + \sum_{i=1}^{p-1} \Gamma_i \Delta y_{t-i} + \varepsilon_t$$

The rank ('r') of the matrix Π will be less than full rank if the variables y_t^s and y_t^g are integrated of order one (i.e. have unit roots) and are cointegrated. In this case there will be 'r' cointegrating vectors/relationships. $\Pi = \alpha\beta'$ where α is an m (the number of variables) by r matrix of 'adjustment coefficients' and measures the feedback on the changes in the variables of divergence from the equilibrium relationship. If there is cointegration, some of the α must be non-zero. The Johansen test allows us to determine r and estimates the cointegrating vector, which, normalising the respective GCC economies real GDP to unity, is $(1, -\beta)$. This restriction is based on the assumption that the smaller GCC economies are unlikely to affect the Saudi economy, although this does not prevent the possibility of feedback in the system. The Johansen-Juselius¹²⁹ tests are used to reject or accept the number of cointegrating equations. This leads to the VECM representation of this model.

¹²⁸ Hakkio, C.S. and Rush, M. "Cointegration: How Short is the Long Run?" *Journal of International Money and Finance*, 10, pp.571-582, 1991.

¹²⁹ Johansen, S. and Juselius, K. "Maximum likelihood estimation and inferences on cointegration with an application to the demand for money" *Oxford Bulletin of Economics and Statistics*, 52, pp.169-209, 1990.

The Vector Error Correction Model (VECM) is used to model the effect of 'short-term' dynamics on the 'long-term' relationship between the two variables and to assess the feedback on the relationship. Imposing the cointegration restriction (1, - β) the VECM in this case is:

$$\text{Equation 5.2. } \Delta y_t^g = \alpha_1 (y_{t-1}^g - \beta y_{t-1}^s) + u_{1t}$$

$$\text{Equation 5.3. } \Delta y_t^s = \alpha_2 (y_{t-1}^g - \beta y_{t-1}^s) + u_{2t}$$

For there to be cointegration and Granger Causality from the Saudi economy to the other respective GCC economies, α_1 should be non-zero, significant and negative, and if the results are in line with the economic reasoning that the smaller GCC economies cannot drive Saudi Arabia's economy, α_2 is not expected to be statistically different from zero.

In order to avoid spurious regression results from our model, as demonstrated by Granger and Newbold¹³⁰, we must establish that the series employed are stationary. If a non stationary variable, i.e. one with mean, variance and covariance that varies over time, is included in the regression it could produce incorrect test statistics. Both the Adjusted Dickey Fuller¹³¹ and Phillips Perron¹³² unit root tests were carried out on the natural logs of the data and each series, as expected, was found to be non-stationary. However, when the data was differenced once the series became stationary, and the null hypothesis of a unit root was rejected in both of the two tests, indicating that the series are all integrated of order one (see Table 5.15).

¹³⁰ Granger, C. W. J. and Newbold, P. "Spurious Regressions in Econometrics", *Journal of Econometrics*, 2, pp.111-120, 1974.

¹³¹ Dickey, D.A. and Fuller, W.A. "Distribution of the Estimators of Autoregressive Time Series with a Unit Root" *Journal of the American Statistical Association*, 74, pp. 427-431, 1979.

¹³² Phillips, P.C.B. and Peron, P. "Testing for a Unit Root in Time Series Regression" *Biometrika*, 75, pp.335-346, 1988.

Table 5.15: Unit Root Tests for GCC Real GDP

Country	Sample	Test	Log-Levels/T Stat	First Differences/ T Stat
Bahrain	1981-2003	ADF	1.191348	-3.9793*
		PP	1.20509	-4.44632*
Kuwait	1981-2003	ADF	-1.04527	-5.1305*
		PP	-0.83352	-5.80218*
Oman	1981-2003	ADF	1.820872	-4.8661*
		PP	4.087027	-3.48431***
SA	1981-2004	ADF	0.44851	-3.65835**
		PP	0.07649	-3.72062**
UAE	1981-2002	ADF	0.209516	-4.42161*
		PP	0.039046	-4.42171*

*Rejects Null at 1%, **Rejects Null at 5%, ***Rejects Null at 10%

In order to examine the nature of the relationship between the variables we test for cointegration. The Johansen¹³³ cointegration test was carried out and the group as a whole was tested first. Two tests were used, the Trace test as proposed by Johansen¹³⁴ and the Maximum Eigenvalue test as established by Johansen and Juselius.¹³⁵ The results of the cointegration tests supported the evidence by Darrat and Al-Shamsi that the GCC real GDP series are in fact cointegrated. The test results also show the presence of more than one cointegrating equation (see Table 5.16). The Trace test finds at least two cointegrating equations at the 99 percent significance level and a total of four at the 95 percent significance level. While the Maximum Eigen Value test confirms that there are at least two cointegrating equations at the 99 percent significance level.

¹³³ Johansen, S. *Likelihood-Based Inference in Cointegrated Vector Autoregressive Models* Oxford University Press, New York, 1995.

¹³⁴ *Ibid.*

¹³⁵ Johansen, S. and Juselius, K. "Maximum likelihood estimation and inferences on cointegration with an application to the demand for money" *Oxford Bulletin of Economics and Statistics*, 52, pp.169-209, 1990.

Table 5.16: Joint GCC Cointegration Test Results

Hypothesized No. of CE(s)	Trace Statistic	5 Percent Critical Value	1 Percent Critical Value
None **	130.2836	76.07	84.45
At most 1 **	81.20594	53.12	60.16
At most 2 **	44.86678	34.91	41.07
At most 3 *	21.87859	19.96	24.6
At most 4	8.389271	9.24	12.97
Hypothesized No. of CE(s)	Max-Eigen Statistic	5 Percent Critical Value	1 Percent Critical Value
None **	49.07765	34.4	39.79
At most 1 **	36.33916	28.14	33.24
At most 2 *	22.98819	22	26.81
At most 3	13.48932	15.67	20.2
At most 4	8.389271	9.24	12.97

*(**) denotes rejection of the hypothesis at the 5%(1%) level.

The cointegration tests were then carried out for each of the four respective GCC states with that of Saudi Arabia. A lag length of two was used because of the rather limited length of the data. The results show that the real GDP of both Oman and Bahrain are cointegrated with that of Saudi Arabia (see Table 5.17). At least one cointegrating equation is identified at the 99 percent significance level in Oman and at the 95 percent significance level in Bahrain. In the case of the UAE and Kuwait, however the results are quite different. The test statistics indicate that neither the UAE economy nor the Kuwaiti economy is cointegrated with the Saudi economy. While in the short run it is possible that the economies share a short term cyclical relationship in the long run there is no evidence of a trending relationship (see Table 5.17).

Table 5.17: Results of Pair-Wise Cointegration Tests

Series: Oman SA			
Hypothesized No. of CE(s)	Trace Statistic	5 Percent CV	1 Percent CV
None **	21.94788	12.53	16.31
At most 1 **	6.625375	3.84	6.51
Hypothesized No. of CE(s)	Max-Eigen Statistic	5 Percent CV	1 Percent CV
None *	15.32251	11.44	15.69
At most 1 **	6.625375	3.84	6.51
Series: Bahrain SA			
Hypothesized No. of CE(s)	Trace Statistic	5 Percent CV	1 Percent CV
None *	14.14285	12.53	16.31
At most 1 *	4.04115	3.84	6.51
Hypothesized No. of CE(s)	Max-Eigen Statistic	5 Percent CV	1 Percent CV
None	10.1017	11.44	15.69
At most 1 *	4.04115	3.84	6.51
Series: UAE SA			
Hypothesized No. of CE(s)	Trace Statistic	5 Percent CV	1 Percent CV
None	4.28402	12.53	16.31
At most 1	0.74626	3.84	6.51
Hypothesized No. of CE(s)	Max-Eigen Statistic	5 Percent CV	1 Percent CV
None	3.537759	11.44	15.69
At most 1	0.74626	3.84	6.51
Series: Kuwait SA			
Hypothesized No. of CE(s)	Trace Statistic	5 Percent CV	1 Percent CV
None *	18.85833	15.41	20.04
At most 1	0.039524	3.76	6.65
Hypothesized No. of CE(s)	Max-Eigen Statistic	5 Percent CV	1 Percent CV
None **	18.81881	14.07	18.63
At most 1	0.039524	3.76	6.65

CV: Critical Value. *(**) denotes rejection of the hypothesis at the 5% (1%) level

As we have been able to establish a long run cointegrating relationship between the pairs, Oman and Saudi Arabia and Bahrain and Saudi Arabia, we can now model the dynamics of the relationship in a VECM, as set out in equations 5.2 and

5.3 above.¹³⁶ This allows us to examine the speed of adjustment to the long run relationship, test for the direction of causality and examine the response of the respective economies to an economic shock in Saudi Arabia.

The estimated cointegrating equation from the VECM for Bahrain and Saudi Arabia is:

$$\begin{aligned}\Delta y_t^g &= -0.01(y_t^g - 1.07y_{t-1}^s) + u_{1t} \\ &\quad (-6.38) \quad (-33.2) \\ \Delta y_t^s &= -0.0007(y_t^g - 1.07y_{t-1}^s) + u_{2t} \\ &\quad (-0.26) \quad (-33.2)\end{aligned}$$

The results confirm our expectations, the adjustment coefficient α_1 is negative (-0.01) and statistically significant (the t statistic in brackets was -6.38). As expected the adjustment coefficient α_2 was close to zero (-0.0007) and not statistically significant (the t statistic was only -0.26). This suggests that over the cointegrated period since 1981 there was feedback from the Saudi economy in the previous period onto the current changes in the Bahraini economy that kept it from diverging significantly from its 'long-run' equilibrium relationship with the Saudi economy. The results also show a rather slow adjustment path, as only 1 percent of the deviation of Bahrain's real GDP from the long-term relationship with Saudi real GDP was adjusted back in any year. The results however, provide strong empirical evidence that Saudi real GDP Granger causes changes in Bahrain's real GDP and not vice versa, over the cointegrated period. These findings support the economic theory about the relationship between these economies discussed earlier.

¹³⁶ It must be mentioned that the number of observations is rather small for a VECM, nevertheless by examining and interpreting the results of the VECM we can add to our understanding of these economic relationships.

The estimated cointegrating equation from the VECM for Oman and Saudi Arabia is expressed as follows:

$$\Delta y_t^g = -0.06(y_t^g - 0.94y_t^s) + u_{1t}$$

(-4.01) (-95.5)

$$\Delta y_t^s = -0.03(y_t^g - 0.94y_t^s) + u_{2t}$$

(-1.44) (-95.5)

Again the adjustment coefficient α_1 is negative (-0.06) and statistically significant (the t statistic was -4.01). This time the adjustment time is quicker as 6 percent of the deviation of Oman's real GDP from the long term relationship with Saudi real GDP is adjusted back in any year. The results also provide evidence that Saudi real GDP Granger Causes changes Oman's real GDP and not vice versa, over the cointegrated period.

Using the VECM system that has been estimated, we extend the analysis and generate impulse response functions to examine the effect of a potential exogenous shock to the system. A shock to the i th variable not only directly affects the i th variable but is also transmitted to the other endogenous variables through the dynamic (lag) structure of the VECM. An impulse response function traces the effect of a one-time shock to one of the innovations on current and future values of the endogenous variables. If the innovations ε_t are contemporaneously uncorrelated, the interpretation of the impulse response is straightforward. The i th innovation $\varepsilon_{i,t}$ is simply a shock to the i th endogenous variable y_{it} . Figures 5.8 and 5.9 illustrate the response of the Bahraini and Omani real GDPs when we introduce a positive shock to Saudi real GDP. In the case of Bahrain, the response to the shock is positive and lasts for approximately eight years. Whereas in Oman, the response is overall neutral, it is initially negative but becomes positive and the affect of the shock dies out more quickly than in Bahrain, after just four years.

Figure 5.9: Impulse Response Function for Bahrain and Saudi Arabia

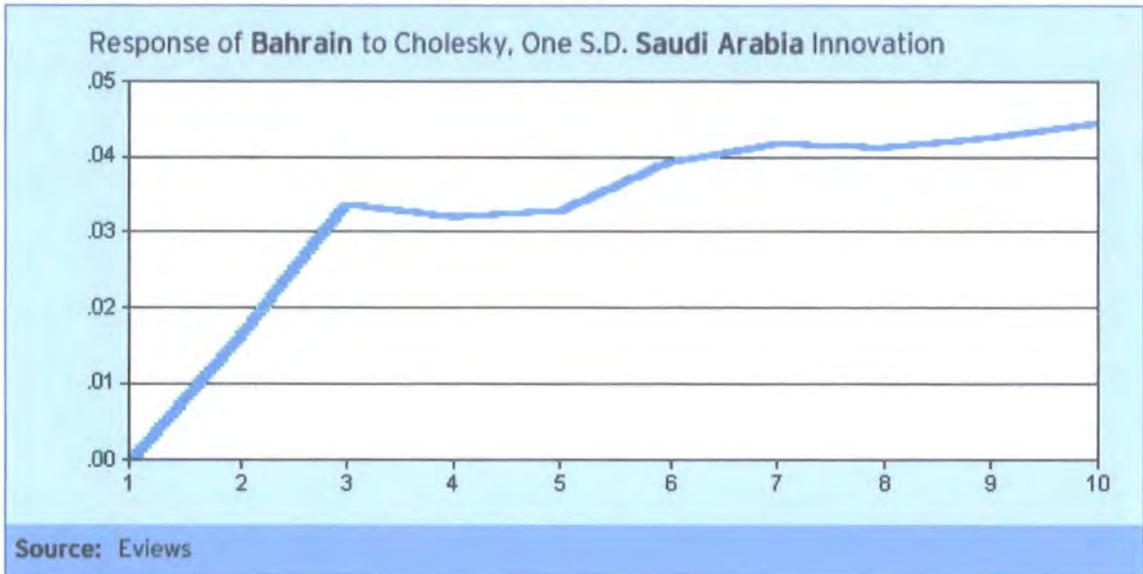
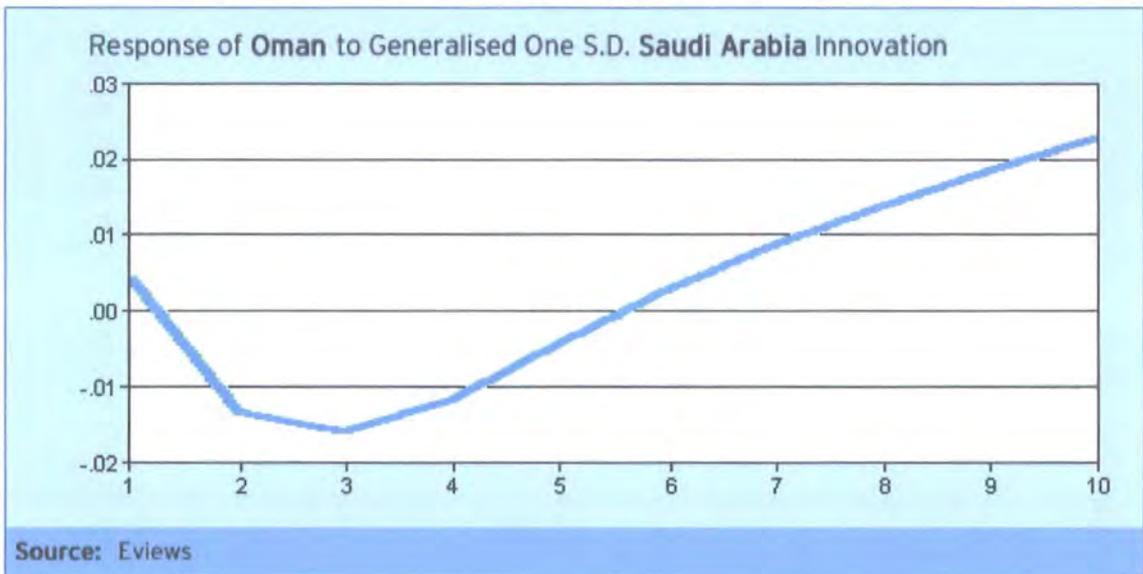


Figure 5.10: Impulse Response Function for Oman and Saudi Arabia



5.6.2 Interpreting the Findings

In summary, it appears from this econometric analysis that whilst there is evidence that the GCC economies have moved together in a long term relationship since the formation of the GCC, there are some interesting disparities in the long run relationships between the individual GCC economies and Saudi Arabia, the dominant economy in the region. The findings presented here indicate that the

UAE and Kuwait do not follow the same long term growth trend as that of the Saudi economy. In contrast the real GDP of Bahrain and Oman do exhibit long term relationships with the Saudi economy, and changes in the Saudi economy Granger cause adjustments in the Omani or Bahraini economies that eventually bring them back to a long term relationship.

One possible explanation for the lack of cointegration between Kuwait and Saudi Arabia is that Kuwait has had a more independent exchange rate arrangement than the other GCC states for several decades, pegging to an undisclosed basket of currencies. While Kuwaiti interest rates have broadly followed those of the other GCC economies, it has had a greater degree of freedom in terms of its monetary policy which may well have allowed it to mitigate regional and domestic shocks to a greater extent than any other GCC economies.

In the case of the UAE, the results might be rationalized by considering the concerted efforts made by the UAE to integrate into the global economy. It has developed an extensive re-export industry and is known as the region's re-export hub. It therefore has extensive global trading links which might suggest that the economy is more exposed to global economic trends than regional ones. In recent years, more than any other GCC economy, the UAE has also liberalized its economy and opened up considerably to international tourism and foreign investment.¹³⁷

In section 5.2 of this chapter "Intra-Regional Trade" our analysis revealed that the trade intensity ratios (TIR) between Saudi Arabia and the UAE were particularly weak and Kuwait's TIR were generally weak with all its GCC neighbours. Weak trade linkages may in part explain why these two GCC economies are not well integrated with that of Saudi Arabia. In fact research by Frankel and Rose found a positive correlation between bilateral trade intensity and business cycles indicating

¹³⁷ For example, allowing foreigners to invest in both certain stocks and in property in designated areas.

that the level of trade between two economies cannot be considered independently from the business cycle and that they are jointly determined.¹³⁸

The importance of being cointegrated with the largest economy in the prospective CU should not be understated and may well have implications for the distribution of costs and benefits of CU to its members. We cannot assume however, that Saudi Arabia will be able to dominate monetary policy decision making in the future GCC central bank. The direction of GCC monetary policy will eventually depend on the set up of the central bank and the votes allotted to each GCC country. In the ECB the largest economy, Germany was given the same voting power on the Governing Council as the smallest economy because of a one country one vote rule.¹³⁹ Indeed some observers have commented that EMU monetary policy has been less appropriate for Germany than it has for the smaller EU economies. The result, it has been argued, is that European monetary policy does not take into account the different effects in terms of GDP or the impact on welfare levels in the union overall.¹⁴⁰ Therefore the structure and voting set up of the future common central bank will have important ramifications. Nevertheless, it seems that in the absence of a long term integration between the UAE, the second largest GCC economy, and Saudi Arabia could be costly for either economy and may lead to friction in future monetary policy decision making.

In concluding, one of the limitations of this type of econometric model is however, that it is backward looking, based on past values of the variables. In the future, it may be the case that if the GCC economies work towards meeting convergence criteria, as did the EMU economies, and with deepening trade integration, the significance of long run regional integration may well grow. Furthermore, as we have discussed in previous sections of this chapter, in recent years there has been increasing capital integration, and an increasing number of examples of large FDI projects between the UAE and Saudi Arabia which will also tighten economic

¹³⁸ Frankel, J.A. and Rose, A. K., "Is EMU more Justifiable ex post than ex ante?" *European Economic Review* 41, pp 753-760, 1997.

¹³⁹ Brueckner, Matthias "Voting Power in the European Central Bank" in Manfred J. Holler, and Guillermo Owen (eds.), *Power Indices and Coalition Formation*, published by Kluwer, 2001.

¹⁴⁰ *Ibid.*

integration. In addition, as was argued in section 5.5 of this chapter, if the GCC economies continue to implement 'within country' diversification strategies then they will also be less likely to face idiosyncratic domestic shocks in the future.

5.7 Conclusion

Of the five OCA criteria we have considered in this chapter (intra-regional trade, labour market mobility, capital market mobility, the degree of economic diversification and level of economic synchronization) it can be said that at the present time, while the GCC economies have traveled a considerable way towards meeting the criteria for an OCA, they have not yet done so to a sufficient degree.

Intra-regional trade is one criterion where the GCC states could do better. While we should be wary of measuring the extent of intra-GCC trade solely by reference to its share of total trade (including oil) and it is true that intra-GCC non-oil trade shows a considerably higher level of regional trade integration, nevertheless we must conclude that so far this criterion for an OCA remains insufficiently satisfied. However, as the GCC states pursue greater economic diversification it is likely that intra-GCC trade will continue to expand and will be further bolstered by a CU as a positive feed-back develops. Furthermore, the findings of the GCC wide business survey indicate that intra-regional trade is particularly important for the region's larger SMEs, which form the greatest part of the GCC business community and contribute significantly to private sector growth.

The GCC scores well in terms of **labour market mobility** firstly because legislation permits nationals to cross borders easily and secondly because the region's significant expatriate labour force is highly malleable. In the medium term, the GCC economies will have to continue to rely on expatriate labour for the growth of the private sector as nationals adjust to the realities of working in the private sector. In view of this, increasing the mobility of the regional labour pool through allowing intra-GCC transfers of expatriate labour would be advantageous once CU is established in terms of adjusting to potential asymmetric shocks. In the long run, educational improvements and the gradual adjustment of expectations should

ensure that the national labour force becomes more flexible considering that, as we have established, there are few remaining legal barriers to their mobility.

In terms of **capital market mobility** it is clear that the GCC is moving in the right direction, not only are Gulf nationals keen to cross borders to invest in one another's stocks but GCC businesses are also increasingly opting to cross-list. The region's leading role in the development and issuance of *sukuk* (Islamic debt) is also carried out intra-regionally with significant cross border cooperation on issuance between financial institutions and corporations. Up until recently, the majority of GCC FDI has flown out of the region, but there are increasing recent examples of intra-GCC FDI which may suggest a turnaround in the previous trend.

The GCC states are not well **economically diversified**. After decades of following economic diversification policies they remain to a large degree dependent on hydrocarbons. However there are pronounced intra-regional variations with regard to this criterion with Bahrain and the UAE achieving a measure of success. Since 2002 when oil prices began their upward trajectory, significant non-oil and gas related investments have been made both regionally and internationally which will also help to diversify future income streams. It is important however, that diversification takes place 'within country' rather than simply 'within region'. The idea that GCC countries should specialise to 'avoid competition' when they diversify away from oil and gas is mistaken and would leave the GCC economies more vulnerable to asymmetric shocks, Fortunately there are some indications that 'within country' diversification is indeed taking place.

We have established that there is a significant level of **economic synchronicity** between the GCC economies on the whole. Using econometric cointegration tests it can be inferred that the GCC economies follow a long term integrating relationship. However, analysis of the relationship on a state by state basis revealed that economic integration between the two largest GCC economies the UAE and Saudi Arabia, as well as between Kuwait and Saudi Arabia is weak. Consequently a monetary policy predicated on the economic conditions of the most populous and economically dominant GCC state may not necessarily be optimal

for the UAE, nor for that matter for Kuwait. This result may have implications for the regional distribution of costs and benefits (which we discuss later in chapter eight).

Failing to meet all of the economic criteria discussed above might mean that CU is not 'optimal' yet it does not prevent CU for the GCC bloc from being feasible. As we have seen, the experience of EMU has proved that not all economic criteria need to be met in order to form CU. In fact, previous research¹⁴¹ has argued that certain OCA criteria, such as the level of economic synchronisation and intra-regional trade, may in fact be endogenous and therefore failing to meet these criteria might not be as costly as expected. Indeed, the process of forming a CU itself may lead to economic convergence among the members and the establishment of a single currency might substantially boost intra-regional levels of trade.

In this chapter we have assessed the appropriateness of CU for the GCC as an economic bloc but throughout our analysis we have compared and contrasted the individual economies. Those areas where respective GCC economies do not adequately meet the OCA criteria gives a strong impression as to where the potential costs of CU might lie (see chapter eight).

Ultimately whether the GCC states are able to successfully form a CU will depend on their political commitment to the process and the preparations that are made in advance. In the following chapter we will discuss whether establishing a common currency is a shared political goal of the GCC leaders and whether other prerequisite policies are in place for forming a feasible CU.

¹⁴¹ For example, Frankel, J.A. and Rose, A. K., "Is EMU more Justifiable ex post than ex ante?" *European Economic Review* 41, pp 753-760, 1997.

Chapter 6 : Policy Prerequisites for a Successful Currency Union

6.1 Introduction

Having covered, in some detail, the suitability of the GCC economies for CU against the various OCA criteria specified in the economic literature, we now turn our attention to additional policy prerequisites which are either deemed essential or highly desirable in order to establish a viable CU. Whereas the OCA criteria fall largely into the field of longer term, structural characteristics, the criteria which we discuss in this chapter relate to economic policy variables – the objects of decisions which will have to be made by Governments and Monetary Authorities and which, at least in principle, can be taken immediately (although – as we discuss in the next two chapters – there may be economic and social costs involved which might deter them from doing so). These additional, policy prerequisites have emerged primarily out of the European CU project and include: fiscal and monetary convergence criteria; effective institutional preparations; completing the Customs Union and Common Market; preparing the private sector and sufficient political determination to pursue the CU project.

As in the previous chapter, we will combine evidence from published sources with the primary research collected whilst based in the region. Fiscal and monetary convergence is critical to guarantee price stability within the monetary union and this is covered at some length in section 6.2. Mechanisms will also need to be in place to ensure that post 2010 the whole union is not jeopardized by any one state's undisciplined fiscal budgets. In particular we focus on convergence in exchange rates, inflation, interest rates, government deficit and public debt to GDP ratios as well as foreign reserve ratios.

Institutional preparations are critical to ensure the cohesion of the union. The establishment of a central monetary authority is necessary to determine and conduct policy for the bloc and improvements must be made in regional data

provision which will underpin monetary policy decisions; these issues are covered in section 6.3. In section 6.4 the obstacles to completing the Customs Union and Common Market are discussed. Completing the Customs Union and establishing the Common Market are essential prerequisites to the CU, without which many of the benefits of a single currency will not be realized. The views of regional experts are useful to this analysis and provide contextual evidence with which to assess the actual degree of monetary and institutional preparations taking place and the obstacles to completing the Common Market.

The attitudes and opinions of the GCC businesses community are pivotal in assessing whether the region can achieve a smooth transition to CU and are dealt with in section 6.5. The findings of the GCC business survey, conducted for this thesis, provide an insight into business sentiment and also on the degree to which the business community is prepared for the switch to a single currency.

The degree of political commitment *and* political motivation among GCC leaders with regard to the process of economic integration and monetary union is considered in section 6.6. As the experience of other CUs has shown, in particular that of EMU, a sustainable CU cannot be achieved without a high level of political commitment to the process. We use qualitative evidence to assess whether the GCC states meet this criterion; in particular we draw upon the opinions of high level GCC experts from interviews conducted throughout the GCC.

6.2 Fiscal and Monetary Convergence

Fiscal and monetary convergence will probably be – if it is not already – the most contentious and complicated prerequisite facing the GCC. Although in one sense the GCC has already cleared one major hurdle in terms of having more or less identical exchange rate policies, agreeing on maximum government debt and inflation targets will be harder to achieve. With the possible exception of establishing supranational institutions such as a central monetary authority and statistical agency, the issue of fiscal convergence will be the hardest to agree upon and achieve.

The GCC convergence criteria are widely anticipated to mirror those of the European Maastricht criteria and the Stability and Growth Pact (SGP) the objectives of which were to achieve important conditions for any prospective CU members - a high degree of price stability, a sustainable government budgetary position and the durability of convergence once CU had been established. GCC central bankers have informally agreed upon working towards fiscal and monetary convergence criteria, yet GCC leaders have yet to publicly endorse them let alone announce when they will set about meeting them.¹

At a meeting of GCC Central Bank Governors in September 2005, it was agreed that the council would adopt Maastricht-style convergence criteria which included inflation convergence targets, capping budget deficits at 3 percent of GDP and keeping gross government debt to below 60 percent of GDP (see Table 6.1).² At the time, the governors said that they hoped to put these convergence criteria before the annual GCC summit which was held later in the year in Abu Dhabi.³ Nevertheless, shortly before the summit was convened, GCC Finance Ministers discussed, but failed to approve, the targets arguing that they needed more time to agree on some of the issues.⁴

¹ Staff Writer "Criteria for Gulf Economic Union okayed" *Saudi Gazette*, 20 December 2005.

² According to the IMF in its 2005 Article IV Consultations with the UAE ("United Arab Emirates: 2005 Article IV Consultation—Staff Report" IMF Country Report No. 05/269), five convergence criteria were discussed by the governors including targets on inflation rates, short-term interest rates, foreign exchange reserves, as well as fiscal deficit and public debt ratios. But that deliberations were continuing on: identifying issues that would need to be addressed in establishing a common central bank; establishing a common data standard and a common fiscal accounting framework and identifying other areas that would need further harmonization.

³ Economist Intelligence Unit *Country Report United Arab Emirates*, December 2005 Updater.

⁴ Gulf Research Center "GCC Economic Report", Dubai, Issue 5, December 2005.

Table 6.1: Comparing the Maastricht and GCC Convergence Criteria

	Maastricht Criteria	GCC Convergence Criteria
1.	Exchange rate fluctuation within the normal margins for at least 2 years without any devaluation against any other member states currency	Long term stability of GCC exchange rates has meant that so far this criterion has been omitted
2.	Inflation rates must fluctuate within 1.5% of the average of the three best performing countries	As Maastricht
3.	Long term interest rates must fluctuate within 2% of bond yields of the three best performing countries.)	As Maastricht
4.	Government deficits must not exceed 3% of GDP ⁵	As Maastricht
5.	Government debt must not exceed 60% of GDP	As Maastricht
6.	No foreign reserve criteria	Foreign reserves must cover 4 months of imports ⁶

Regardless of whether the GCC economies meet these convergence criteria, there is the issue of the appropriateness of these particular criteria for the GCC economies. The GCC economies are very different to those of the European Union and their high degree of resource dependence means that their ability to meet fiscal deficit and debt criteria is subject to the vagaries of the international oil market.

Prior to the provisional agreement on the nature of the GCC convergence criteria, a senior GCC Secretariat official, Dr. Abdel Aziz al-Uwaisheq, director of the

⁵ This rule however, was not binding under certain economic circumstances, see Eichengreen, B. and Wyplosz, C. "Stability Pact: More than a Minor Nuisance?" *Economic Policy*, No. 26, pp. 65-113, April 1998.

⁶ This is not technically a convergence criteria but has been set as part of the preparations to create a single monetary authority.

GCC's economic integration department, commented on the difficulty of meeting and sticking to the criteria, "We looked at the historical experience and we found sometimes that (the GCC economies) had to run a deficit of 15 or 20 percent of GDP because the price of oil is unpredictable. So it will be difficult to have a hard and fast rule and say your budget may not have a deficit of more than 3 percent."⁷ Nevertheless, the GCC states will need to improve their fiscal discipline in order to be able to sustain the cohesion of the future CU. The presence of large disparities in the fiscal positions of the GCC states could well create tensions that threaten the unity of the currency bloc.

Unlike the EMU convergence criteria which were actually firm and unconditional requirements, the GCC's convergence criteria appear to be more in the nature of targets (nothing has been said with regard to the consequences of a given GCC state not having met one or a number of the criteria). In the case of EMU those states that were not able to meet the criteria were in fact prevented from joining: such was the case with Greece initially. The question that arises in the case of the GCC convergence criteria therefore is – what will be the incentives for these economies to meet the criteria and how will they be enforced?

These questions remain to be addressed by either the GCC Secretariat or the GCC Finance Ministers. One incentive to meet the criteria might be the loss of economic credibility should they fail to do so. However, several of the economic criteria impinge on national sovereign issues such as government spending and at times of low oil prices the will to comply with regional convergence criteria may be weak in the face of overriding national interests such as paying public sector wage bills.⁸

An accurate analysis of the degree of convergence in the fiscal and monetary indicators of the GCC states ultimately depends to a large degree on the

⁷ Staff Writer "Volatile oil is a headache for Gulf monetary union" *Gulf Times*, 30 October 2004.

⁸ Later in this section we discuss the views of GCC experts on the CU, several of whom commented that meeting such fiscal convergence criteria might be a sticking point of the monetary union project.

availability and reliability of GCC national data. It remains the case that GCC national data is often incomplete and untimely and there are a number of statistical discrepancies in particular with data relevant to convergence criteria.⁹ This then inevitably affects any evaluation of convergence.

Overall, in order for the convergence criteria to be assessed accurately and for the GCC states to monitor each other's convergence there needs to be much more transparency and standardization of GCC data otherwise the convergence criteria become rather meaningless and simply rhetorical. Without improved statistical provision progress towards convergence cannot be garnered and meeting them might simply be fudged (this issue is discussed in more depth in section 6.3.2 of this chapter). Indeed, the results of our own analysis can only be tentative due to the quality of existing GCC data.

This sub-section will be broken down into the following areas: exchange rate convergence; inflation levels; interest rates, levels of government deficit and debt and finally the issue of foreign exchange rate reserves. It concludes by assessing how well the GCC states have been able to meet these provisional criteria over the historical period of study (1980-2005).

6.2.1 Exchange Rates

Considering that the GCC sovereign currencies are currently all pegged to the dollar, a high degree of exchange rate convergence has already been attained with little effort. In chapter four "Economic Performance and Policy 1980 – 2005", the exchange rate performance of the GCC states was discussed at some length. It was established that GCC exchange rates had experienced high levels of stability against the dollar, and against each others' currencies (see chapter four, section 4.2.5).

⁹ Six months after the end of the year the statistical data for that year is still not officially available.

Whilst there is agreement on the need to peg the GCC currencies to the US dollar prior to the establishment of the CU, what will need to be decided however, is what to do with the single currency once it is launched. Thus far, it has not been formally stated whether the future common currency will be pegged to an external anchor, the US dollar or a basket of currencies, or whether it will operate under a floating exchange rate system.

All indications are that the GCC will, at least in the early stages of its new single currency, opt to stick with the dollar peg. However, it may, in time, modify this policy position though, as there are a number of perceived benefits to be gained from a more flexible exchange rate regime, which we discuss in the chapter 7 (see section 7.3.2), and which have stimulated other oil exporting nations, such as Norway, to choose a floating exchange-rate arrangement.

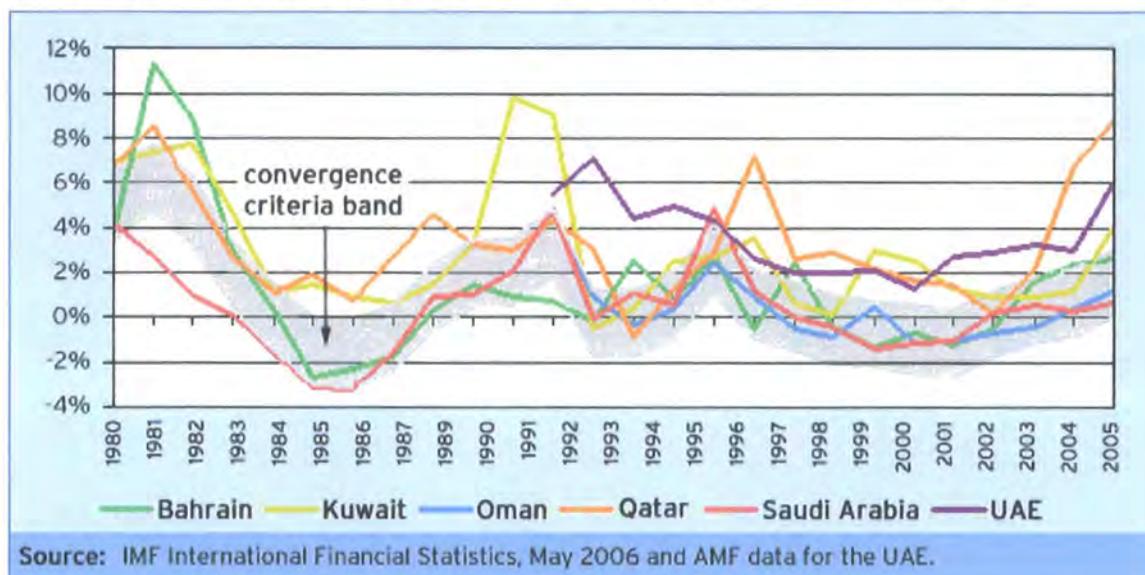
6.2.2 Inflation Rates

Inflation in the GCC states has generally been low, only infrequently reaching double digits and averaging less than 4 percent on aggregate between 1980 and 2005. A caveat must be made however with regard to the consistency of inflation statistics across the GCC states. For instance, the individual GCC states do not use the same base year for their published CPI series, neither are the 'weighted basket of goods' consistent, with differences in the share of goods, services and administered prices in the CPI.

In previous analysis in chapter four (section 4.2.1) inflation rates across the GCC states were examined and compared. It was discovered that despite the common policy of pegged exchange rates and a shared preference for low inflation rates, price levels across the GCC have varied considerably. For example, average inflation in the UAE between 1980 and 2005 was 3.6 percent but in Oman it was only 0.43 percent and in Saudi Arabia 0.51 percent. The median inflation rate in the UAE was 3 percent but only 0.36 percent in Oman and in Saudi Arabia 0.45 percent (see chapter four, Table 4.2).

Upon examination it appears that the inflation rates of several GCC states since 1980 have breached the convergence criteria rule, which stipulates that inflation levels must fluctuate within 1.5 percent of the average of the three best performing members. Figure 6.1 illustrates that GCC inflation rates have frequently been outside of the 3 percent band of convergence. With the exception of Oman, all the GCC States have breached the inflation rule in the past on several occasions. Qatar, the UAE and Kuwait have breached the rule the most and on considerably more occasions than both Bahrain and Saudi Arabia. During the period of analysis only once, in 1989, did all the GCC states meet the inflation convergence criteria rule.¹⁰

Figure 6.1: GCC Inflation Rates and the Convergence Criteria Rule

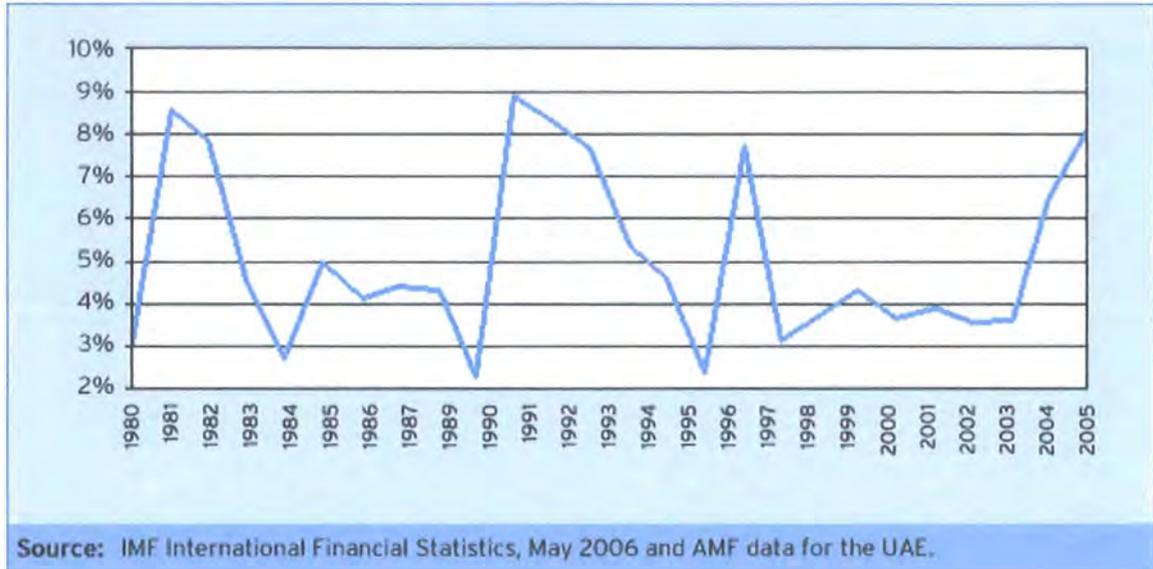


From an analysis of the available data, two inflationary groups emerge, one – the low inflation bloc including Oman, Bahrain and Saudi Arabia, while the second group – the high inflation bloc, includes the UAE, Qatar and Kuwait. In fact there continues to be considerable divergence between the highest and lowest inflation rates in the GCC economies (see Figure 6.2). This divergence has widened once again during the current oil price boom, where states such as the UAE and Qatar have experienced high levels of liquidity and inflationary pressures. In the UAE and

¹⁰ CPI data for Oman and the UAE is only available from the IMF and AMF beginning in 1991.

Qatar, where prices and labour costs are relatively flexible, these price pressures have been particularly noticeable in property markets, and have led to rising rents, which form a large proportion of the CPI index in these countries.¹¹

Figure 6.2: GCC Inflation Rate Differential



Inflation differentials were also a cause for concern in the run up to EMU. However, as the date for MU approached the EU countries adjusted their fiscal and monetary policies in order to be able to meet the rules of the Maastricht Treaty and inflation rates began to converge. The inflation rate spread between the Eurozone countries decreased dramatically from as much as to 20 percent in the beginning of the 1990s to around only 1 percent by mid 1999. However, following the launch of the Euro the spread then widened again and since has remained within a range of between 3 percent and 4 percent.¹²

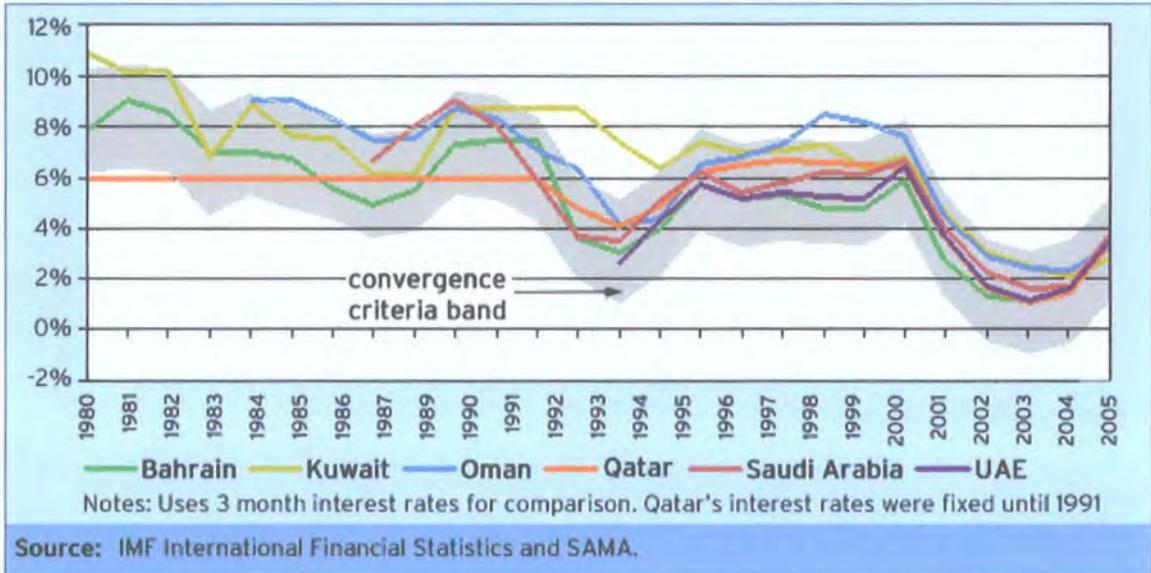
¹¹ Housing and housing related costs make up 36 percent of the CPI in the UAE according to Staff Writer "Central Bank plans debt issue to control inflation" *Reuters*, Dubai, 11 August 2005.

¹² Egert, B., Ritzberger-Gruenwald, D. and Silgoner, M.A. "Inflation Differentials in Europe: Past Experience and Future Prospects" in *Monetary Policy and the Economy*, Austrian Central Bank, May 2004.

6.2.3 Interest Rates

In contrast to GCC inflation rates, interest rates have shown a considerable degree of convergence over the period of study.¹³ The *de facto* dollar pegs in the region have meant that GCC interest rates have moved in line with interest rates in the US and concomitantly with each other. There have however, been a few occasions in the past when a GCC state would have broken the interest rate convergence rule. One such occasion was following the Iraqi invasion of Kuwait when interest rates were raised in an attempt to prevent capital flight (see Figure 6.3) and another instance was due to Oman's interest rate regulations in the late 1990s.¹⁴

Figure 6.3: GCC Interest Rates and the Convergence Criteria Rule

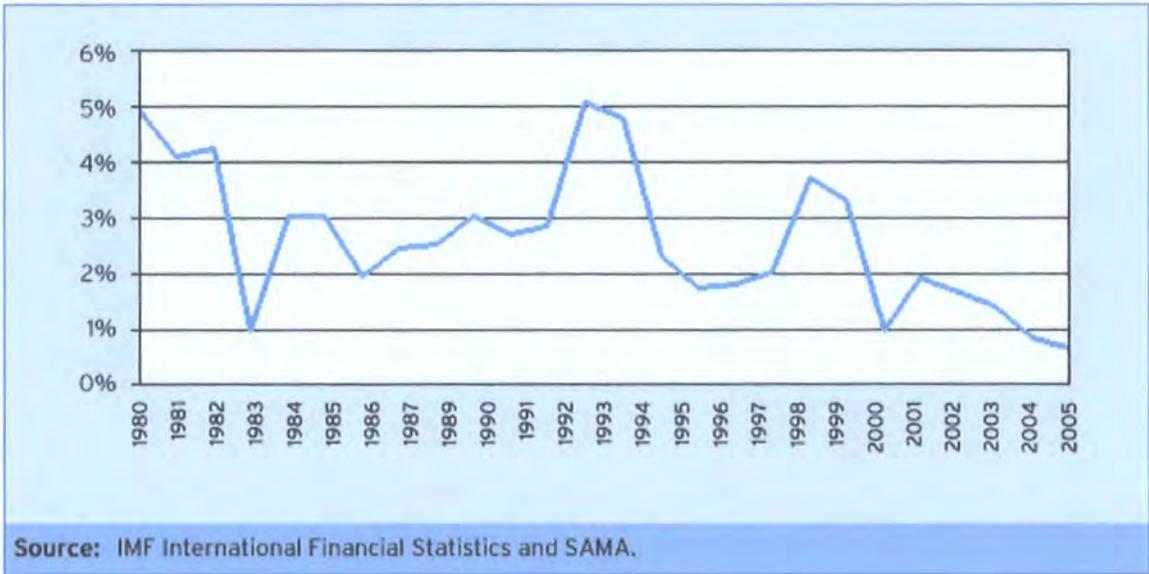


Excluding the peak after the Gulf war the interest rate spread was at its highest in 1980 at 4.9 percent, between Bahrain with the lowest interest rate and Kuwait with the highest. However, the interest rate spread has narrowed over time, coming down to its lowest spread at 0.7 percent in 2005 (see Figure 6.4).

¹³ Three month interest rates are used rather than long term interest rates as was the case in EMU because several GCC money markets do not have long term interest rate products, such as ten year bonds, therefore for comparative purposes we use short term interest rates.

¹⁴ Sturm, M. and Siegfried, N. "Regional Monetary Integration in the Member States of the Gulf Cooperation Council", European Central Bank, *Occasional Paper Series*, No. 31, June 2005.

Figure 6.4: GCC Interest Rate Spread



6.2.4 Government Deficits

A high level of fiscal discipline is an important requirement for the members of any CU. Undisciplined fiscal spending can undermine the monetary stability of a CU and allow big spenders to free ride on the credibility of fiscally restrained member countries. Rules to restrict the level of government budget deficits and debt are therefore critical to the sustainability of a CU. Having said this, the optimal level of deficits and debt is debatable, fiscal rules that are too tight might possibly make it hard for the authorities to use expansionary fiscal policy in the event of an economic downturn.

A few regional experts felt that fiscal policy issues would play an important part in whether or not the CU went ahead as scheduled. One Emirati government official said “Budgets are the most important part of economic and political reform and at the moment we have fabricated budgets. Any monetary authority will not be able to look at managing finances and reserves if there is no transparency or discipline.” While one Omani academic said “In 2010 economic issues will have an impact, if oil prices are low there will have to be tough fiscal discipline and small states will be in difficult position.”

Figures on the level of domestic public debt are, in certain cases, not readily available and there can be large disparities between figures depending on the data source (for example between a national data source and the AMF or IMF). Figures for the UAE's government budget also have to be interpreted with caution as the budget at the federal level does not take into account income returns on investments abroad which would often have offset the value of a deficit. Presumably, this is why, after years of deficits, the UAE has not needed to issue much public debt.¹⁵ In its 2005 Article IV Consultations with the UAE, the IMF said that there was a need for it to adopt a consistent and comprehensive set of public sector fiscal accounts.¹⁶ The IMF recommended that the Emirates adopt a common methodology across the individual Emirates and the Federal government budget systems, "consolidated fiscal accounts for the seven Emirates and the Federal government based on harmonized classifications and methodologies will need to be developed and be available without significant delay."¹⁷

GCC fiscal policy management has been problematic in the past, particularly because the income base of regional governments is narrow and depends largely on income derived from oil and gas export revenues. In 1994 75 percent of GCC government revenues were derived from oil and gas and this share had only fallen marginally to 70 percent by 2004.¹⁸

During the 1970s, huge oil revenues accrued to the GCC economies and spending rose dramatically, part of which went on recurrent expenditure such as public sector wage bills. Large infrastructure projects and massive development of public utilities also absorbed substantial revenues over a prolonged period. Consequently when oil prices fell during the 1980s and then stagnated for much of the 1990s it proved very difficult for the governments to cut back their recurring expenditures when revenues declined and as a result large deficits appeared.

¹⁵ Alexander's Gas and Oil Connections "UAE puts up tough fight against global economic storm" (Accessed at <http://www.gasandoil.com/goc/news/ntm15154.htm>) 20 November 2001.

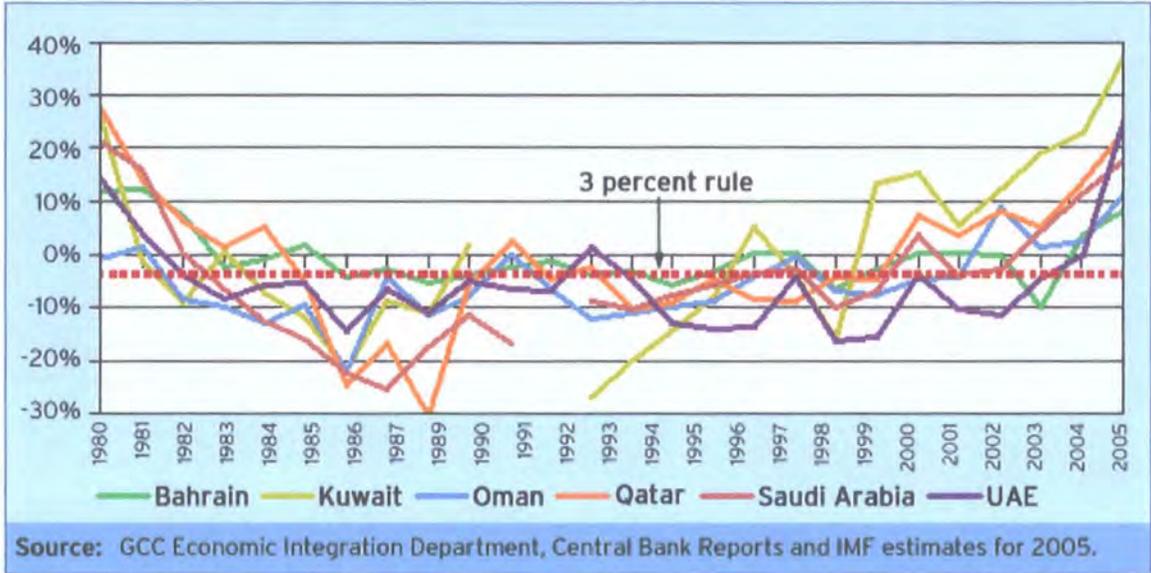
¹⁶ "United Arab Emirates: 2005 Article IV Consultation—Staff Report" IMF Country Report No. 05/269, 2005.

¹⁷ *Ibid.*

¹⁸ See chapter four, table 4.5.

During the second half of the 1980s and for a large part of the 1990s GCC governments recorded budget deficits exceeding the 3 percent deficit rule due to a prolonged period of low oil prices (Figure 6.5). Repeated budget deficit offenders, according to GCC Secretariat figures, have been the UAE, Oman and Saudi Arabia. The UAE has breached this criteria a record twenty-one times since 1980, Oman eighteen times and Saudi Arabia by no less than sixteen times (see Table 6.3). In addition, Saudi Arabia, Oman, Qatar and Kuwait all experienced budget deficits of more than 20 percent since 1980.

Figure 6.5: GCC Government Deficits to GDP and the Three Percent Rule



Econometric tests carried out by Fasano and Wang in 2002, revealed that GCC fiscal policies are highly procyclical and therefore that GCC government spending is correlated with oil prices.¹⁹ During times of low oil prices GCC government spending has been cut back rather than expanded as one might expect if an active fiscal policy were being pursued. Such pro-cyclical fiscal policies were identified in many Eurozone countries prior to MU and the fiscal prudence rules contained in the Stability and Growth Pact were designed in order to limit this practice.²⁰ It is

¹⁹ The findings of this paper were discussed in some detail in chapter 2, section 2.5, Fasano, U. and Wang, Q. "Testing the Relationship between Government Spending and Revenue: Evidence from GCC Countries" *IMF Working Paper*, November 2002.
²⁰ Jaeger, A. "Cyclical Fiscal Policy Behavior in the EU Countries," *IMF Country Report* No. 01/201, 2001.

worth noting however that during the current oil price boom (2002–2006) GCC governments have held back on spending and saved a considerable proportion of their surplus income which might suggest that a longer term policy perspective is being adopted.

By 2004, when the oil price boom had set in, almost all of the GCC states had moved back into a surplus budget position. Of the additional oil revenues earned by the GCC states between 2003 and 2005 Saudi Arabia used the largest share of its surplus to repay its public debt, Bahrain, Oman and Kuwait used their surpluses to cover non-oil fiscal deficits and the UAE and Qatar saved virtually all their additional revenue.²¹ In several GCC states public sector wages were raised, but in Saudi Arabia for example, the pay rise of 15 percent for public sector employees was the first salary increase across the sector for more than twenty years. The UAE also increased public sector wages, by 35 percent for nationals and 15 percent for foreigners increasing its future wage bill.²²

In 2005 significant investments were made by GCC oil stabilization funds and government investment bodies, which will provide diversified streams of income in the future and help to reduce oil income dependence. The primary function of such investment funds is to maintain fiscal discipline through separating public expenditure from oil price volatility. Most GCC states have oil stabilization funds either in name or kind. State controlled investment bodies, although not mandated as 'stabilization funds' can implicitly be viewed as such, and have invested hundreds of billions of dollars in diversified assets (see Table 6.2).²³

²¹ IMF, World Economic and Financial Surveys, *Regional Economic Outlook: Middle East and Central Asia*, May 2006. p.22.

²² *Ibid.* p.21

²³ Rutledge, E. "Overseas Acquisitions Vital For Tomorrow's Stability" Business Bulletin 8-14 April 2006, Gulf in the Media, Gulf Research Center, Dubai.

Table 6.2: GCC Oil Stabilisation and Investment Funds

	Name of Institution	Estimated Size of Fund
Bahrain	Reserve Fund for Strategic Projects	\$936mn (end of 2004)
Kuwait	General Reserve Fund Reserve Fund for Future Generations Kuwait Investment Authority	\$100bn (at least)
Oman	State General Reserve Fund & Oil Fund	\$2bn
Qatar	Stabilisation Fund & Oil Fund	\$4.26bn (end of 2004)
Saudi Arabia	No official fund (Figure for estimated overseas assets)	\$700bn
UAE	Abu Dhabi Investment Authority Dubai International Capital International Petroleum Investment Company Istithmar Mubadala Development Company	\$250 - \$300bn

Source: Adapted from IMF Regional Economic Outlook, *op.cit.* p.24, september.2006 and data from State Street Global Advisors Limited (Accessed at <http://www.ssga.com>)

During any future oil price decline GCC governments can therefore, if necessary, utilize the returns made from their foreign holdings as well as even selling off valuable assets if oil prices were to fall significantly for a protracted period of time.²⁴ GCC governments are using conservative estimates for oil prices in their coming budgets which should also enhance fiscal discipline.²⁵ The prudent behaviour of GCC governments during this oil price boom may mean that during future periods of low oil prices, large fiscal deficits may be avoided and there is a greater chance that fiscal rules might be met.

²⁴ Return on investments made by the UAE's Abu Dhabi Investment Authority meant that whilst oil prices were particularly low in 1998 and early 1999, the UAE had more than enough income to balance the books. In addition, the investment income from assets held by Kuwait's Reserve Fund for Future Generations, which are mainly in overseas capital markets has become the second largest source of government revenues after oil, contributing roughly a third of total revenues.

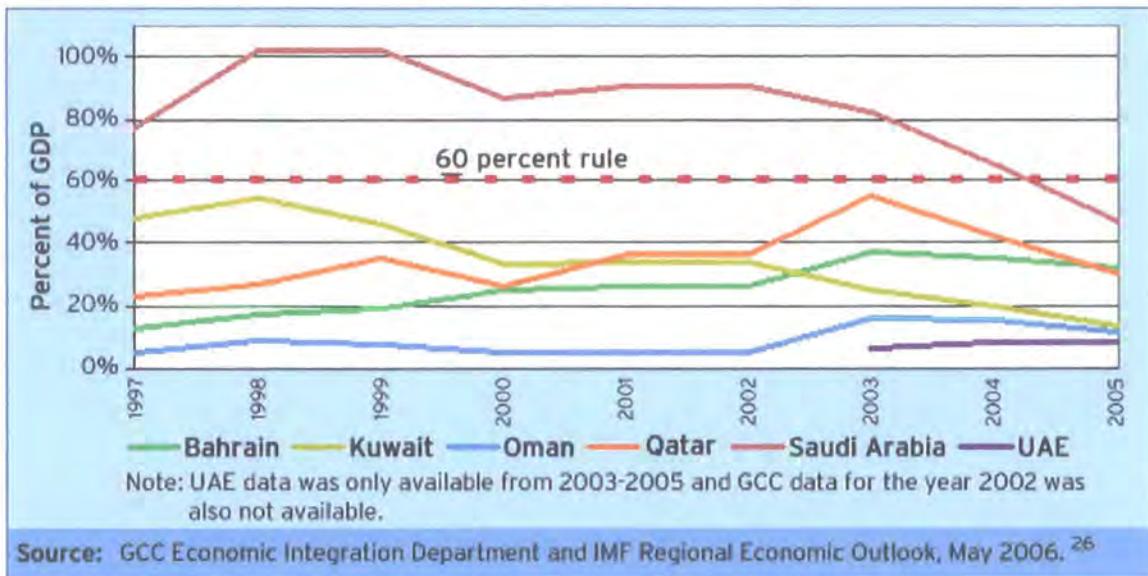
²⁵ IMF, World Economic and Financial Surveys, *Regional Economic Outlook: Middle East and Central Asia*, May 2006, p.22.

6.2.5 Government Debt

In assessing the degree to which the GCC economies have met the debt to GDP criteria, a number of questions relating to the reliability of debt to GDP ratios are raised. For example, the GCC Secretariat has doubts about what should be the definition of debt and whether debt to quasi-public institutions should be included or not. There is also discussion about whether external debt should be monitored and should total government liabilities be subject to the debt rules.

According to the available data, which could only be obtained going back to 1997, most GCC states have been within the limit of the 60 percent debt to GDP ratio, with the exception of Saudi Arabia (see Figure 6.6). Up until 2005 Saudi Arabia's debt to GDP ratio had been above the limit, in 1998 Saudi's debt reached a high of 102 percent of its GDP as a result of persistent budget deficits. The Kingdom has however, recently made concerted efforts to reduce its domestic debt burden and has reduced the debt to GDP ratio substantially, by more than half to below the 60 percent limit (Saudi Arabia's debt to GDP in 2005 stood at 46.5 percent). The UAE, by comparison, displays the lowest debt to GDP ratio of the group, which stood at just 8.4 percent of its GDP in 2005. The UAE has been able to avoid accumulating public debt because the returns on its investment assets have covered budget deficits. In 2005 all the GCC states were able to meet the 60 percent debt to GDP convergence criteria.

Figure 6.6: GCC Domestic Debt to GDP and the Sixty Percent Rule



Qatar is the only other GCC state where its domestic debt to GDP ratio has recently been close to the 60 percent limit, in 2003 its debt to GDP ratio rose to 55 percent. Qatar also has considerable external debt, at about 62 percent of GDP in 2001,²⁷ but Qatar has issued this debt in order to invest heavily in its upstream and downstream natural gas industry which is the central pillar of Qatar's economic development strategy. In fact, a high level of public debt may not necessarily be a bad thing for a transitional economy if the funds are being invested in developing key industries targeted for long term growth, as has been the case in Qatar. But borrowing to cover recurrent expenditures, as was the case with Saudi Arabia, will ultimately lead to an unsustainable fiscal position.

6.2.6 Foreign Reserve Requirements

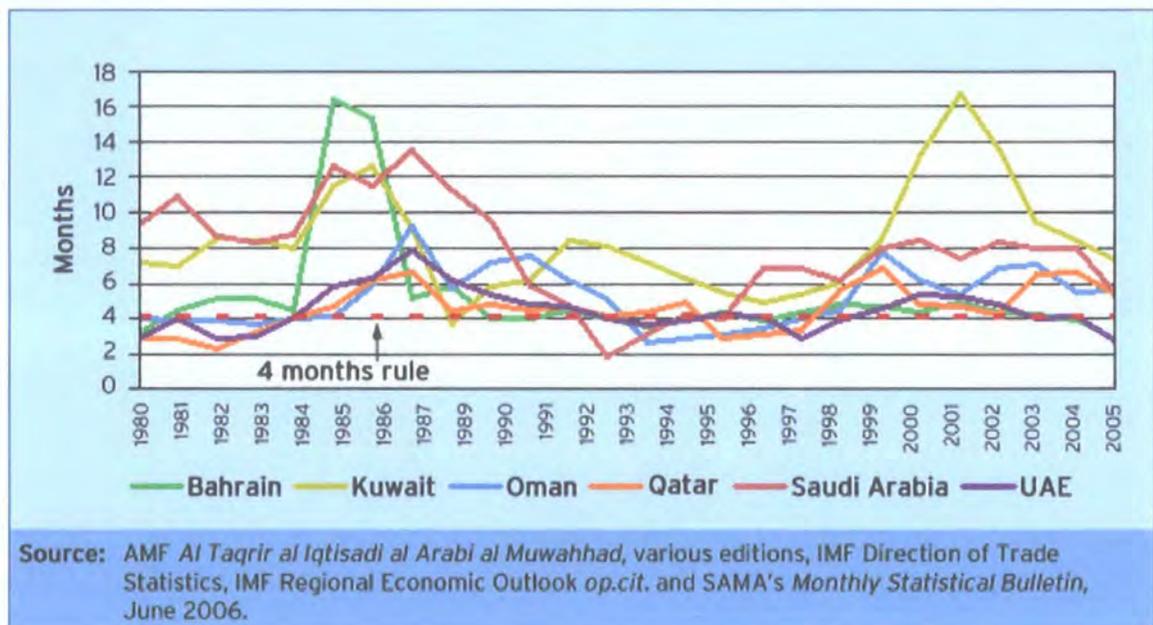
The GCC leaders have provisionally agreed to holding reserves equal to cover four months of imports as a preparatory step towards establishing a central monetary authority. According to AMF data, over the past two decades, all the GCC states have broken this criterion at some point, although Kuwait only broke the criterion once in 1988 and surprisingly it did not break the criterion after the Gulf war in

²⁶ IMF, World Economic and Financial Surveys, *Regional Economic Outlook: Middle East and Central Asia*, May 2006.

²⁷ According to data from the GCC Secretariat Economic Integration Unit.

1991. In fact, Kuwait has had extremely large foreign reserves in some years, which in 2001 for example, covered nearly 17 months of imports (see Figure 6.7). Although, the lowest level of reserve cover recorded was 1.9 months of imports in Saudi Arabia, the Kingdom only broke the criterion in two years in 1992 and 1993. The UAE has a high import propensity²⁸ and has consequently breached this criterion most frequently over the past two and a half decades. Both the UAE and Bahrain breached this criterion as recently as 2005, when their reserves fell to 2.8 and 2.9 months of import cover. For Bahrain it was a second consecutive year of not meeting the criterion as in 2004 reserves cover only amounted to 3.8 months of imports.

Figure 6.7: Reserve Cover to Months of Imports and the Convergence Criteria Rule



6.2.7 Historical Record Vis-à-vis Convergence Criteria

This analysis has indicated that the GCC economies may not find it an easy task to meet the Maastricht style convergence criteria that they are reportedly considering setting themselves. Based on past performance the GCC economies would have

²⁸ Mohammad, Y.H.J. and El-Sakka, M.I.T "Demand for Imports in the GCC Countries," *Journal of the Gulf and Arabian Peninsula Studies*, 27(100): pp. 43-84, 2001.

repeatedly broken several convergence criteria. Although it must be borne in mind that the past is not always the best guide to future performance, these findings can act as a warning signal indicating areas of convergence that may continue to be problematic for the GCC economies. For example, the UAE, Qatar and Kuwait have frequently breached the inflation limit rule in the period examined, while Saudi Arabia would also have breached the debt to GDP ratio on several occasions (see Table 6.3). The UAE, Saudi Arabia and Oman would have had trouble in meeting the 3 percent fiscal deficit as a proportion of GDP limit. However, the UAE's continuous budget deficits are more likely to be due to poor statistical reporting on the part of the UAE rather than repeated fiscal imprudence.

Despite problems with the data, it is worth considering the degree to which these economic constraints will be binding for the GCC economies in the future. Saudi Arabia's debt burden has been greatly relieved in recent years and if this trend continues the limit on debt should not be exceeded. The 3 percent fiscal deficit to GDP rule may also be problematic for the GCC economies should oil prices fall unless the trend towards diversifying income streams through oil stabilization funds and investment arms continues to build pace. The experience of the Eurozone countries in failing to meet the deficit to GDP ratio is also a warning sign of the challenges associated with this convergence criteria limit. Furthermore, inflation differentials among the GCC economies have continued to persist over time and therefore both the UAE, Qatar and to a lesser extent Kuwait, will struggle to remain with the inflation rule limit.

Table 6.3: Number of Years Convergence Criteria Rules Breached

	Period	Bahrain	Kuwait	Oman	Qatar	SA	UAE
Inflation limit*	1980-2005	6	14	0	16	8	15
Interest rates**	1980-2005	0	5	4	3	1	0
Foreign reserves	1980-2005	7	1	8	8	2	9
Fiscal deficit as % GDP***	1980-2005	8	12	18	13	16	21
Fiscal debt as % GDP	1997-2005	0	0	0	0	8	0
Total		21	32	30	40	35	45

Source: Author's calculations

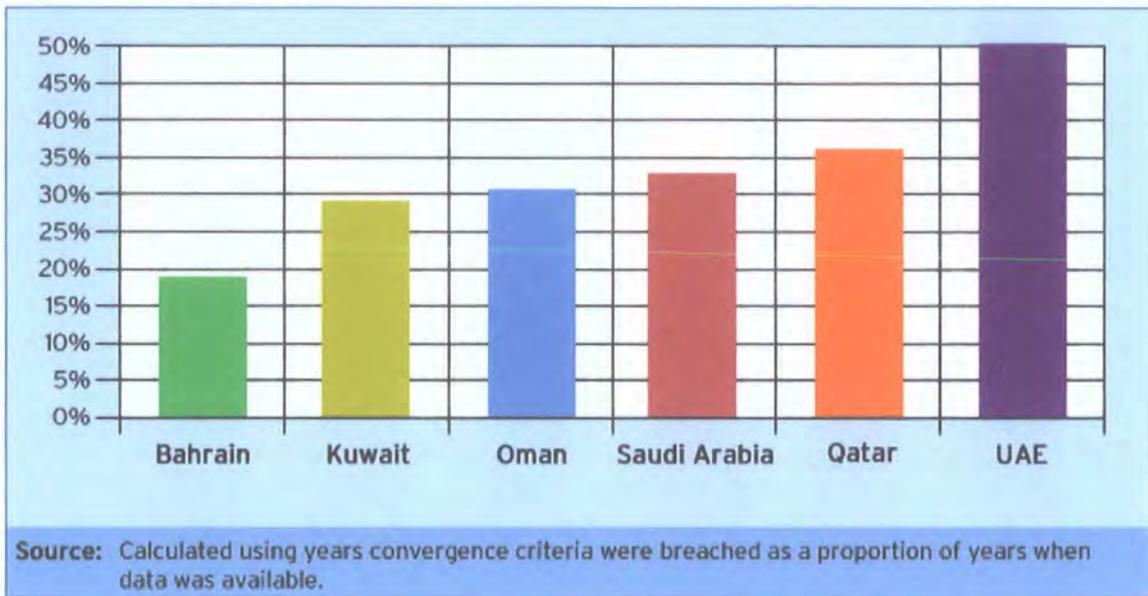
Notes: *Inflation data for the UAE and Oman only begins in 1991. **Interest rate data began in 1984 for Oman, in 1987 for SA and in 1993 for the UAE.

***Fiscal Data during Gulf war omitted, years 1990 and 1991 for Kuwait and 1991 for SA.

Overall, the UAE and Qatar would have had the greatest difficulty meeting the convergence criteria during the period of analysis. Consequently these two states have spent 50.6 percent and 35.4 percent respectively of the period under analysis breaching the convergence criteria (see Figure 6.8).

Once the exact convergence criteria have been officially announced and the GCC leaders disclose that they are working towards meeting them, it will be important for the GCC's economic credibility that they are achieved. Otherwise their ability to form a cohesive and sustainable CU may well be brought into question. Consequently, there will be hard bargaining over the exact limits of the convergence criteria and it is therefore likely that eventually the GCC finance ministers will only agree to much 'looser' convergence targets.

Figure 6.8: Proportion of Time Period Examined that Convergence Criteria were Breached



6.3 Institutional Preparations

The coordination of economic and monetary institutions across the GCC states is important to the overall cohesion of the economic bloc. Indeed, the institutional set up of the monetary union will affect the credibility of the whole process and should serve to strengthen the ties between the member states. The creation of a GCC central bank and the provision of regional data upon which to base the monetary policy decisions of the bloc, are essential prerequisite conditions for the functioning of the CU.

However, a significant proportion of those experts interviewed, 45 percent, felt that the monetary and institutional preparations for GCC CU that were in place by late 2005 were insufficient. A much smaller proportion of interviewees – 18 percent – felt that they were sufficient. One independent researcher in the UAE who felt that the preparations were inadequate said that there was little institutional coordination in his opinion and this made him skeptical saying “without the institutional setup how can it happen by 2010?” An official at the UAE’s central bank said that the pace of reforms related to and necessary for CU were insufficient; “adoption of the accompanying regulatory and institutional reforms is slow”.

The coordination among GCC institutions, particularly central banks to date has been insufficient, according to a large proportion of regional experts, including a number of Central Bank officials themselves. GCC experts believe that supranational institutions require strengthening in terms of both independence and capacity if they are to adequately support the CU. In particular experts felt that harmonizing regional data sets and establishing supranational monetary institutions such as a GCC central bank should be priorities. These issues are discussed in detail in the sub-sections below.

6.3.1 Establishing a GCC Central Bank

It is generally accepted that to have a viable CU there needs to be a single supranational central bank so that decision making on the single monetary and exchange rate policy is centralized.²⁹ Despite initially preferring to retain their national central banks the GCC leaders subsequently agreed to establish a single central bank.³⁰ The transfer of monetary policy decision making to a supranational monetary authority will inevitably involve the transfer of some national sovereignty to the regional institution. It is probably for this reason that the decisions as to the mandate of the bank, its organizational structure and its location, have yet to be agreed upon. Eventually decisions will also have to be taken on the distribution of seigniorage revenues and management of foreign exchange reserves. Furthermore, the critical political-economy decision of the voting structure of the monetary policy committee also remains to be determined.

A few regional experts commented that the decision to establish a single supranational monetary authority itself had not been an easy one. One Kuwaiti central bank official said, "Some countries had second thoughts in particular over the issue of the GCC central bank." A Kuwaiti government official said, "I don't

²⁹ Sturm, M. and Siegfried, N. "Regional Monetary Integration in the Member States of the Gulf Cooperation Council", *European Central Bank, Occasional Paper Series*, No. 31, June 2005, p.63.

³⁰ Rutledge, E. "Establishing a Successful GCC Currency Union: Preparations and Future Policy Choices" Gulf Research Center, *Policy Analysis*, December 2004.

know that they can have a unified central policy and still have individual central banks, so this could be a major obstacle.”

In late 2004, the UAE offered to host the new GCC central bank, and according to some sources will indeed be the chosen location.³¹ The location of the central bank will hold some symbolic value for the GCC states and therefore enthusiasm for hosting the region’s central bank is perhaps understandable. However, one Emirati government official berated the GCC leaders for focusing on what he considered to be a trivial issue, “In terms of a central bank they are more interested in deciding where it will be located rather than the internal mechanisms of operating a single policy and other major issues.”

Indeed, the experience of EMU has shown that substantial preparation time is needed to establish a regional central bank. The European Monetary Institute was set up as a precursor to the European Central Bank in order to carry out technical research and make monetary preparations, four years prior to the electronic launch of the single currency and six years before notes and coins were introduced.

However, several experts felt that the GCC’s supranational monetary authority need not follow the example of the EMU, because of the unique socio-economic context of the GCC states. One AMF expert said, “In terms of the institutions the GCC does not need to copy the European Central Bank exactly.” Another AMF official commented along similar lines, “Institutional requirements may not be that relevant for the GCC but they must fit the GCC economies, they may not need a central bank because there are only six GCC countries so the coordination issue is easier.” Such regional views are in contrast to those of the European Central Bank, one ECB economist interviewed said “They must have a single central bank because they need a single exchange rate policy. They cannot conduct this through a committee of governors – it would be too difficult to conduct a single exchange rate policy. You need single currency area analysis and staff to do this.”

³¹ Staff writer “UAE to host GCC central bank” *Arab News*, 25 October 2004.

At present, cooperation between GCC monetary institutions takes place through biannual meetings of the Central Bank Governors' Committee.³² In addition to this, according to information obtained from first-hand interviews, a technical committee meets several times during the year and reports to the Central Bank Governors. The GCC Secretariat is the main supranational organization in operation, and in 2002 a Monetary Union unit was established at the Secretariat at the decision of the Supreme Council.³³ However, the weakness of the GCC Secretariat was commented upon by one Emirati government official who said "Another obstacle (to CU) is the weakness of GCC institutions such as the Secretariat. It has no leverage or power to implement decisions and this is an institutional problem." The economic characteristics of the GCC countries as rentier states³⁴ has historically impeded the development of their institutions and this may inhibit the building of strong institutions to support the single monetary policy.

The mandate of the GCC central bank is another key decision that must be agreed upon by all the GCC leaders and must be compatible with the mandates of the existing GCC national central banks. In the case of the ECB, its single overriding objective is to maintain price stability in the Eurozone, but other central banks, such as that of the US, also attempt to stabilise economic growth.

It is clear that since the inception of the GCC, the monetary policies of its six Central Banks (or mandated Monetary Authorities) have been broadly similar. The objective has been to achieve stable nominal exchange rates through exchange rate targeting (see chapter four, section 4.3.5, for a discussion of GCC monetary policy). In terms of monetary policy objectives it seems as though there is a strong consensus among GCC central bankers in favour of maintaining a low inflation environment. Therefore, reaching agreement on the mandate of the new central bank may not prove to be too difficult.

³² Sturm, M. and Siegfried, N. 'Regional Monetary Integration in the Member States of the Gulf Cooperation Council', European Central Bank, Occasional Paper Series, No. 31, June 2005.

³³ *Ibid.*

³⁴ Luciani, Giacomo (ed.) *The Arab State*, University of California Press, 1990.

While there is an apparent convergence in terms of monetary preferences there are however existing disparities with regard to money markets and monetary policy instruments which must be standardised prior to CU if a single monetary policy is to be implemented effectively.³⁵ Saudi Arabia for example is the only GCC state which issues debt instruments with a maturity of ten years while most other GCC money markets are much shallower and bond maturities much shorter; typical maturities range between three and five years.

A single monetary policy will however require that a common set of monetary policy tools to be in operation across the GCC states. Several GCC experts commented on the fragmented nature of the GCC's money markets. One UAE-based commercial banker said, "We can't see any new instruments coming in to follow the SAMA. Following a single central bank there will have to be a level playing field for all banks and for the markets if they want the CU to be cohesive."

Finally, within the sphere of political-economy considerations will be the decision on the voting structure of the monetary policy committee. In the case of EMU, each member state was given equal voting powers, disregarding economic size. However, Saudi Arabia's position within the GCC is even more significant than that of Germany within EMU; its economy and population is greater than the aggregate sum of all the other five members. In a regional interview Mundell remarked "I hope that the Gulf countries will not make the same blunders committed by the EU. Certainly, the EU failed to grant Germany its true weight".³⁶ Therefore there may be an economic and political case for giving Saudi Arabia, by far the most populous state, greater voting powers than the smaller GCC states, as the ramifications of the single monetary policy on Saudi Arabia will therefore affect the welfare of the vast majority of the union's citizens. While such a voting structure may not be particularly appealing to the smaller GCC states, anything else is unlikely to be acceptable to Saudi Arabia. In this respect therefore, a certain amount of political

³⁵ Fasano, Ugo and Staff Team, *Monetary Union among Member Countries of the Gulf Cooperation Council*, IMF, p.23, 2003.

³⁶ Al-Hajji, A. F., "A Special Interview with Robert Mundell - Nobel Laureate in Economics" *Al Watan*, (translated from Arabic) 1999.

realism may be required by the smaller states in order to elicit the participation of Saudi Arabia in the CU project.

6.3.2 Regional Data Provision

Common statistical standards are particularly important for members of a CU to be able to monitor a nation's adherence to fiscal and monetary rules, and for a regional monetary policy committee to be able to make informed decisions based on sound economic data for the region. Yet the standardization, consistency and disclosure of the GCC's national statistics remain a major challenge to the process of regional economic integration.

As was discussed in section 6.2 national data is often inconsistent and incomplete across the GCC region, furthermore, regional data collected by the AMF may also contradict national data.³⁷ For example, Qatar does not currently publish constant GDP figures, Qatar Central Bank (QCB) and Qatar's Planning Council only publish nominal GDP (without price adjustments). The measure of inflation is also not consistent across the GCC states for example Qatar currently uses the base year for CPI as 2001 whereas the UAE uses 2000.

GCC experts felt strongly that institutional coordination and better preparation is required in producing harmonized and consistent GCC statistics in advance of the CU.³⁸ One Omani central bank official felt "much more has to be done on a statistical front we need to be able to compare these economies and this is only happening slowly." Another central bank official, this time in Bahrain, complained about the slow pace of standardizing economic data, he said "They need to unify the methodology of collecting the data". He went on to say that "The technical

³⁷ In the case of Bahrain, this was found to be the case, see Rutledge, E. *The Experience of Economic Diversification in Bahrain, 1987-1997*, The Bahrain-British Foundation, London, 1999.

³⁸ Research papers by the IMF and ECB have also pointed out that work needs to be done in terms of harmonizing and improving GCC statistics. See Abed, G.T., Erbas, S. N. and Guerami, B. "The GCC Monetary Union: Some Considerations for the Exchange Rate Regime", *IMF Working Paper*, April 2003.

committee agreed upon using international standardized systems but implementation needs to be speeded up.”

The provision of sound and credible data for the region has assumed a new level of urgency since CU was scheduled. New regional statistics will need to be calculated upon which appropriate monetary policy for the whole region can be predicated. According to the IMF the provision of such regional data is of overriding importance and the institute has recommended the building of a GCC statistical organization, a Gulf version of ‘Eurostat’.³⁹ However, the GCC leaders have yet to agree on the policy of establishing a supranational statistical agency.

In the case of the EMU, several bodies and institutions were involved in the collation of comparable regional statistics several years prior to the launch of the euro. In 1992, a Working Group on Statistics was set up, this body also liaised with the Statistics Division at the European Monetary Institute, established in 1994 and eventually replaced by the ECB, in order to establish a solid statistical base for the EMU.⁴⁰ Eurostat itself was originally established prior to the process of EMU in 1953, but in producing comparable statistics for Europe it also fulfilled an important role in providing monetary and fiscal statistics in the process of EMU and today it also provides Eurozone data to the ECB.

6.4 Creating the Common Market

Establishing a Common Market is an essential policy step towards CU, without it many of the benefits of the single currency will not be realized (as we will discuss in chapter seven). The Common Market includes establishing a Customs Union along with allowing complete factor market mobility. Article Three of the GCC Economic Agreement of 2001 specifically dealt with the “GCC Common Market” and stipulated that:

³⁹ Al-Mansouri, A.K.L. and Dziobek, C. “Providing Official Statistics for the Common Market and Monetary Union in the Gulf Cooperation Council (GCC) Countries—A Case for “Gulfstat”” *IMF Working Paper WP/06/38*, p.27, February 2006.

⁴⁰ *Ibid.*

“GCC natural and legal citizens shall be accorded, in any Member State, the same treatment accorded to its own citizens, without differentiation or discrimination, in all economic activities, especially the following:

1. Movement and residence
2. Work in private and government jobs
3. Pension and social security.
4. Engagement in all professions and crafts
5. Engagement in all economic, investment and service activities
6. Real estate ownership
7. Capital movement
8. Tax treatment
9. Stock ownership and formation of corporations
10. Education, health and social services

Member States shall agree to complete implementation rules sufficient to carry this out and bring into being the Gulf Common Market.”

The GCC states agreed to establish the Common Market by 2007. Despite the fact that the GCC leaders are taking steps to implement it, (see chapter 5, section 5.3 and 5.4) through enacting legislation to facilitate the free movement of labour and capital across the bloc, it is unlikely to be established by 2007. For instance, at the 24th GCC summit in 2004 it was agreed by the GCC leaders that the deadline for completing a unified pension and social security system could be as late as 2010.⁴¹ In addition, complications over the signing of bilateral FTAs have delayed the finalization of the Customs Union, an essential prerequisite of the Common Market.

⁴¹ Badr-El-Din A. I. “Intra-National Labor Mobility Between Arab Gulf Cooperation Council (AGCC) States –Towards Activating AGCC Economic Integration Process and Optimizing Human Resources Exploitation.” Economic Research Forum, 12th Annual Conference, Cairo, December 2005.

Details on establishing the Customs Union were also included in the 2001 Economic Agreement. It was said that the Customs Union will be implemented no later than January 2003. The Customs Union included:

1. A common external customs tariff (CET).
2. Common customs regulations and procedures.
3. Single entry point where customs duties are collected.
4. Elimination of all tariff and non-tariff barriers, while taking into consideration laws of agricultural and veterinarian quarantine, as well as rules regarding prohibited and restricted goods.
5. Goods produced in any Member State shall be accorded the same treatment as national products.

In fact, the Customs Union was launched in 2003 and this was seen as a major achievement. According to a Qatari central bank official "The biggest obstacle (to CU) was to reach an agreement about the Customs Union and that was approved in 2003." But when Bahrain chose to negotiate a FTA bilaterally with the US in 2004 and give the US preferential treatment equal to its GCC neighbours the completion of the Customs Union was put at risk.

With regard to international trade agreements the 2001 Economic Agreement stated that member states would "Negotiate collectively in a manner that serves the negotiating position of the Member States." Therefore, bi-lateral trade agreements clearly contravene the agreement. Saudi Arabia unusually made public its displeasure at what it saw as Bahrain flouting GCC trade policy. Saudi Arabia's Foreign Minister Prince Saud Al-Faisal said of the bilateral FTAs, "the (Free Trade) agreements entered into are in clear violation of the GCC's economic accords and decisions. What is more important, these agreements impede the progressive steps needed to achieve full GCC economic integration."⁴²

⁴² Staff Writer, 'Saud slams neighbors for undermining GCC solidarity' *Arab News*, 6 December 2004.

Other GCC states have however, since followed suit. In October 2005, Oman also signed up to a bilateral FTA with the US⁴³ while Qatar and the UAE began negotiations. However, Qatar's FTA negotiations were frozen after what it called as unreasonable conditions being imposed upon it by Washington⁴⁴ and the UAE's negotiations are taking longer than expected.⁴⁵ Unfortunately, the issue has set a precedent indicating that the GCC states are willing to flout GCC integration principals and charters if they believe it is in their national interests to do so.

Without each GCC state negotiating a similar FTA with the US the third and final stage of the Customs Union, which involved abolishing the customs functions of the intra-GCC border offices, cannot be completed.⁴⁶ This is because GCC states without US FTAs will have to be levy tariffs on US goods arriving as intra-GCC imports from GCC states with US FTAs, which will also be in conflict with the principle of the single point of entry. In fact, in late 2004, Saudi Arabia's Finance Minister, Dr. Ebrahim Al Assaf, announced plans to impose unilateral tariffs on US goods coming into Saudi Arabia from Bahrain.⁴⁷

In addition, in the absence of a harmonized trade policy it will be much harder for the GCC states to act as a regional economic bloc in international dealings and negotiations. One Emirati government official believed that bi-lateral FTAs had gone ahead because some GCC states were frustrated with multilateral negotiations, which in the case of the European Union had taken more than ten years to negotiate, "the EU FTA has taken at least 10 years and the GCC states need to reach agreements sooner. We want a liberal open policy to attract FDI and we can't wait for Saudi Arabia as it is not in our national interests." Yet one commercial banker in the UAE felt that the EU FTA negotiations had had a positive effect on the GCC, "The EU has acted as a catalyst (for GCC integration) because

⁴³ Negotiations took just seven months and were completed on 3 October 2005, *GCC Economic Report*, Issue 3, Gulf Research Center, Dubai, October 2005.

⁴⁴ Staff Writer "Doha puts freeze on free-trade talks with Washington 'There are issues that need to be resolved'" *Agence France Presse*, 1 May 2006.

⁴⁵ Ameen, Ahmad "We do not want to harm our interests" *Gulf News*, 24 June 2006.

⁴⁶ GCC Secretariat General, *Implementation Procedures for the Customs Union of the Cooperation Council for the Arab States of the Gulf (The GCC Customs Union)*, 2003.

⁴⁷ AMEinfo, "Saudi/Bahrain trade dispute intensifies" 9 January 2005

they have said come to us as a region and not individually and the GCC have realized that they need to act as a region to boost trade and investment and this has been important.”

The disharmony in trade policy across the GCC states was thought by a large proportion of GCC experts to represent a significant stumbling block to the economic integration of the GCC states. According to an expert on GCC CU at the European Central Bank “Bilateral FTAs put in jeopardy the whole Customs Union and illustrates that you must have a common trade policy, but they haven’t understood this.” One Emirati government official said “US FTAs are an obstacle (to the integration process) and this is a political issue that must be dealt with.” According to one GCC official, the impact of the bilateral FTAs with the US could be serious for the region’s full integration, “The Bahrain-US FTA is a crisis, it goes against the economic agreement and will be a test of the strength of the GCC and its viability, the problem has to be solved. The Customs Union started in 2003 and the transition stage should be over at the end of 2005 but the end could be delayed if the Bahrain problem isn’t solved.” In fact, rather ominously, implementing the final stage of the Customs Union has been postponed by two years.

6.5 Preparing the Private Sector

Private sector expectations about price stability and monetary credibility are crucial in determining future investment decisions and consequently economic growth. Expectations are influenced by the provision of information and therefore, preparing businesses and households for the CU adequately will be critical in reducing uncertainty and supporting economic confidence.

The transition to CU is likely to produce important indirect effects which materialize through adjustments in the behaviour of economic agents to the change in economic system.⁴⁸ GCC policy makers will therefore need to take action, to

⁴⁸ Commission of the European Communities, *One Market, One Money An Evaluation of the Potential Benefits and Costs of Forming an Economic and Monetary Union*, European Economy No. 44, October 1990.

inform, educate and prepare in order to smooth the transition to the single currency.

Regional experts, interviewed for this thesis, were asked how they thought GCC citizens perceived the CU and whether they thought they were prepared for it or not. The majority of interviewees, 51 percent, thought that GCC citizens were not at all prepared for the CU.

One AMF official commented "I'm not sure that they are sufficiently prepared and I would advise more promotion as happened before EMU they need to do more, I don't think it is too early as this is an ambitious project and needs much time." One Omani academic felt strongly about this issue, "The process does not have any credibility, getting citizens on board is important but that is not happening now. They are not prepared and this is a problem because there is a lack of trust and confidence." Several experts concurred with this sentiment. One independent researcher in the UAE said "There is a lack of education on this and more information is needed. They are not being prepared at all. We need more than a couple of years to educate people and bring them round and promote monetary union, I don't think it is too early to start to do this."

The findings of the GCC wide business survey certainly underlined the fact that GCC businesses are not at all prepared for the CU, (see Table 6.4) and that this is a concern for them. Furthermore, there was a recognition that business uncertainty about the transition to the new monetary system may be costly for the private sector.

Table 6.4: Business Responses to Survey Question Thirteen

Is your business making preparations for the CU in 2010?				
Response	Yes	Planning to do so at a later stage	No	Total
Percent	0%	26.2%	73.8%	100.0%

In the business sample not a single GCC business said they were currently making preparations for the single currency although just over a quarter of respondents said that they would do so closer to 2010. Little specific information has been disseminated from the GCC Secretariat with regard to preparing for the CU thus far and even central bank officials have admitted a lack of preparedness for CU.⁴⁹

In the EMU countries concerted publicity campaigns informing businesses and the general public began at least three years before the launch of the euro and therefore there will soon be pressure on the GCC states to do the same from international institutions if they are to credibly meet the CU target of 2010.

It should be of concern to GCC policymakers that most businesses said that they desired assistance in beginning to prepare for CU now and yet they are not receiving any help. The majority of business respondents – 59 percent – felt that GCC governments should be assisting and providing information for businesses to prepare for the CU at this time (see Table 6.5). The statistical significance of this majority was confirmed at the 95 percent confidence level (53-64 percent). Slightly more than one third of business respondents, 35 percent, felt that the GCC governments should provide assistance but closer to 2010. Only in Qatar, did the majority of businesses surveyed feel that GCC governments need not help businesses prepare until a later date.

⁴⁹ It should be noted that both the interviews and the survey took place during 2005. At that point in time there were still four full years prior to the launch of CU.

Table 6.5: Business Responses to Survey Question Sixteen

Should the Government be providing assistance in preparing for the currency union?				
Response	Yes	Yes, but closer to 2010	No	Total
Percent	59.0%	34.9%	6.2%	100.0%

The experience of EMU also shows that businesses can expect to incur some initial costs from the launch of the single currency. Businesses will be required to adapt their information technology, accounting, marketing, pricing and payroll systems in advance of the launch of the single currency and they must be made aware that this will only be a one off cost if they are to continue to see the process in a favourable light.

However, GCC business survey respondents were uncertain as to whether the introduction of the single currency would temporarily increase their costs or not. The majority of business respondents, 52 percent, were unsure as to whether it would or not, whereas 37 percent thought it would not increase their costs and only 12 percent thought it would (see Table 6.6). More than any other size of company it was SMEs that felt the CU would temporarily increase their costs, with 47 percent believing so. Unlike larger companies, SMEs may find it harder to absorb any increase in their costs resulting from the CU and therefore are more likely to be concerned by this. As several GCC states are developing and enacting policies to foster the growth of SMEs (see chapter four, section 4.3.3) it would be wise for them to provide assistance to these businesses on preparing for CU as soon as possible.

Table 6.6: Business Responses to Survey Question Nineteen

Do you expect the introduction of the single currency to increase your costs?				
Response	Yes	No	Not Sure	Total
Percent	11.7%	36.5%	51.8%	100.0%

The urgency of providing this assistance is all the more acute given that the majority of business respondents, 57 percent, felt that some harm to their businesses would be caused by the introduction of the CU (for more details see chapter seven, section 7.2.3).

6.6 Political Commitment and Motivation

Previous research has suggested that the traditional economic OCA criteria may be endogenous, i.e. that the political decision and clear commitment to establishing a CU *itself* has a positive feedback facilitating those economic adjustments required for the satisfaction of the OCA criteria.⁵⁰ In this respect it could be said that the political commitment to CU itself becomes a major policy prerequisite. In this section we aim to establish the degree of political commitment of the GCC leaders to the process of CU. This is not necessarily a straight forward task, due to the lack of transparency in the decision making process at the highest level in the GCC states. However, in addition to discussing the degree of political commitment to CU as evidenced by the pace of the process to date, we also attempt an analysis of the motivations of the GCC leaders behind the plan to establish a CU. As we shall argue, there may be an important relationship between the type of motivation which drives the decision making process for CU on the one hand, and on the other, the intensity of the political commitment to reaching that objective.

⁵⁰ Frankel, J.A and Rose, A.K. "The Endogeneity of the Optimum Currency Area Criteria", *NBER Working Paper 5700*, August 1996.

6.6.1 Political Commitment to GCC CU

The formation of the GCC and the signing of the Economic Agreement in 1981 can be seen as the starting point for GCC economic integration and ultimately the creation of a Customs Union and a Common Market along European lines. However, the pace of progress faltered in the years following the ratification of the initial Economic Agreement.

It was not until the 2001 summit that the GCC leaders agreed to spur on the economic integration process and signed a new Economic Agreement leading to the establishment of the Customs Union which still did not come into force until 2003.⁵¹ An Emirati government official commented "They were supposed to have Customs Union in 1985-87 so it will probably be the same for the common currency, although they will never admit it." One Saudi government official remarked "It does not seem there is sufficient preparation towards the monetary union other than the meetings and the expression of interest or willingness". Another Saudi official said in a similar vein that few concrete decisions had been made and most meetings ended with little more than an "expression of willingness" to consider things further.

One Emirati academic who doubted the commitment behind the CU project said "It is a common thing, and many groups of countries are trying to achieve it. But over the last twenty years progress towards integration has been very slow and this suggests that it isn't being taken seriously". An Emirati government official remarked, "It is an appealing concept for many and is taken as a fashion. Developing countries often try to emulate the developed countries but without looking seriously into the impact." While one Kuwaiti central bank official felt "They are trying to show unification but there is no incentive or drive for it."

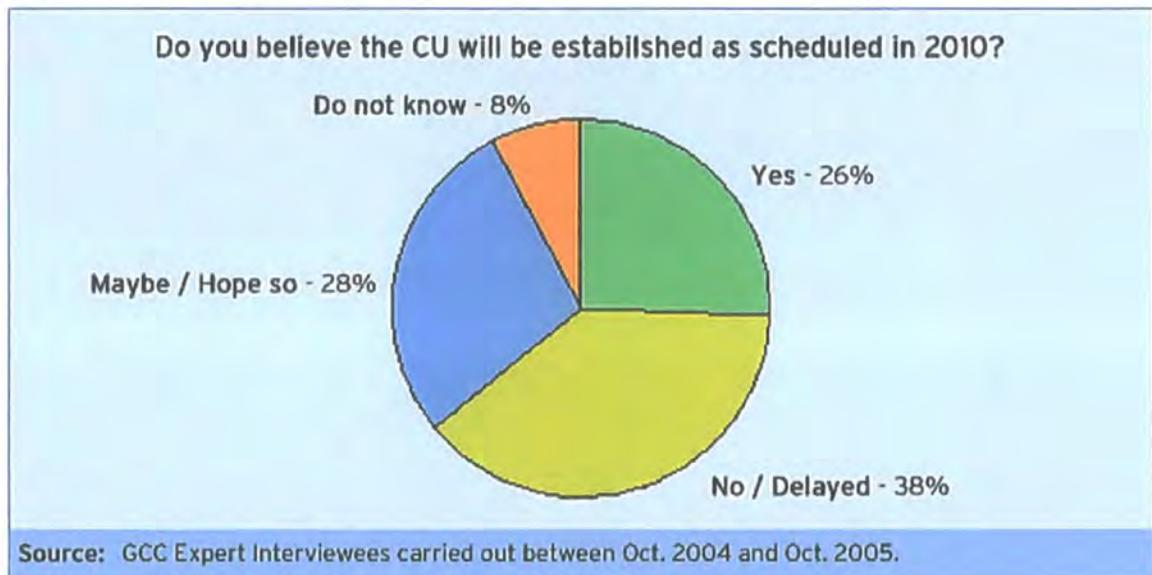
Crown Prince Abdullah himself admitted frustration over the slow pace of progress in his address to the 22nd GCC summit in 2001 "For over twenty years, the progress of the GCC (towards CU) has been very slow when compared with the

⁵¹ Forming a Customs Union had been a GCC objective since the nineties.

pace of the modern age.” Not surprisingly, the slow pace of regional economic integration in the past has raised concerns over the level of political commitment to the process. In 2001 Crown Prince Abdullah admitted that part of the problem was “our adherence to an exaggerated concept of sovereignty.”⁵²

When regional experts were asked whether or not they thought the GCC CU would be established as scheduled in 2010, the largest proportion of experts thought that it would be delayed. Approximately 38 percent did not expect the CU to be established as scheduled, while 28 percent said they ‘hoped so’ or ‘maybe’ leaving only 26 percent who said they did think it would be established on schedule (see Figure 6.9).

Figure 6.9: Interviewee Responses to Question Thirteen



Of those experts that felt the CU would not be established by 2010 most said that they thought it would be delayed by a period of between two to five years. However, two interviewees felt more pessimistic, one Saudi government official said ominously “I am inclined to say that it might not be established in the foreseeable future.”

⁵² Al-Saud, Abdullah bin Abdulaziz “Address to the Gulf Cooperation Council” *Middle East Policy*, Vol. IX, No. 1, March 2002.

Several experts based their responses on their perception of the political will of the GCC leaders. Others anticipated delays simply because past experience had shown frequent delays in the implementation of other important GCC policies and some said that they did not think the GCC states would be adequately prepared in time. One Emirati government official commented "Monetary union was first mentioned in 1982; until today we have still not achieved this. From past experience it will not happen on schedule, unless something extraordinary happens." While one commercial banker in Kuwait said "they won't be ready on time, everything in the region takes so long it will be indefinitely delayed."

However, one Emirati government official considered that external as much as internal factors had weakened the political will for CU. He said "It will not be on time because the political will is not there, and the Americans won't allow it. The bilateral FTAs have shown that they (the US) prefer to see division among the GCC states." As we have already noted bilateral FTAs with the US are inherently inconsistent with the achievement of GCC CU and it may be that future relationships with the US, more than political lethargy on the part of the regional elites, will determine the speed with which the GCC CU project now advances. This important observation leads us directly to the question of motivation. What were (and are today) the primary causal factors pushing the ruling elites in the Gulf states towards a CU.

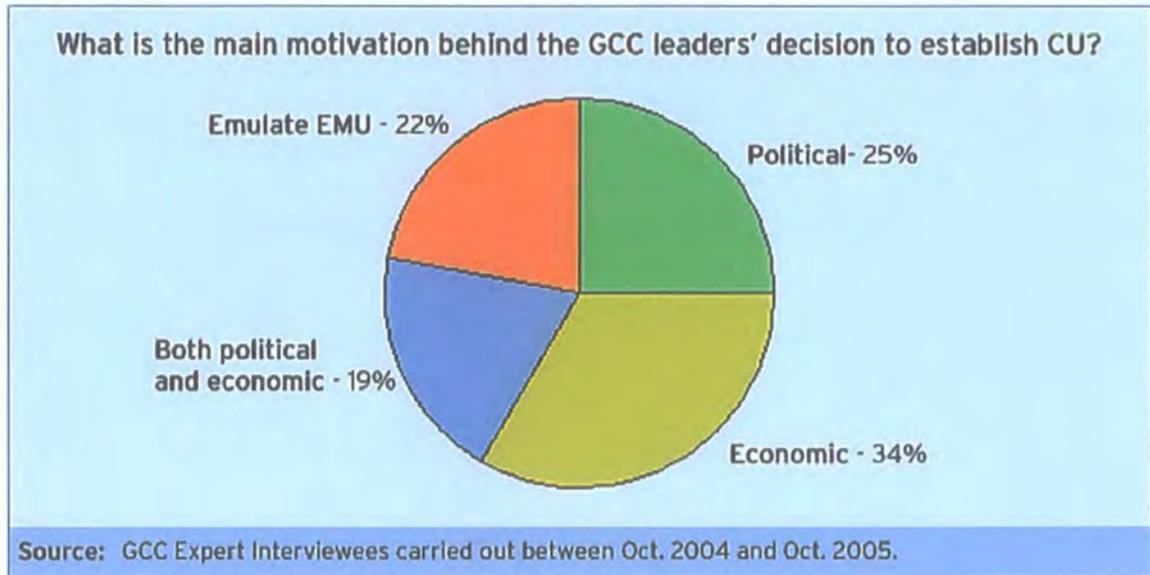
6.6.2 The Motivations behind GCC CU

GCC experts were asked what they thought was the primary motivation behind the GCC leaders' decision to commit themselves to CU. The question was deliberately open ended in order to allow interviewees to express their own views and opinions on the factors influencing the process. However, while interviews were carried out in complete confidence, it must be admitted, that interviewees in some GCC states may have been inhibited from answering this question in a frank and open manner.

With this caveat, it emerges that the largest proportion of regional expert interviewees, 33 percent, felt that the motivation behind establishing a GCC CU

was based on economic considerations, However, a quarter of respondents said that they thought the key rationale was political, 19 percent, thought that the decision was as much political as economic and 22 percent believed that emulating the success of the EMU was the main source of motivation (see Figure 6.10)

Figure 6.10: Interviewee Responses to Question One



Among those who cited economic reasons only, one Omani academic thought, “The Intention is to advance economic integration in trade and to exploit economies of scale”. An independent researcher in Kuwait said emphatically “There is an economic rationale, they realize there are efficiency gains to be had, especially considering that they have many similarities, they feel it would be easy. I have no doubt it is driven by economic considerations.” One commercial banker in Kuwait said “It is because of economic reasons, they are very small countries and it is the only way for them to compete and create economies of scale, without economies of scale it makes developing manufacturing industries difficult for them.” While one Emirati central bank official felt that monetary union would act as an important catalyst for future economic reforms, he commented “the adoption of the common currency will trigger much needed reforms that will improve dramatically growth prospects and diversification away from oil for all member countries.”

Of those respondents who thought that political motives were the most important driving force, one Bahraini central bank official felt this way, "The objective is to be unified from a political point of view. Following this they have tried to develop the relationship in economic terms." Another central bank official, this time in the UAE, remarked "In our view, one of the main motivations is political: the commitment of the leadership to the unification of the Gulf region" While one AMF official commented "The forming of the GCC was a political issue and now they want to give an economic layer to their political club. But the economic motivation is secondary." While one Saudi GCC Secretariat official commented "Political integration is key. The GCC was established in 1981 and the Economic Agreement was signed as a means to strengthen the bloc".

In addition to the comments of interviewees, the Director General of the AMF, Dr. Jassim Al Mannai, in a keynote address at the Gulf Euro summit in 2000 expressed his view that "Economic and monetary union is above all a political project. The main purpose is not only to raise economic efficiency, but essentially to change and improve the way the region is managed and governed."⁵³

A number of interviewees felt that the motivation was both economic and political. One independent researcher in the UAE said "Politics and economics are inseparable." Another independent researcher on the GCC said "There will be some economic gains in fostering integration and diversification. But as with Europe it is ultimately a political decision".

Some 22 percent of interviewees felt that the GCC states were simply following a trend inspired by the example of EMU. Crown Prince Abdullah of Saudi Arabia himself alluded to this in 2001, saying "The example of the European Union is a model to follow".⁵⁴ One Saudi government official also thought this was a factor and remarked, "Having agreed to the Customs Union the GCC, following the

⁵³ Keynote Address by Dr. Jassim Al Mannai, Director General of the Board, Arab Monetary Fund, on The Euro Impact on the GCC Economic and Finance, Gulf Euro Summit, Dubai, 8-9 October, 2000.

⁵⁴ Al-Saud, Abdullah bin Abdulaziz. *op.cit.*

traditional EU inspired integration process, has moved to establish a monetary union.” One Emirati central bank official remarked, “After the formation of the GCC in 1981 the aim was to emulate what the EU has achieved.”

However, it should be noted that in the case of the European Union any reading of the relevant EU literature makes it clear that both the formation of a Common Market and the establishment of CU were driven primarily by a political imperative rather than being based on the economic merits of the project.⁵⁵ Despite some major economic disparities between its members, EMU succeeded because of the perceived political advantages of the project rather than its economic merits.⁵⁶

Political commitment to EMU was itself driven by political motivations. For over a century Europe had been torn apart by internecine wars culminating in the horrors of WW II. The politicians who drove the CU and Common Market agenda were haunted by the disaster of earlier years in which millions had died and they were determined that this should never happen again. In particular they were obsessed with the idea that the perennial struggle between Germany and France, which had lasted from the Franco Prussian War of 1870 until the collapse of the Nazis in 1945, would never be repeated. The formation of the European Union was the outcome of these political and strategic decisions much more than any desire to e.g. establish economies of scale in production or free trade between the European nations *per se*.

Returning to our panel of regional experts, while it is true that the largest proportion of experts, 34 percent, thought that the economic rationale was the main motivating force, the remaining 66 percent either explicitly or implicitly recognised the importance of political motivation in varying degrees. The second largest group (25 percent) thought politics the primary issue, 19 percent also recognised that politics played a part along with economic factors, and the 22 percent who thought

⁵⁵ Feldstein, M. "The Political Economy of the European Economic and Monetary Union: Political Sources of an Economic Liability" *The Journal of Economic Perspectives*, Vol. 11, No. 4, pp23-42, autumn 1997.

⁵⁶ *Ibid.*

that emulation of the European Union was the leading motivating factor seems to suggest that these interviewees recognised that the Union's success was, at least in part, a political, phenomenon.

One could go further. The experience of the EU suggests that the stronger the role of political, as opposed to economic, considerations in motivating the participants in a potential CU, the stronger will be the political commitment to the process of implementing that CU. Admittedly the evidence for this proposition is scant since there have been so few CUs formed, but *a priori* it seems plausible and, as we have said, the experience of the European Union and EMU certainly supports it. In the following chapter, we will return to the issue of political motivation in discussing the political benefits of forming a CU (see chapter seven, section 7.5.2)

6.7 Conclusion

It would appear in some ways that the GCC states fair better in terms of their suitability for CU vis-à-vis OCA criteria than they do in terms of their prospects for implementing appropriate economic and political policies prior to 2010. Even though they have a major advantage in comparison with the EU countries prior to MU in that they have stable fixed exchange rates as well as sharing cultural and linguistic traits, several key stumbling blocs remain. These challenges include; agreeing to, and meeting, the fiscal and monetary convergence criteria, deciding upon the mandate, set up and location of the central bank, improving regional statistics, completing the Customs Union and Common Market and preparing the private sector from scratch. But above all else the political commitment to the very concept of CU still appears to be less than wholehearted in the case of some of the GCC states.

Nevertheless, that is not to say that this problem cannot be overcome and it may be that the current political turbulence in the Middle East may bring the GCC countries to a greater awareness of the overall gains that can be obtained from much greater economic (and political) integration, of which the formation of successful CU is but one part, albeit a very important one. In other words, as we

suggested in the previous section of this chapter, as the political and geo-strategic pay-off from CU becomes more apparent, so the political commitment to pushing ahead with the CU project will increase.

Chapter 7 : The Potential Costs and Benefits of a GCC Currency Union

7.1 Introduction

The potential costs and benefits of a GCC CU depend primarily on two factors. Firstly, the degree to which member states meet the OCA criteria (see chapter five) and secondly, whether the essential prerequisite policies are implemented (see chapter six). The main *direct* cost of joining a CU is the loss of an independent monetary policy setting. The potential cost of ceding monetary sovereignty depends on several factors including intra-regional labour and capital mobility and the degree to which the economic cycles of prospective members are synchronised. The *direct* benefits of CU arise from efficiency gains through a reduction in transaction costs and elimination of exchange rate uncertainty. The size of these direct gains is contingent on the level of intra-regional trade and investment. There will also be many other indirect potential costs and benefits arising from the integration and convergence process. Furthermore, policy decisions taken *ex post* will also have the potential to benefit the economic bloc.

Indirect benefits of CU may also be enjoyed by both consumers and producers arising from the establishment of a single market. Access to an enlarged market will help businesses exploit economies of scale and at the same time increased competition will lead to pressure on prices. Greater integration of the Gulf's financial markets will offer more diversified investment and funding opportunities and help to allocate capital more efficiently.

Several decades after formulating the OCA theory, Robert Mundell considered a wider range of associated costs and benefits of establishing a CU, many of these political economy considerations are of particular relevance to the GCC

economies.¹ One such indirect benefit may arise as a result of the GCC becoming a more powerful and cohesive entity with greater influence in economic and political discussions with the ability to act as a countervailing influence against the domination of neighbouring powers.² Mundell also proposes that the prospective members of a CU may consider the advantages from establishing an international currency, from which they could earn seigniorage revenues.³ While one possible reason why a potential member state may be reluctant to join a CU, suggests Mundell, could be that it wants to protect the secrecy of its national statistics. Indeed, rumours persist that some Gulf monarchies benefit from oil sales that are kept out of the given country's national accounts.

The loss of some degree of national sovereignty over fiscal policy may therefore be considered a 'cost' by some prospective member states even though tighter fiscal discipline is likely to benefit the union as a whole. Where such 'loss of sovereignty' costs are felt particularly acutely by the rulers of a particular GCC state they may even constitute a serious obstacle to the very progress of CU itself. However, we must be aware that in a political context in which there may be a serious transparency deficit with respect to basic financial data on the state's incomes and expenditures, the costs incurred in the alleged 'loss of sovereignty' may be 'costs' to the ruling elite alone.

That is not to say, that the enforcement of fiscal discipline rules by a supranational GCC body might not initially involve possibly painful adjustment costs for some member states if it means that spending plans have to be curtailed. This illustrates the point that some factors that may initially incur some short-term costs will eventually result in long-term benefits. Just as improved fiscal discipline in the GCC should, in time, lower borrowing costs for the region, improve business confidence and help to attract greater levels of FDI.

¹ Mundell, Robert A. "Updating the agenda for monetary union" in *Optimum Currency Areas: New Analytical and Policy Developments*, (Eds. Blejer, M.I., Frenkel, J.A., Leiderman, L., and Razin, A.) IMF, 1997.

² *Ibid.*

³ *Ibid.*

Finally, we should be aware of the relevance of the 'Lucas Critique' to an analysis of the costs (and benefits) of GCC CU.⁴ Once CU is established some asymmetries between GCC states that may have made CU appear more costly for them, may simply become less acute, because the adoption of the union itself has changed the behaviour and expectations of economic agents. In such a situation, which is similar to the argument put forward by Frankel and Rose⁵ that many of the OCA criteria are 'endogenous' to the policy of CU, there will undoubtedly be much fewer costs of forming the CU.

The aim of this chapter is to discuss the potential costs and benefits of CU for the GCC as a whole. In doing so we make particular use of empirical evidence drawn from the GCC business survey and from opinions provided by regional experts, in interviews for this thesis. It will be left to the following chapter (chapter eight) to look at the costs and benefits of the envisaged CU on a country by country basis.

The potential impact of CU on GCC business expectations and the potential micro economic efficiency gains which may over time translate into macroeconomic growth are considered in section 7.2. Within this section, we examine the following: the potential efficiency gains of CU, the impact of the CU on GCC wide prices, the expected effect on the business climate and investment decisions and finally the implications for the growth of GCC capital markets.

Section 7.3 concentrates on how CU will influence the ability of the GCC economies to adjust to potential economic shocks. Despite employing interest rates primarily for exchange rate targeting, the GCC national central banks have some, albeit limited, monetary policy independence with which to steer their domestic economies. In this section we assess the potential cost of losing this monetary policy autonomy which will not be available to them once tied into CU.⁶ It

⁴ Lucas, Robert, "Economic Policy Evaluation: A Critique", in *The Phillips Curve and Labour Markets*, (Eds.K.Brunner and A.Melzer), Carnegie-Rochester Conference Series on Public Policy 1: 19-46, 1976.

⁵ Frankel, J. A. and Rose, A. K, "The Endogeneity of the Optimum Currency Area Criteria," *Economic Journal*, Royal Economic Society, vol. 108(449), pages 1009-25, July 1998.

⁶ See chapter 4 "GCC Economic Performance and Policy 1980-2005".

also discusses the choice of exchange rate arrangement and monetary policy for the single GCC currency once established. This policy remains to be determined and in light of differences in existing monetary policy preferences may prove to be a contentious issue for the GCC leaders.

Section 7.4 considers the fiscal policy consequences of CU. Fiscal discipline is required for CU stability and inevitably translates into some loss of national sovereignty over fiscal policy decision making. Firstly, we discuss the importance of appropriately designed fiscal rules for the region that do not impinge on the economic development of these states. Following this, we assess the relevance of the alleged 'cost' to fiscal policy sovereignty and the extent to which it may be merely a cloak for a desire to hide the misappropriation of public funds by ruling elites, while at the same time recognising that the perception of such a potential 'cost' may slow the process of CU.

In the final section, section 7.5, the main political economy dimensions of CU are considered. The likelihood of the 'Gulf dinar' becoming a significant 'Islamic Currency' and the conditions required for such a scenario and whether or not such an outcome is perceived as desirable is first discussed. Finally this section focuses on one particular benefit of CU not usually considered by economists: that forming a successful CU may strengthen feelings of solidarity and socio-political unity among the members, sentiments which may enhance the region's self confidence and its international status.

7.2 Business Expectations and Growth

At the micro level and from the perspective of businesses, the direct gains from forming a CU comprise efficiency gains which are assumed to arise from the elimination of transaction costs and exchange rate uncertainty. The corresponding

improvements in micro level efficiencies are expected to lead to increases in macroeconomic output and welfare gains for consumers.⁷

In the case of the GCC economies, these gains are often expected to be rather limited because of the region's existing fixed exchange rates and relatively small levels of intra-regional trade. However, the removal of exchange rate costs erodes the non-tariff barriers to trade in goods and services that can hinder trade and therefore may promote its growth. Section 7.2.1 investigates the potential significance of micro economic efficiency gains as described above, using evidence from the GCC business survey as well as previous trade analysis carried out in chapter five.

Building on the benefits of a Common Market, a single currency also allows for the direct comparison of the price of goods and services across member states and therefore is expected to reduce price discrimination and foster greater competition. The potential impact of the CU on region wide price levels and price transparency is discussed in section 7.2.2.

The expectations of the GCC business community are important because they influence future investment decisions; which ultimately drive private sector growth. Therefore the expectations of the GCC business community regarding the effect of the CU on their businesses and the eventual success of the CU are examined using evidence from the business survey in section 7.2.3.

Finally, the indirect effect of a single currency on the region's capital markets is examined in section 7.2.4. The experience of EMU has illustrated that the indirect effect of the single currency led to a significant increase in regional and international liquidity attracted to pan-regional investment vehicles and an expansion of issues particularly in the region's corporate bond markets.

⁷ Commission of the European Communities, *One Market, One Money An Evaluation of the Potential Benefits and Costs of Forming an Economic and Monetary Union*, European Economy No. 44, October 1990.

7.2.1 Potential Efficiency Gains

Analysis in chapter five revealed that intra-GCC trade, at less than 8 percent of total imports, was low in conventional terms and when trade as a proportion of regional GDP was compared with the EMU countries prior to establishing a CU.⁸ However, as a proportion of non-crude oil trade, intra-GCC exports are more important amounting to 18 percent of total exports.⁹ Moreover, our business survey sample showed that a large proportion of GCC businesses, in particular for SMEs, have strong trading links with other GCC states.¹⁰ SMEs constitute a large segment of the GCC business community¹¹ as was reflected in the business sample,¹² and the burden of currency-related transaction costs weighs heavier for them than for larger companies. This suggests therefore that the single currency, by eliminating albeit small exchange rate transaction costs for a significant number of SMEs should be beneficial for these businesses.

Measuring the aggregate potential savings from the removal of these micro level costs is important, but in the absence of aggregate bank data on GCC exchange rate transactions, it is difficult to come to a precise estimate of their size. In the case of EMU the savings for businesses through the removal of exchange rate related transaction costs was estimated to be equal to 0.4 percent of the European Community's GDP.¹³ Therefore, in the case of the GCC economies such savings are clearly likely to be smaller than that of the European Community.

Indeed, when GCC businesses were asked what they considered to be the main obstacles to the growth of their business within the GCC, exchange rate related costs were not considered to be very important. Respondents most frequently chose 'restrictive regulations' as being the main obstacle to their growth at 34

⁸ Intra-regional trade formed only 2.6 percent of GCC GDP in 2004 compared with 12.8 percent of the Eurozone's GDP in 1998.

⁹ In 2002, see chapter 5, table 5.5.

¹⁰ See Chapter 5, section 5.2.

¹¹ According to one report SMEs represent 93 per cent of Saudi Arabia's total business enterprises. See Ismail I. Sajini, 'Effects of WTO on Small & Medium Enterprises' *Arab News*, 19 January 2004

¹² See appendix F, for a detailed analysis of the economic characteristics of the GCC business survey sample.

¹³ Commission of the European Communities, *Ibid.*

percent followed by 'Lack of skilled labour' at 16 percent, while only 6.6 percent of respondents chose 'Exchange Rate Related Costs' (see Table 7.1).

Several other obstacles were therefore felt to be more important than exchange rate related costs which will be eliminated by the CU. This result indicates that businesses perceive other micro-level factors affecting the business environment in which they operate to be of greater importance to the growth of their businesses. The simplification of bureaucratic formalities and harmonisation of business regulations across the GCC are therefore important reforms that will improve the GCC's growth potential and foster greater intra-GCC trade. They should therefore be considered by GCC policy makers as complementary reforms in the process of achieving regional economic integration.

Table 7.1: Business Views on the Obstacles to the Growth of their Business

Potential Obstacle	Frequency
Restrictive Regulations	33.9%
Lack of Skilled Labour	15.9%
Lack of Clear Property Rights	14.1%
Protective Tariffs and Quotas	14.1%
Lack of Access to Credit	14.1%
Exchange Rate Related Costs	6.6%
Other Obstacles	1.3%
Total	100%

Source: GCC Business Survey on Currency Union, June-September 2005

Businesses were also asked explicitly whether CU would offer benefits to their company and in what ways. Overall, the majority of respondents, 84 percent,¹⁴ thought that the CU would provide some micro level benefits. Businesses were prompted to consider what these benefits would be, and the removal of exchange rate risk and new business opportunities were thought to be of the greatest potential benefit. Businesses chose 'Reducing Exchange Rate Risk' and 'New

¹⁴ When the 95 per cent confidence interval for this proportion was calculated, the confidence limits (84 +/- 4 per cent) confirmed that a comfortable majority of businesses held this view.

Business Opportunities' most frequently as the areas with the highest and second highest potential for benefiting their businesses. The remaining two areas of 'Increasing Sales' and 'Reducing Transaction Costs' were more frequently chosen as having the least, or second least potential for benefiting businesses (see Table 7.2).

Table 7.2: Business Views on the Potential Benefits of GCC CU

	Some Benefit				None	Total
	Highest potential	2nd Highest potential	3rd Highest potential	Least potential	None	
Reducing Exchange Rate Risk	31%	21%	16%	16%	16%	100%
New Business Opportunities	29%	20%	20%	15%	16%	100%
Reducing Transaction Costs	21%	20%	19%	24%	16%	100%
Increasing Sales	20%	19%	19%	26%	16%	100%

Source: GCC Business Survey on Currency Union, June-September 2005.

So although GCC businesses did not consider currency and exchange rate issues to be very important when asked the *unprompted* question about factors limiting the growth of their businesses, they did acknowledge the importance of exchange rate risk when asked the *prompted* question about the benefits of GCC CU. This would seem to suggest that in spite of the fact that CU issues do not rank very highly for GCC businesses at present, there is nevertheless support for any measures which would reduce future exchange rate risks and clearly CU would achieve this objective.

It should also be pointed out that as well as leading to some efficiency gains in the traded goods market, the GCC market for services should also benefit from CU. In

fact, a substantial proportion of the survey respondents were service sector companies.¹⁵ The introduction of the single currency is expected to increase the demand for services across the region as intra-GCC tourism and travel is facilitated.

7.2.2 The Single Market and Prices

An indirect gain from the elimination of transaction costs is to reduce the potential for price discrimination between the GCC markets. Price discrimination occurs because of segmentation between markets brought about, at least in part, by the existence of different national currencies.¹⁶

A single GCC currency will allow for direct comparison between the price of goods and services across the GCC states thus making price discrimination much more difficult for producers. In light of extensive intra-GCC tourism and travel, price disparities will become increasingly obvious to consumers. The improved price transparency will benefit consumers and should have positive implications for both consumption and investment decisions. For reasons such as these, the majority of regional experts interviewed felt that CU will be in the best interest of GCC citizens. However, much will depend on the establishment of the Common Market in removing other non-exchange rate related transaction costs for businesses operating across the GCC.

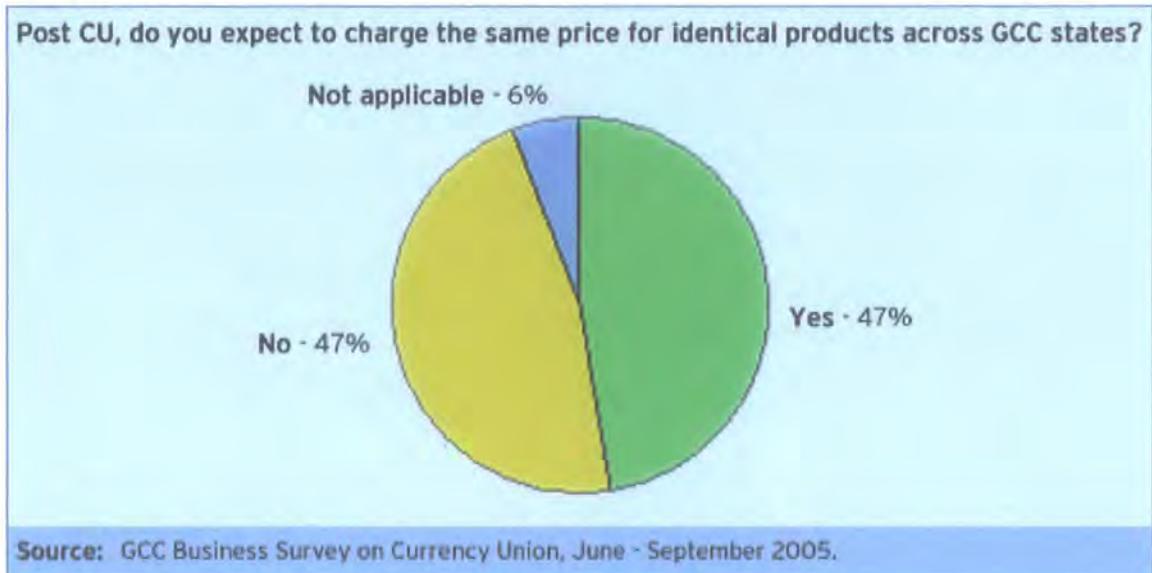
The business survey conducted for this thesis provides some information on the potential impact a single GCC currency will have on GCC wide prices and price discrimination within the GCC. Businesses were asked whether they expected to charge the same price for identical goods across the region after the introduction of the single currency. In fact, business respondents were split equally as to whether or not they would charge the same prices for identical products across the GCC, (see Figure 7.1). Those respondents that said they wouldn't charge the same price

¹⁵ See appendix F.

¹⁶ Engle, C. and Rogers, J. "How Wide is the Border?" *International Finance Discussion Paper*, no. 498, Washington D.C.: Board of Governors of the Federal Reserve System, 1995.

for their goods cited 'varying operating costs' most frequently such as differences in local taxes, fees and overhead costs; such factors can also be considered as a form of transaction costs. This result suggests that eliminating the cost of buying and selling foreign currencies across the GCC is not the only source of transaction costs for businesses.

Figure 7.1: Impact of Currency Union on Price Discrimination



This finding has implications for purchasing power parity (PPP) across the GCC states following CU. Previous research by Hassanain¹⁷ found evidence of PPP in the real exchange rates of the GCC states. However, past deviations from PPP have been persistent, due to years of fixed nominal exchange rates, periods of high dollar volatility and weak goods market arbitrage.¹⁸ Such persistent deviations in PPP distort efficient resource allocation across the region as well as penalizing customers in some GCC states.

Therefore, without the establishment of a single GCC market, allowing for effective arbitrage between traded goods markets and the removal of non-exchange rate related transaction costs, differences in PPP following the launch of the CU are

¹⁷ Hassanain, Khalifah "Purchasing power parity: further evidence and implications" *Review of Middle East Economics and Finance*, Vol. 2, No. 1, 63-77, April 2004.

¹⁸ *Ibid.*

likely to continue.¹⁹ This finding was supported by several regional experts who felt that the assumed benefits to GCC consumers would be dependent on the full implementation of the GCC Common Market. In mid 2006, it was reported that the GCC Secretariat was expected to announce a proposal making the pricing of all consumer goods in all six GCC currencies mandatory, evidently an attempt to improve price transparency and goods market arbitrage.²⁰

The initial impact of introducing the GCC single currency may cause some temporary inflationary pressure, as was the case in the Eurozone countries.²¹ These post CU inflation increases stem from the conversion of prices in the old national currencies which are then rounded up to the nearest unit price in the new currency. While it will be important for GCC governments to provide rules instructing when prices should be rounded up or down, inevitably there will be some surreptitious price increases as businesses attempt to recoup some of their costs from adjusting their business systems to the new currency.

Of those businesses in the survey sample that thought the introduction of the single currency would increase their costs, the overwhelming majority, 67 per cent, said that they would pass these on to customers. This finding suggests that inflation will rise initially following the introduction of the single currency, although it is uncertain to what degree.

¹⁹ In the case of EMU, the bulk of price convergence across the members was found to occur following the completion of the single market, rather than after the launch of the common currency. See Rogers, J.A. "Monetary union, price level convergence, and inflation: How close is Europe to the United States?" *International Finance Discussion Paper*, No. 740, Board of Governors of the Federal Reserve System, October 2002.

²⁰ Al Hakeem, Mariam "GCC to require price tags in all Gulf currencies" *Gulf News*, 10 July 2006.

²¹ The increase in eurozone inflation rates was not however, reflected in the official statistics of the Eurozone countries. Evidence suggests that the Eurozone inflation rate was underestimated and that there has been a downward bias in measuring inflation since 2002 of at least 6 percent. The economic rationale proposed by the authors for this phenomenon is that the currency changeover acted as a device that led firms with market power to increase their prices. See Marini, G., Piergallini, A. and Scaramozzino, P., "Inflation Bias after the Euro: Evidence from the UK and Italy", Centre for Financial and Management Studies, School of Oriental and African Studies, London, August 2004,

7.2.3 Business Climate and Investment

GCC businesses were also asked whether they expected the single currency had the potential to harm their businesses and in what way. The majority of respondents, 57 percent, believed that there would be some negative effects from the CU on their businesses (see Table 7.3). The statistical significance of this majority (i.e. > 50 per cent) is confirmed by the confidence interval at the 95 percent level (57 +/- 5.5).

Of the potentially negative effects of the CU for businesses, 44 percent of businesses ranked 'Increased Competition' as causing the 'Most Harm' or second most harm and 35 percent of businesses felt that 'Increased Economic Uncertainty', had the greatest or second greatest potential to harm their business.

The responses to this question indicate that concerns over increasing regional competition are uppermost in the minds of GCC businesses. In particular, SMEs rather than larger companies were concerned about the initially harmful effect on their businesses of increased regional competition. However, although individual businesses may fear increasing competition and consider it to be a potential cost of the CU, in the long run increased competition should be beneficial for the economies in the region.

Table 7.3: Business Views on the Potential Costs of GCC CU

	Some Harm			None	Total
	Most Harm	2nd Most Harm	Least Harm		
Increased Competition	30%	14%	13%	43%	100.0%
Changing Payments System	12%	22%	23%	43%	100.0%
Increased Economic Uncertainty	14%	21%	22%	43%	100.0%

Source: GCC Business Survey on Currency Union, June-September 2005.

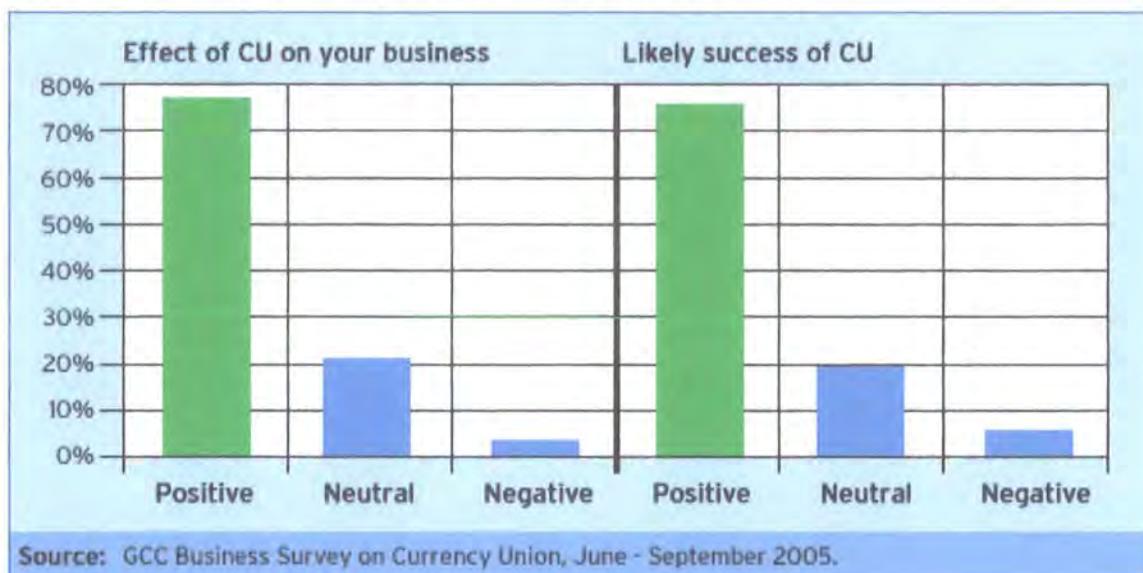
Up until recently, intra-GCC competition in goods and services has been fairly limited. Therefore the emergence of stronger regional competition could potentially be beneficial in stimulating efficiency improvements and company restructuring which will eventually help to prepare GCC companies for competition in international markets, which they will face as all six GCC states are now members of the WTO. Increased intra-GCC competition may also potentially put pressure on prices which will be welfare enhancing for GCC consumers.

In spite of the fact that GCC businesses expressed a number of concerns about the potential costs of CU (see Table 7.3) and the fact that *unprompted* they do not rank exchange rate costs very highly as an obstacle to the growth of their own individual businesses (see Table 7.1), it is nevertheless significant that the results of the GCC-wide business survey indicate a general optimism in the business community at the macro level regarding the future CU.

When businesses were asked how they felt about the overall effect of a GCC single currency and its likely success, the results were very positive. The majority of businesses – 76 percent – felt ‘very optimistic’ or ‘optimistic’ about its likely success. The 95 percent confidence level for this 76 percent ‘optimistic’ reply was calculated at (76 +/- 5). Only 5 percent of the businesses sampled were ‘pessimistic’ or ‘very pessimistic’ (see Figure 7.2).

Businesses were also optimistic about the CU when it came to their own prospects. When asked specifically how they thought the single currency would affect their businesses, the majority of businesses – again, 76 percent – said that they thought the effect would be ‘good’, or ‘very good’. The strength of this result was also supported at the 95 confidence level (76 +/- 5). Only two percent of the business respondents thought that the effect of the CU would be ‘bad’ or ‘very bad’ (see Figure 7.2). From this result it would be fair to say that overall GCC businesses appear to think that CU will be a ‘good thing’ but consider other factors (e.g. restrictive regulations) to be of greater priority for their businesses.

Figure 7.2: Business Expectations Regarding the CU



Overall, the responses of the survey sample indicate that GCC businesses are reasonably confident about the expected success of the GCC CU and are optimistic about the likely effect it will have on their businesses. This finding bodes well for investment trends and thus growth in the GCC economies during the transition period to currency union.

Similarly, the majority of regional experts interviewed for this thesis, expect the CU to have some positive effect on the region's economic development. Generally, it is considered that many gains will result from the establishment of the Common Market but that the single currency will provide additional benefits through improving efficiency, competitiveness and promoting investment. The enlarged economic market will allow GCC businesses to exploit economies of scale that were not available to them previously, a theme to which we will return in chapter eight.

7.2.4 Capital Market Growth

Despite being listed by Mundell, in the OCA literature, as an important adjustment mechanism compensating for the loss of flexible exchange rates resulting from CU,

capital market integration is in fact an endogenous criterion that is likely to be promoted by the policy of forming a CU.

The experience of the euro has shown that the financial sector can gain substantially from the introduction of a unified currency. The impact of the euro on European financial markets and corporate bond markets in particular, has been significant. Euro denominated equity markets amounted to much more than the sum of aggregate national markets and corporate bond markets saw significant growth post EMU. Corporate debt issuance expanded substantially on the launch of the euro, "with the combined issuance of the corporate and financial sectors more than quadrupling since 1998".²² The introduction of the euro, it is also thought, led to the lessening of other technical and regulatory constraints which had previously segmented European financial markets.²³

Integration between the relatively segmented GCC financial markets is a process which has been occurring gradually over the period of study, but the pace has quickened in the past few years.²⁴ GCC capital markets have expanded rapidly in recent years, with stock market capitalization to GDP reaching on average 177 percent of GDP in 2005.²⁵ However, the markets still suffer from limited breadth of investments and illiquidity as a large proportion of shares are held by government entities. For example, according to Luciani, two of the main Saudi companies by market capitalization, SABIC and Saudi Telecommunications Company, account for 45 percent or more of the total worth of the *Tadawul* bourse, yet only 30 percent of their shares are available for trading and of that 30 percent much is in the hands of long term institutional investors that hold onto it for the long run.²⁶

The inauguration of the single currency and the Common Market will accelerate the process of GCC capital market integration and potentially benefit these markets

²² Galati, G. and Tsatsaronis, K. 'The Impact of the Euro on Europe's Financial Markets', *Bank for International Settlements Working Paper* No. 100, July 2001.

²³ *Ibid.*

²⁴ See Chapter 5, section 5.4.

²⁵ Calculated using data from GCC stock exchanges and Central Banks.

²⁶ Luciani, Giacomo "The Pace and Problems with GCC Privatizations" in *Gulf Yearbook 2005-2006*, pp. 147-155, Gulf Research Center, Dubai, 2006.

directly and indirectly. The direct effects of the single currency comprise of the removal of exchange rate risk and future uncertainty about exchange rates as well as increasing the transparency of asset prices and returns. Further indirect effects operate through the enlargement and deepening of GCC financial markets which reduces liquidity risk. In addition, the reduced risk of cross border transactions will generate increased diversification options for regional investors and allow for the rebalancing of portfolios towards assets that may have previously been considered too risky, thus increasing the breadth of GCC financial markets as well.²⁷

There is also much room for the development of GCC secondary bond markets which have remained relatively undeveloped with GCC bond issues amounting to less than an estimated 3 percent of GDP.²⁸ GCC Islamic bonds, commonly referred to by their Arabic name, *sukuks*, have grown significantly in importance and have attracted significant investments in recent years. As was the case in EMU, new issues of *sukuks* in the single GCC currency will most likely attract greater regional funds, as well as international capital. As of the end of 2005, most GCC *sukuks* have been issued in dollars, only the First Islamic Investment Bank of Bahrain had issued a *sukuk* in euros.²⁹ With the launch of the unified GCC currency, the choice of issuing in the regional currency will be attractive for GCC governments and corporations in order to reduce their currency exposure.

Furthermore, depending on the success of the Gulf 'dinar' and whether the currency remains pegged to the dollar or not, it could become the currency of choice in the issuance of non-GCC Islamic *sukuks* which so far have also been predominantly issued in dollars.³⁰ Opening up further to international investors should also increase liquidity in these markets; as new pan-GCC investment vehicles are likely to attract additional GCC as well as international funds.

²⁷ Danthine, J.P., Giavazzi, F. and Ludwig von-Thadden, E. "European Financial Markets after EMU: A First Assessment", *NBER Working Paper 8044*, December, 2000.

²⁸ Sturm, M. and Siegfried, N. "Regional Monetary Integration in the Member States of the Gulf Cooperation Council", *European Central Bank, Occasional Paper Series*, No. 31, June 2005.

²⁹ The Liquidity Management Centre, Global Sukuk Table, July 2006, (accessed at <http://www.lmcbahrain.com/>)

³⁰ Wilson, Rodney, "Exchange rate issues for Muslim economies" International Seminar on Macroeconomics in Islamic Perspective, International Islamic University Malaysia, September 2004.

Approximately two fifths of the GCC experts interviewed thought that the region's capital markets would benefit from a single currency. One independent researcher remarked "Monetary Union is a good vehicle for financial market integration. It will lead to more efficient allocation of resources with better returns." One AMF official commented "Capital markets, investment and FDI will benefit, capital movement will be much easier and GCC companies will thrive as a result." Indeed, the benefits that accrue to the GCC's capital markets are unlikely to be felt in the financial sector alone. There is a body of literature that argues that financial market development is an essential precursor for the development of the broader economy through the efficient allocation of capital.³¹

Following the launch of the euro merger and acquisition (M&A) activity in Europe's banking sector grew at an unprecedented rate, having a major impact on bank restructuring and eventually leading to the emergence of international banking firms and networks.³² M&A activity in the GCC banking sector has been very weak so far. National GCC banks have been protected from competition by strong legal constraints that have allowed them to earn huge economic rents. However, by 2004 regional competition was emerging slowly as the National Bank of Kuwait, Emirates International Bank and the Bahrain based Gulf International Bank had all opened branches in Riyadh.³³ By increasing the competitive pressures in the GCC banking industry GCC retail customers can be expected to benefit from improved services.

The single currency should also result in increasing competition between the GCC stock markets. Following the significant stock market corrections in the first quarter of 2006, the Saudi authorities announced it would turn the Tadawul stock market into a share holding company open to private involvement, seemingly to "help the stock market operate on a more professional and transparent basis and introduce

³¹ See for example, King, R. and Levine, R. "Finance and Growth: Schumpeter Might Be Right" *Quarterly Journal of Economics*, Vol. 108, pp.717-725, 1993.

³² Danthine, *op.cit.*

³³ Wilson, *op.cit.*

new products and services".³⁴ Greater competition for regional capital following the launch of the single currency might also lead to pressure for further improvements in efficiency of other national stock markets.

Ultimately a leading national financial market is likely to emerge, at the expense of other national stock markets. In this regard, the markets of Saudi Arabia (with the largest stock market capitalization in the region) and Kuwait (the longest standing and broadest market) would be best placed to take this position. Conversely, it seems unlikely that a single regional market will be established. In Europe domestic stock markets have survived in part due to remaining national legal and regulatory differences and this may well turn out to be the pattern in the GCC.³⁵

In order for the GCC financial sector to reap the full benefits of the single currency however, a number of accompanying reforms will be necessary. The removal of existing barriers to market integration, such as differences in national financial market legislation and auditing standards as well as other legal and fiscal obstacles, are also required. Cooperation among the GCC financial authorities in creating a regional Financial Services Authority would also be beneficial in simplifying regulations for market participants and thus facilitating cross border investments. Furthermore, the increased risks of financial contagion brought about by tighter integration will require improved supervision and better regulation of the GCC financial system to ensure its stability overall.

7.3 Adjusting to Economic Shocks

Despite pegging their exchange rates to the US dollar and following the interest rates of the anchor currency, the GCC states still have some short term monetary policy independence which they utilize according to their national economic conditions.³⁶ The loss of this marginal independence through the move to a

³⁴ Staff writer "Saudi to privatise bourse" *Gulf Daily News*, 10 May 2006.

³⁵ Wilson, *op.cit.*

³⁶ Jadresic, E. "On a Common Currency for the GCC Countries", *IMF Policy Discussion Paper*, December 2002, p.12.

common monetary policy could therefore prove to be a cost for some GCC economies. This issue is discussed in detail in the first half of this subsection. In the second half of this sub-section we discuss the choice of exchange rate regime following the launch of the single currency, which will have important implications for the role of monetary policy in the GCC economies. Ultimately, the policy choice will have to be agreed upon by the GCC leaders but in light of existing differences in policy preferences, national interests may have to be compromised in order to reach agreement on a common regional exchange rate regime that can provide net benefits for the bloc on aggregate.

7.3.1 Loss of Monetary Policy Independence

Many observers have concluded that there will be little cost to the GCC states from losing independent monetary policy because the fixed pegs to the US dollar already rules out their use of independent interest rate setting. However, the GCC central banks do have some, albeit limited, control over domestic monetary issues (see chapter four, section 4.3.5). GCC interest rates are required to broadly follow the US' monetary policy in order to maintain the domestic exchange rate pegs however, there is a margin that the GCC central bank's frequently utilise in controlling the domestic economic environment. However, following the introduction of the CU, interest rate differentials among the GCC states will not be permitted as it could jeopardize the stability of the CU and thus this degree of monetary policy flexibility will be lost.

In 2005, GCC central banks responded to their own particular domestic inflationary concerns using their monetary policy independence. Kuwait retains more monetary policy independence than any of the other GCC states and has a band of adjustment around its dollar peg of plus and minus 3.5 percent up until 2010. In May 2006 Kuwait decided to utilize its flexible arrangement and allow its currency to appreciate against the dollar by 1 percent. The move was in response to the decline in the dollar which had fallen by 7 percent against the euro since the start

of the year and the increasing cost of Kuwaiti imports from the eurozone economies.³⁷

Following the appreciation of the Kuwaiti dinar the Executive President of the Omani central bank, Hamood Sangour Al Zadjali, announced that in his view the Kuwaiti monetary policy was clearly at odds with that of Oman's, he said emphatically "no developing country aiming at diversification and export promotion, can afford a policy of exchange rate appreciation". Rather than being concerned by the effect of the declining dollar on rising import costs as was Kuwait, conversely Oman considered the nominal depreciation to be a bonus, Al Zadjali said "Oman's nominal exchange rate has been depreciating modestly since 2001, helping our non-oil exports".³⁸

In early 2006 Saudi Arabia failed to immediately follow interest rate rises in the US on two occasions as it felt that domestic inflation did not require tightening of monetary policy and it was concerned about falls in the Tadawul stock market. According to the SAMA central bank governor, Hamad Saud Al Sayyari, "We have our own considerations, policies, our own local developments. We don't have to move exactly to match the (US) move. It depends on the domestic situation."³⁹ However, at the end of June 2006, just prior to another US interest rate rise, SAMA was obliged to raise its interest rates after excessive bank arbitraging to exploit the interest rate differential between the dollar and the Saudi riyal threatened the stability of the peg.

The symmetry of the GCC business cycles and their degree of economic convergence will affect the magnitude of any potential costs arising from the loss of monetary policy independence. It is perhaps significant therefore that diverging inflation rates continue to be a potential problem among the GCC states. In 1981 the GCC inflation rate differential was 8.5 percent yet by 2005 there had been no

³⁷ Rutledge, E. "The dollar declines, while the euro shines" in *Gulf Research Center's Business Bulletin*, Dubai, 13-19 May 2006.

³⁸ Kumar, Palazhi Ashok "Central Bank of Oman defends fixed peg of rial to dollar" *Times of Oman*, 16 May 2006.

³⁹ Staff writer "Saudi has no plan to revalue riyal: Official" *The Peninsular*, Qatar, 26 June, 2006.

discernible convergence with the differential at 8.1 percent (see chapter six, figure 6.2). Clearly the optimal monetary policy for low inflation states such as Bahrain, Oman and Saudi Arabia differs to that for the high inflation states, the UAE, Qatar and Kuwait (see chapter six, section 6.2.2). Therefore, the common monetary policy could lead to macroeconomic costs and the ability of the GCC economies to adjust through other mechanisms will be important.

Furthermore, while econometric evidence presented in chapter five (see section 5.6), indicated that the GCC economies collectively followed a long run cointegrating relationship, pair-wise cointegration analysis showed evidence of only a weak relationship between Saudi Arabia and the UAE and Kuwait. Again, this suggests that a common monetary policy based on the largest member state's economic circumstances may not be optimal for either the UAE or Kuwait.

In the absence of any exchange rate flexibility the GCC economies will have to respond to economic shocks through factor market adjustments. At present the GCC labour markets and wages are very flexible due to the presence of a large expatriate work force (see chapter five, section 5.3). In response to national or regional shocks expatriate labour flows, particularly from South Asia, are highly elastic. The large pool of mixed skills labour in countries like India and Pakistan available at internationally competitive prices has also kept labour costs down and will continue to do so for at least the next decade or so.

Recent reforms in capital market regulations are also allowing for increased intra-regional capital flows which will help to mitigate potential national shocks. Intra-GCC FDI has witnessed an upturn in recent years indicating that investors in respective GCC states are increasing their claims on their neighbour's economic output. For example, between 2000 and 2006 UAE investment in Saudi Arabia amounted to 41 percent of the Kingdom's total FDI.⁴⁰ Furthermore, there is evidence that the GCC economies are moving towards greater 'within country' diversification as opposed to 'within region' diversification (as discussed in chapter

⁴⁰ Hassan, Javid "UAE Is Top Investor in Kingdom" *Arab News*, 19 June 2006.

five, section 5.5). Such trends could be evidence of the region's increasing economic integration. As the process of integration proceeds and deepens this in itself should lessen the occurrence of national economic shocks.

7.3.2 Regional Exchange Rate Policy Post CU

Leading up to the launch of the CU the GCC leaders have agreed to stick with the US dollar pegs, which will be the basis of determining the future conversion rates and is an appropriate interim currency regime. Post CU however, the choice of exchange rate regimes remains to be decided. The debate over future monetary policy will be whether they continue to delegate their monetary policy to the currency anchor country, the US, or whether they take control of their monetary policy tools by moving to a more flexible exchange rate arrangement.

The UAE's Central Bank Governor, Sultan Nasser Al Suwaidi, said in July of 2006 that there was no need to change the dollar peg at the moment. He argued that "The dollar peg serves (the GCC) economies very well", but significantly he went on to say "Of course in four years' time we'll move into a CU and a single currency that will be for a bigger geographical area that will have a bigger weight on the international arena, so it will have to be floated then."⁴¹ Indeed, it is generally accepted that the currency of a monetary union would normally be free floating and would allow greater flexibility in responding to global economic shocks.⁴²

The debate regarding the choice of currency regime post CU intensified in the first half of 2006 as the US dollar declined against other major currencies, in particular the euro. Consequently, the GCC economies witnessed deterioration in their purchasing power, and their foreign reserves rapidly losing value. Inflationary pressures, already high from the oil price induced economic boom, were rising further as import costs grew (more than a third of GCC imports originate in the Eurozone economies) (see chapter four, table 4.9).

⁴¹ Khalaf, Roula "UAE shifts 10% of its reserves into euros" *Financial Times*, London, 13 July 2006.

⁴² Munchau, W., "Lessons from monetary union" *Financial Times*, London, 4 January 2004.

As we have already observed, the move by Kuwait to revalue its currency against the dollar illustrated its strong intolerance to increasing import costs and rising inflation and a preference for a stronger currency. While Oman signalled its policy preference for a weak riyal in order to promote non-oil export growth as part of its diversification strategy.⁴³ For similar reasons, other low inflation states such as Saudi Arabia and Bahrain, are likely to prefer a weak exchange rate, while high inflation economies such as the UAE and Qatar will have similar preferences to Kuwait.

As a consequence of the growing inflation concerns, the desire for greater monetary policy independence was voiced from regional institutions such as the AMF. Jassim Al Mannai, chairman of the AMF said "We need to see interest rates free in our hands to use them in order to moderate the economic cycle. When we have a boom, we need to cool down the economy through the interest rate mechanism. We cannot do it now because of currency pegging."⁴⁴ Moving away from the dollar peg towards a more flexible exchange rate regime, as promoted by the AMF Chairman and the UAE Central Banker among others, will allow the GCC economies greater domestic economic control and increased room to adjust to global shocks.

While several regional experts felt that the dollar peg had served the GCC economies well, helping to keep inflation low and providing monetary policy credibility, many other experts considered it to have outlived its usefulness to the GCC economies and that there were now drawbacks from this policy. One GCC official commented "While pegging GCC currencies to the US dollar was beneficial in the 1980s and early 1990s, of late it has become a burden." Another Emirati government official said "The dollar peg has served them well so far in terms of price stability but the cost to foreign currency reserves has been substantial. The devaluing dollar has not been of benefit to them because of their increasing trade with Asia and EU."

⁴³ Kumar, *op.cit.*

⁴⁴ Staff writer "Arabs need free monetary policy to control inflation" *Gulf Times*, Qatar, 27 June, 2006.

The majority of experts interviewed for this thesis felt therefore that there would be economic advantages from switching to a more flexible exchange rate regime. They cited factors such as the possibility of greater monetary policy independence and stabilising import costs rather than just export revenues. Several experts felt that a more diversified exchange rate regime would also promote economic diversification. A number of IMF reports have also concluded that a flexible and competitive exchange rate would be more conducive to economic diversification and the long anticipated expansion in non-oil trade.⁴⁵ Furthermore, some experts thought that a flexible exchange rate regime would also give the GCC states more political, as well as economic independence.

In light of the strong economic case for switching to a more flexible and independent arrangement many regional experts thought that post CU a switch would take place. Only a few regional experts thought that a change in the exchange rate regime would never take place based on external political factors. One Omani academic said "I don't think this will happen because they are tied to US policy and a move to show independence would not be well received by the US."⁴⁶

There are several potential exchange rate regime options open to the GCC once they have entered into a unified currency. The two main options, being considered (not including maintaining the status quo) are either a free floating currency or continuing to anchor the currency but to a diversified, possibly trade weighted basket of currencies. The future exchange rate policy of preference for the region, according to the IMF, depends on two considerations, stability and competitiveness.⁴⁷

⁴⁵ See Jbili, A. and Kramarenko, V. "Choosing Exchange Regimes in the Middle East and North Africa" International Monetary Fund, Washington D.C., 2003 and Abed, G.T., Erbas, S. N. and Guerami, B., "The GCC Monetary Union: Some Considerations for the Exchange Rate Regime" *International Monetary Fund Working Paper*, April 2003.

⁴⁶ In chapter 6, section 6.6.1, it was revealed that regional experts also felt that the involvement of the US in the region would lead to a delay, and possibly even deter, the establishment of the CU.

⁴⁷ Abed, G.T., Erbas, S. N. and Guerami, B. "The GCC Monetary Union: Some Considerations for the Exchange Rate Regime" *IMF Working Paper*, April 2003.

While a free float could provide greater flexibility and competitiveness than opting to peg to a trade weighted basket of currencies, the latter is likely to provide more continuity and stability. Yet, expert opinion in the region is split on the optimal exchange rate regime choice for the GCC CU and it therefore seems likely that there will also be divergence among the exchange rate policy preferences of the various GCC leaders and Central Bankers. If these differences persist, post CU, it is likely that the current dollar peg will be kept as a 'compromise solution'.

The UAE Central Bank Governor clearly expressed his view on the future choice of exchange rate regime, saying "I would prefer a free floating regime by 2015, since firstly it is more consistent with market determined price systems, and secondly because it would relieve member countries from having to build the reserves needed to defend the currency pegs and the problem of countries' contributions to reserves that comes with it."

However, there may well be diverging views on the future decision on the region's common exchange rate regime reflecting national economic policy objectives and interests. Indeed, one AMF official remarked "After CU they will be strong enough to decide but there will be many conflicting views between them and much will depend on the economic conditions at the time." In the future CU therefore, the loss of national monetary policy setting may become more of a controversial issue.

It is likely that a free floating exchange rate would lead to a stronger exchange rate for the GCC economies; according to IMF estimates by as much as 15 percent.⁴⁸ Such an appreciation of the exchange rate may not be particularly helpful for those countries, such as Oman and Bahrain, which are seeking to diversify their exports.

Research by the IMF⁴⁹ examined the economic case for pegging to a basket of major international currencies vis-à-vis continuing to peg to the US dollar. The

⁴⁸ Staff writer "Saudi Arabia Drafting Regulations to Facilitate Issuance of Islamic Bonds" *Arab News*, 22 June 2006.

⁴⁹ Abed, *et al. op.cit.*

authors of the report, Abed *et al*, argued that as GCC oil exports were denominated in dollars and a large share of Asian imports were also invoiced in dollars continuing to peg to the dollar would be the best option for ensuring stability. However, the share of total GCC imports from the European Union in 2004 constituted 33 percent of total GCC imports (see chapter four, table 4.9), while imports from dollar pegged Asian countries⁵⁰ amounted to only 13 percent of total imports.⁵¹ Of this proportion, imports from China constituted the largest share at 8 percent. However, China is under pressure from the US in particular, to move to a more market based floating exchange rate and as China's internal economic development and consumption growth gains pace it will relinquish the need for it to hold down the value of its currency against its major export market, the US.

Furthermore, Abed *et al* contend that as the majority of GCC assets have been held in dollars, it is prudent to continue with the dollar peg for the time being. However, the currency allocation of GCC assets, is based not only on their exchange rate regime but also on the expected return on assets. As we have seen since the dollar's substantial decline in 2004 and more recently in 2006 GCC central banks are sensitive to the expected return on their assets⁵² and consequently are increasingly opting to hold their reserves in stronger currencies such as the euro.⁵³

In conclusion, the authors of the IMF report recommended that a basket peg with a heavy dollar component would be the best choice of exchange rate for the future common currency. Such a regime, they argue, would provide stability but at the same time a degree of flexibility to improve the competitive edge of non-oil exports.

While there was no consensus among regional experts as to the optimal exchange rate policy for the GCC economies, with both advantages and disadvantages to a

⁵⁰ Of the five most significant Asian exporters to the GCC Japan, India, Korea and Singapore are not pegged to the dollar. Only China is pegged to the US dollar.

⁵¹ According to IMF Direction of Trade data.

⁵² Bank for International Settlements, *International banking and financial market developments*, BIS Quarterly Review, December 2005.

⁵³ See for example, Staff writer "UAE committed to diversify forex reserves: Suwaidi" *Khaleej Times*, 27 June 2006.

free float regime and a peg to a basket of currencies, the largest share of interviewees favoured the latter. One Emirati government official thought “It is best to link to a basket of currencies based on the direction of trade.” One Kuwaiti government official felt that “They need to diversify in terms of what is the best anchor and look at trade and financial relations both would favour a basket with euro and dollar components.”

On the cost side it was thought that a peg to a basket of currencies would be less transparent and difficult for GCC institutional expertise to manage. One Omani academic thought “it is not easy to have a basket peg, costs of implementing it and switching are high.” However, the Central Bank of Kuwait had managed its peg to an undisclosed basket of currencies for several years without any difficulty in the past.

Of those experts that felt a floating exchange rate would be most beneficial, one commercial banker in the UAE said “As these economies mature they should move to a flexible exchange rate regime such as a float. Then they could have an active and independent monetary policy.” However, a few experts felt that a free float would be too risky for the GCC economies at first. One Omani central bank official said “They need time for a float because they will be tested in the market.”

Other experts however, thought that the GCC’s ample foreign reserves would provide a cushion against any speculative activity, for example one Kuwaiti academic said “Their exchange rates have been very resistant because of their large international reserves and they could have a managed float, because the unified central bank would have ample resources.” Furthermore, the GCC leaders could opt for a managed float within a reference band that would provide a greater degree of stability, but at the same time allowing for exchange rate adjustments.

While the choice of exchange rate policy post CU remains uncertain, experts agree that a more flexible exchange rate regime would be preferable in allowing both adjustments to global economic shocks (such as a substantial decline in the US dollar) and independent monetary policy predicated on regional economic

conditions. The launch of the single currency provides an opportune moment for the GCC states to adjust their exchange rate policy to a regime that reflects the fact that these economies are maturing and seeking to diversify further.

7.4 Fiscal Policy Implications

One of the biggest challenges and one which, in the short term at least, may incur the most 'costs' is that of enforcing fiscal discipline on member states. While there are important reasons for adhering to some form of fiscal discipline, such as preventing the negative effects of excessive borrowing from spilling over to other members, the imposition of Maastricht style rules are likely to prove problematic for the highly cyclical GCC government budgets that remain dependent on volatile hydrocarbon revenues.

Agreement on the exact nature of the fiscal discipline rules is therefore expected to prove to be difficult for the GCC leaders. In principle, the GCC leaders have agreed that there should be a mechanism similar to the European Stability and Growth Pact (SGP) but to date there has been no agreement on the precise metrics (e.g. the appropriate debt/GDP ratio). Moreover, in passing, it should be noted that not all experts agree on the appropriateness of SGP type approaches to fiscal discipline for the GCC. For example, in a recent IMF working paper, Krueger and Kovarich argued that "Each CU has a unique structure and possibly, the GCC CU might develop a loose arrangement very different from any other union."⁵⁴ We discuss such matters in the first half of this subsection.

Furthermore, in order to assess adherence to fiscal policy rules once set, there will need to be improved budget reporting and much greater fiscal transparency. In certain GCC states, where budget transparency is poor, this may be viewed as politically costly in the short run. However in the long run improvements in budget

⁵⁴ Krueger, R. and Kovarich, E. "Some Principles for Development of Statistics for a Gulf Cooperation Council Currency Union", *IMF Working Paper*, June 2006.

reporting will undoubtedly prove to be beneficial for the GCC economies. These issues are dealt with in the second half of this subsection.

7.4.1 Fiscal Policy Discipline

Fiscal discipline among the member states of a CU is necessary for it to be not just stable but also sustainable. Increasing debt issuance by one member drives up interest rates in the CU's capital markets thus making new debt issuance more costly for other members and their existing debt repayments larger. In such a situation, if the other CU members opt to stabilize their debt to GDP ratios, they will be forced to cut back on expenditures and follow contracted fiscal policies themselves.

Ultimately, countries issuing large amounts of debt and with high debt to GDP ratios, will find this position unsustainable particularly if the interest payment on the government's debt exceeds the growth rate of GDP. Unsustainable budgetary positions increase the risk of debt default or debt monetization (through printing money), both of which would jeopardize the monetary stability of the CU. Furthermore, highly indebted member states might be tempted to put pressure on the central monetary authority to soften interest rates, interfering with the conduct of monetary policy.

Therefore, in order to avoid the type of negative externalities arising from fiscal indiscipline in CU, as described above, in Europe the 'Stability and Growth Pact' (SGP) set out specific fiscal prudence rules for EMU members.⁵⁵ These rules restrict fiscal deficits to 3 percent of GDP and public debt to 60 percent of GDP. However, in practice the SGP rules have been ignored by some European countries.

Indeed, the fiscal restraints imposed on the EMU members by the SGP have been controversial. Following the adoption of the SGP, research indicated that it could

⁵⁵ These rules were initially laid out in the Maastricht Treaty of 1992 but were later strengthened in the form of the SGP in 1997.

have potential macroeconomic costs that could condemn Europe to “a low – level equilibrium trap”, furthermore it was concluded that the SGP would divert Europe’s attention away from important structural reforms that were needed to improve growth prospects.⁵⁶

The adoption of fiscal rules, such as those of the European Union’s SGP designed for diversified and developed economies, cannot therefore be considered appropriate for the GCC’s transitional economies and may potentially impede the economic development of the region and as indicated in the quotation from Krueger and Kovarich above, a more flexible arrangement may be more suitable for the GCC countries.

Conversely, if fiscal rules are too loose there could potentially be disagreement and friction between member states. For example, while Saudi Arabia ran up considerable debt in the past, Kuwait has been relatively fiscally prudent and Qatar which has issued a large amount of external debt to develop its natural gas reserves, would be heavily penalized if excessive spending and borrowing by Saudi Arabia drove up interest rates on the region’s sovereign debt market. It would be preferable for the GCC states to have ‘intelligent’ fiscal rules, that may be less transparent, but that work well in providing stability but also take into account their stage of economic development, rather than stringent rules that simply don’t work because they aren’t appropriate for the economies of the region.⁵⁷

In chapter six (section 6.2), the degree to which the GCC states had met certain fiscal rules over the last 25 years was assessed in detail. In brief, whilst, the UAE, Saudi Arabia and Oman have all suffered from successive periods of budget deficits throughout the 1980s and 1990s, according to available data, only Saudi Arabia had to resort to issuing substantial levels of public debt. In 1998 and 1999 the Kingdom’s public debt reached a maximum of 102 percent of GDP and between 1997 and 2004 the 60 percent deficit rule would have been breached

⁵⁶ Eichengreen, B. and Wyplosz, C. “Stability Pact: More than a Minor Nuisance?” *Economic Policy*, April 1998.

⁵⁷ Munchau, *op. cit.*

continuously. However, since the oil price rises beginning in 2002 Saudi Arabia has used its large successive budget surpluses to pay down its debt to more sustainable levels, estimated at just 46.5 percent of GDP in 2005.

This underlines the fact that, unlike the European economies, GCC budgets are highly dependent on hydrocarbon revenues and are therefore very vulnerable to oil and gas price changes. However, since 2002 oil and gas prices have been on an upward trend and many energy economists in 2006 were concluding that energy prices are unlikely to see a substantial correction in the near, or even medium term.⁵⁸ Based on such oil price expectations, in practice, the GCC states may not face great difficulties in meeting fiscal policy discipline rules in the years leading up to the scheduled date of CU. Yet in the long run, post CU, the challenge to significantly diversify government revenues in order to improve budget stability will remain and intensify for some GCC states.

In light of this, several GCC states are diversifying their official oil funds and other investment vehicles into non oil and gas investments which should provide substantial non-oil and gas related income streams in the future.⁵⁹ The IMF has also recommended on several previous occasions that the GCC governments should introduce a Value Added Tax on luxury goods and harmful items such as tobacco. Some GCC states, such as the UAE, are reportedly considering the practicalities of introducing VAT however, there has been no official confirmation that the system will be implemented at all so far.⁶⁰

Adhering to fiscal discipline rules can therefore provide benefits such as improving the coherence of the CU, ensuring a stable macroeconomic climate and at the same time encouraging FDI. However, questions over the effective enforcement of

⁵⁸ See Till, Hilary "Commodities at the Crossroads" Presentation to Chicago Chapter of QWAFEFW, 31 May 2006, (available at www.premiacap.com/commodities) Till concludes that 'oil markets may be in a state of continual crisis ...resulting in a bull market that is sustainable for years.' Similarly 'bullish' conclusions about future oil prices have regularly been drawn by other commodity market analysts e.g. Paul Horsnell of Barclays Capital, Arjin Murti and Brian Singer of Goldman Sachs.

⁵⁹ See Chapter 6, section 6.2, "Government Deficits".

⁶⁰ Nambiar, Sona *The GRC Gulf Business Weekly Report*, Gulf Research Center, Dubai, 11-17 March 2006.

fiscal rules and therefore their credibility have led to major criticisms of the value of this policy. Post EMU, several eurozone countries breached the fiscal rules,⁶¹ however the threat of imposing fines, amounting to as much as 0.5 percent of GDP, have never been enforced and consequently the credibility of the fiscal rules has been severely undermined.⁶²

At the time of writing, with less than four years to go before the scheduled launch of the single currency, the GCC secretariat have yet to announce the precise mechanisms by which fiscal prudence rules could, or would be enforced. As Saudi Arabia has been the main violator of the fiscal debt to GDP ratio in the past, enforcement of fiscal rules by the smaller GCC economies is likely to prove inherently difficult.

7.4.2 'Loss of Fiscal Policy Sovereignty'

Appropriately designed fiscal rules are critical in providing long term fiscal sustainability and should be a matter of concern for all GCC states. But agreement on them is however, proving to be difficult to achieve. According to one GCC Secretariat official who was interviewed, "The main obstacles to forming a successful CU include reaching agreement on fiscal policy limits. The implementation of fiscal limits has been achieved in principle during 2005. If the summit blesses the agreement in December, this would pass a major milestone." Ominously, in the 2005 GCC summit final communiqué there was no mention of the fiscal limits.

Any adherence to fiscal policy rules will inevitably require improved fiscal data transparency and more accurate and standardized methods of budget accounting, as was discussed in the previous chapter (see section 6.3.2). Statistics have political resonance particularly for the autocratic regimes of the GCC states and can be subject to manipulation. Data transparency is often patchy as in some GCC states the legislative supervision of spending by the ruling families is insufficient. A

⁶¹ France, Germany and Italy have all breached the 3 percent of GDP budget deficit rule.

⁶² See *The Economist* "Europe and the Euro: The Death of the Stability Pact", 29 November 2003.

senior GCC Secretariat official, Dr. Abdel Aziz al-Uwaisheq, director of the GCC's economic integration department, commented on the data issue saying "We have different levels in the GCC, Oman, Bahrain and Kuwait have high levels of transparency. The others are working on it."⁶³

Saudi Arabia's budget reporting, in particular, is considered to be opaque,⁶⁴ and in the past its record of off-budget accounting has been heavily criticized.⁶⁵ An article in the *Financial Times*⁶⁶ in 2002 cited an IMF report which estimated that 20 percent of Saudi Arabia's oil receipts were not acknowledged in the government budget of 2000, the missing oil revenues were accounted for by off-balance sheet expenses of the state oil company comprising of "generous stipends to the 7,000 member royal family". Such opaque budget reporting could potentially be unacceptable to other more transparent CU members, such as Kuwait. One Emirati academic said that "The fiscal aspects of CU particularly worry me because apart from Kuwait, which is the only GCC country with transparent government procedures, government budget reporting is still a problem and it is a very important prerequisite for CU".

This raises the critical issue of economic/fiscal sovereignty. Several GCC expert interviewees felt that the 'loss of fiscal policy sovereignty' would potentially be viewed as a considerable political economy cost to the GCC regimes. Indeed, this was also considered to be one of the main obstacles to the CU project. One Qatari academic believed that losing sovereignty over economic decision making would be a major sacrifice for the GCC states, "The biggest obstacle is the idea of losing

⁶³ Staff Writer "Volatile oil is a headache for Gulf monetary union" *Gulf Times*, 30 October 2004.

⁶⁴ According to the US Department of Commerce (<http://strategis.ic.gc.ca/epic/internet/inimr-ri.nsf/en/gr120123e.html>) "The Saudi budget planning process is opaque. Little is known about the method of planning and the actual breakdown of anticipated revenues and expenditures. Some items are off budget."

⁶⁵ Giles Whittell, writing in *The Times*, argued that institutionalised corruption in Saudi Arabia was rumoured to "siphon the revenue from 600,000 barrels of oil a day to fund the louche lifestyles of the country's 15,000 princes", see Whittell, Giles, "The Last Oil Rush", *The Times*, 25 October 2001. Writing for the US' Foreign Policy in Focus, Terry Lynn proffered that Saudi budgeting is "murky" and at least "10,000 princes receive stipends of up to \$270,000 per month, see Lynn Karl, Terry and Gary, Ian "Oil & Development", US Foreign Policy in Focus, October 2004.

⁶⁶ Khalaf, Roula "Saudi Arabia urged to speed up economic reform" *Financial Times*, 23 October 2002.

control over economic policies but they are still fighting over this, every time they talk about sovereignty over policy they fall out.”

However, ‘fiscal sovereignty’ arguments may be used as an excuse for the perpetuation of practices which are inimical to the transparency and honesty which are themselves a prerequisite of a successful CU. While increased budget transparency may not be welcomed by those with a vested interest in the status quo, economically speaking, improving fiscal budget reporting can be considered to be an essential adjustment cost, which will bring about many benefits in the longer term.

Indeed, some expert interviewees felt that reduced government ‘sovereignty’ over fiscal and economic policies would eventually constitute a benefit to the region. One independent researcher in the Emirates commented “It will minimise the control of rulers over economic issues and limit their power to influence economic and fiscal policies so it will reduce their interference in these areas.” While one Emirati academic remarked “In the short run there will be political costs but in the long run it is a step in the right direction.”

At the same time one must be realistic. An independent researcher in Kuwait said with regard to the issue of tighter fiscal discipline “the costs of CU include the loss of government authority and this is significant in most GCC states because they don’t have strong institutions and decision making is highly centralized.” In the experience of EMU, fiscal rules and coordination have proved to be a controversial and at times problematic area. On this basis, in the context of the existing GCC political regimes losing absolute fiscal sovereignty could prove to be prohibitively expensive and it is perhaps in relation to this particular ‘cost’ that there are grounds for some pessimism as to whether GCC CU will ever take place.

7.5 Political Economy Dimensions

The successful launch of the GCC single currency and a move towards an independent exchange rate regime offers the GCC states the potential to establish

the world's first significant Arab and 'Islamic' currency. Backed by two fifths of the world's oil reserves and massive financial assets a floating GCC currency could have significant strength and would be attractive to other Arab and Muslim countries that might choose to anchor their own currencies to the Gulf 'dinar' and to hold it as part of their foreign reserves. In the first half of this subsection we discuss such political benefits arising from a successful GCC CU which may be equal to, or even greater than the perceived economic benefits.

The prospective CU also represents an opportunity for the GCC states to strengthen both their economic and political ties and to emerge as a more cohesive and unified regional bloc. These matters are discussed in the second half of this subsection; we argue that much will depend on the success of the CU and the degree to which it is accompanied by other reforms. First and foremost it will involve overcoming past political disharmony between the members. The role of Saudi Arabia in the region is also of question, if it is perceived as a domineering force it could set back integration but on the other hand it could act as a driving force in the regional integration process.

7.5.1 Creating an Anchorage and Reserve Currency

Should the GCC leaders opt for an independent exchange rate regime and monetary policy then the GCC currency could be established as a regional currency to be used as an anchorage and reserve currency throughout the Arab and Muslim world. Depending on the strength and stability of the 'Gulf dinar', other Muslim and Arab countries might choose to peg their currencies to it and those countries with strong trade links to the region might also choose to hold it in their foreign reserves. Furthermore, if the GCC leaders chose to invoice their oil sales in the new currency this would generate increased demand for the currency and generate substantial seigniorage revenues. As well as the financial gains for the GCC states, the emergence of the 'Gulf Dinar' as a regional currency would, perhaps more importantly, give the GCC states substantial prestige in the Arab and Islamic world.

GCC experts were equally split on the prospect of the GCC single currency becoming a regional reserve and anchorage currency. It was felt that several economic and political factors would come to bear on whether the Gulf 'dinar' could emerge as a regional currency. Factors such as the development and diversification of these economies, economic growth prospects, accompanying economic reforms and the credibility of the new currency will all influence the strength and stability of the independent GCC single currency. Others mentioned that political risk would play an important part and that improved transparency and accountability in the region would be a necessary condition, as would the perception of the GCC monetary authority as a professional and effective institution, for a regional currency to emerge.

The 'Gulf Dinar', if successful, could be presented as an alternative 'Islamic' currency, providing a religious motivation for holding the currency in addition to the economic rationale outlined above. 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.⁶⁷

While a few experts felt that the GCC economies were too insignificant for their currency to become an anchorage and reserve currency, several others disagreed. One government official in the UAE felt "It is conceivable, for example people hold Swiss francs in reserves. If you achieve a reputation for low inflation and stability and you have good policies it may be attractive for neighbouring countries, such as Iran and Pakistan, whom you trade with to hold your currency in reserve." Another expert, this time a Qatari central bank official said "The huge oil and gas reserves of the region, the big financial reserves of the Gulf States and their annual current

⁶⁷ Rutledge, E. "Establishing a Successful GCC Currency Union: Preparations and Future Policy Choices" Gulf Research Center, Policy Analysis, December 2004.

account surpluses are factors that will influence the single currency's ability to become a reserve currency.”

Indeed, an important consideration for the strength of a future independent GCC currency would be the large oil and gas reserves held by the GCC states. Approximately 40 percent of the world's proven oil reserves and 23 percent of global gas reserves belong to the GCC states (see Table 7.4). According to energy analysts the world will become more dependent on oil and gas from the Gulf as other producing areas, such as the UK North Sea and Indonesia, go into terminal decline. In addition to these energy reserves, the GCC states also have considerable mineral deposits.

Table 7.4: GCC Energy Production and Reserves, 2005

	Oil Production ('000 bpd)	Share of World	Oil Reserves (bn bbls)	Share of World	Gas Production (bcm)	Share of World	Gas Reserves (tcm)	Share of World
Bahrain	n.a.	n.a.	n.a.	n.a.	9.9	0.4%	0.09	0.1%
Kuwait	2,643	3.3%	101.5	8.5%	9.7	0.4%	1.57	0.9%
Oman	780	1.0%	5.6	0.5%	17.5	0.6%	1	0.6%
Qatar	1,097	1.4%	15.2	1.3%	43.5	1.6%	25.78	14.3%
SA	11,035	13.6%	264.2	22.0%	69.5	2.5%	6.9	3.8%
UAE	2,751	3.4%	97.8	8.1%	46.6	1.7%	6.04	3.4%
GCC	18,306	22.6%	484.3	40.3%	196.7	7.1%	41.38	23.0%

Source: BP Statistical Review of World Energy, 2006.

Notes: Gas Production and reserves in bn cubic metres (bcm) and trillion cubic metres (tcm).

Of the GCC countries Saudi Arabia has considerable mineral reserves, including large deposits of Iron ore, Gold, Copper, Phosphate, Bauxite and Magnesite. Saudi Arabia is therefore investing substantial funds into its mineral sector. Moreover, the GCC, due to its oil and gas feedstock is competitively placed to produce Steel, Iron and Aluminium. Some GCC states are already major manufacturers of Aluminium

and in the coming five years it is likely that the Gulf will become firmly established as the global hub for this important commodity. In addition, several GCC states have recently established commodity exchanges, with two functioning in Dubai and two more in the pipeline in Dubai and Qatar.⁶⁸

For this reason, an independent GCC currency is likely to be characterized as a 'commodity currency' where the currency reflects the price of a commodity and rises and falls in line with it. A switch to invoicing their oil sales 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.⁶⁹ 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.⁷⁰ One government official in the UAE said "It is very possible it could happen as it would be in their interests."

Furthermore, another advantage might be that the market mechanism would tend to limit the extreme swings in the price of oil. When demand for oil is high the currency would appreciate thus making the commodity price more expensive and eventually putting downward pressure on demand thus limiting domestic inflationary pressures. During times when demand is weak, the currency would depreciate making the price of oil cheaper thus stimulating demand growth.⁷¹

There are of course associated drawbacks to forming a 'commodity currency', as well as the advantages already discussed. As a 'commodity currency' the Gulf 'dinar' would most likely be more volatile than previously, and potentially more

⁶⁸ The UAE has the Dubai Gold and Commodities Exchange and the Dubai Diamond Exchange set up by the Dubai Multi Commodities Centre. Furthermore, the Dubai Mercantile Exchange is being established in Dubai's International Financial Centre and Gulf Energy is setting up an energy focused commodities exchange in Qatar's Energy City to be called the International Mercantile Exchange.

⁶⁹ It is envisaged that oil invoicing in the single currency would be likely to take place in the GCC's long term oil contracts or on one of the region's energy bourses, rather than on international markets which would at least require that non-GCC OPEC producers agree to the arrangement.

⁷⁰ Rütledge, *op.cit.*

⁷¹ Wilson, *op.cit.*

vulnerable to speculative attacks. One Omani academic felt that “With no currency band it might prove to be too volatile.”

It could also be problematic for GCC export diversification as non-oil exports would be more likely to suffer from ‘Dutch disease’ when currency appreciations make non-commodity exports less competitive. In such a case, other Islamic countries may be less inclined to peg their currency to the ‘Gulf dinar’, however, they would still need to hold the currency as part of their reserves in order to purchase GCC oil. Nevertheless, despite these potential drawbacks several oil exporting countries have adopted floating exchange rate regimes, the most successful example perhaps being Norway.

However, while several regional experts felt that there would be economic benefits from invoicing oil in the GCC currency, a few felt that the political costs would be too high. For this reason, the majority of regional experts felt that the likelihood of the GCC states switching to invoice oil in their own currency was currently rather small. One Kuwaiti academic commented “The US reaction would be a very important factor. US pressure has often had an influence on these economies, for example military contracts have often gone to US companies after pressure being exerted.” Another expert, this time an independent researcher in the UAE said “Such a move would provoke hostility from the US and would be politically risky. The margin of economic benefit does not outweigh the political risk.”

On the other hand, in the light of America’s disastrous policies in Iraq combined with its increasingly partisan support for Israel, some GCC states may now be questioning the utility of the traditional *de facto* alliance with the US and asking themselves precisely what is the advantage to them of maintaining this historical dependence at a time when important new strategic partners – in particular China – are offering them a variety of economic and security arrangements.⁷²

⁷² See Rutledge, Ian, *Addicted to Oil: America’s Relentless Drive for Energy Security*, I.B. Tauris, London, Chapter 12, 2005.

7.5.2 Strengthening the Regional Bloc

The potential political economy gains from forming a single GCC currency are significant. At the very least it should solidify the GCC as the dominant regional economic bloc. It should also make the GCC function more cohesively as an economic bloc. If the Gulf Dinar is more than a loose currency arrangement then it is highly likely that it will strengthen the GCC both economically and politically. On aggregate the GCC states, many of which have very small economic mass, will enjoy much greater bargaining power in international forums and negotiations than they would have done individually, especially in light of the global strategic significance of the regional bloc, holding two fifths of global oil reserves (see Table 7.4).

The consensus among those regional experts interviewed on the subject, was that the CU will strengthen the GCC not just economically but also politically. For instance, one Saudi government official said "The CU means that there is no going back on the integration and unification process. It also means that GCC countries are willing to surrender a good part of their sovereignty to the group." Other experts feel it might make the region more stable and accountable. One independent researcher in the UAE felt that "It should enhance the power of democratic institutions as it will create a regulatory role with other states and involve the delegation of power to institutions and technocrats." A Saudi government official said "If you integrate more and promote the mutual interests of the citizens then the region will become more stable and the political environment less volatile."

While the pace of GCC regional integration in the past has been criticized,⁷³ it is often cited as the most successful and resilient sub-regional Arab organisation.⁷⁴ When compared to the Arab league for instance, the GCC as a regional bloc is considered to have achieved a meaningful level of integration. One Kuwaiti independent researcher said that the GCC had "The right ingredients, they all have

⁷³ Humayon Dar, A. and Presley, John R. 'The Gulf Co-operation Council: A Slow Path to Integration?' *The World Economy* 24:9, 2001, pp.1161-1178, Blackwell Publishers Ltd, 2001.

⁷⁴ Legrenzi, Matteo "The Gulf Cooperation Council in Light of International Relations Theory" *International Area Review*, Vol. 5, No. 2, pp. 21-37, Fall 2002.

strong credible currencies and they also have political strength. The Arab league has been reduced to nothing and the GCC is the only Arab bloc that is working.” The successful establishment of the GCC CU will therefore be considered as an important sign of the bloc’s regional strength. Conversely if the GCC does not set up a Common Market by 2007, or establish the single currency by 2010, it will lose a great deal of credibility.

While it is anticipated that the CU will provide political economy gains for the bloc as a whole, some smaller states may incur costs. One independent researcher said that “What is crucial is whether they are prepared to relinquish national sovereignty – which has to be pooled at the supra-national level and the key point is do the political leaders realise this?”

One particular challenge for the smaller GCC states and for the sustainability of the union is if Saudi Arabia attempts to use the project as a vehicle for exercising economic dominance and therefore political leverage, over its smaller neighbours. In the past, concerns over Saudi Arabia’s dominance have led the smaller GCC states to resist a more pervasive integration.⁷⁵ Yet conversely, Saudi Arabia’s determination to drive forward the regional integration process could be a unifying influence on the other GCC states.

Along with unresolved territorial disputes between Saudi Arabia and some of its neighbours,⁷⁶ the issue of bilateral FTAs with the US illustrated the continuing power struggle between Saudi Arabia and some of the smaller GCC states. Despite Saudi Arabia’s public disapproval both Bahrain and Oman have signed bilateral FTAs with the US putting their national interests before those of the region.

⁷⁵ *Ibid.*

⁷⁶ Such as the dispute between the UAE and Saudi Arabia over the waters of Al Adeed, in the mid-1970s the UAE ceded a small piece of land to Saudi Arabia in a border agreement but retained sovereign rights over the waters; Saudi Arabia still disputes this. However, not all border disputes within the region have involved Saudi Arabia, with Bahrain and Qatar for example disputing the Hawar Island.

One Kuwaiti commercial banker commented "Bahrain couldn't wait for the FTA with the US and so it went ahead with it anyway, and this is revealing." Furthermore, these bilateral FTAs may reflect a diverging approach to economic reform between Saudi Arabia and the smaller GCC states. WTO membership is a precondition of these FTAs with the US, but Saudi Arabia only acceded to the WTO in 2005, whereas Oman joined in 2002 and Bahrain had been a member since its launch in 1995. It is apparent that states such as Bahrain, Oman and also the UAE are keen to liberalise and open their economies at a much faster pace than Saudi Arabia (see chapter eight for more discussion on this).

In fact, it is not the first time that the relationship between the smaller GCC states and the US has acted as a divisive factor in GCC economic and political unity. Following the events of 9/11, Qatar strengthened its relations with the US while Saudi Arabia was seemingly ostracized by the Americans creating regional tension, "there is political rivalry between some GCC states in particular between Qatar and Saudi Arabia." one AMF official remarked. In addition, Bahrain has opposed the building up of the region's unified military force *Peninsular Shield*, because it considers American protection to be a better guarantee of its domestic security, although as suggested above, this perception may now be changing.⁷⁷

If the GCC states achieve their aim of forming a strong CU then a greater degree of political integration will also have been established. In this case the unified political strength of the GCC should be more effective in acting as a "countervailing influence against the domination of neighbouring powers"⁷⁸ i.e. Iran. Concerns over Iran's influence in the region abound, particularly in Saudi Arabia and Bahrain where large Shia populations are controlled by ruling Sunni elites. Furthermore, the international dispute concerning Iran's nuclear programme, with the US and its allies insisting that Iran is attempting to build nuclear weapons, have raised alarm bells over future regional security.

⁷⁷ Legrenzi, *op.cit.*

⁷⁸ Mundell, Robert A. "Updating the agenda for monetary union" in *Optimum Currency Areas: New Analytical and Policy Developments*, (Eds. Blejer, M.I., Frenkel, J.A., Leiderman, L., and Razin, A.), International Monetary Fund, 1997.

Iran has in the past made several claims over GCC territories. In 1970 Iran laid claim to Bahrain which it considered part of its wider territory, since then it has also occupied three islands, the Greater and Lesser Tunb Islands and Abu Musa Island, which are also claimed by the UAE. Therefore, in the case of Bahrain and the UAE in particular, greater integration with their Arab Gulf neighbours may be in the interest of their national security. In fact, some Gulf analysts have attributed the formation of the GCC itself as a reaction to the 1981 Iran-Iraq war and fears that Iran's Shia revolution might eventually be exported to other Gulf states.⁷⁹ Therefore Iran's increasing bellicose stance over its nuclear weapons programme might once again act as a politically motivating factor in greater GCC integration.

One other consideration the GCC will need to take into account is the impact a CU will have on future enlargement of the economic bloc. Although no new members have been admitted to the GCC since its inception, several neighbouring countries are keen to join, Yemen being one such country. Yemen's accession to the GCC would almost certainly incur some short term economic costs. Significant funds would have to be invested in Yemen in order for its economic fundamentals to converge with the other GCC economies.

The existing economic divergence between Yemen and the GCC is stark. The average Yemeni's income is some twenty eight times less than that of a GCC national (see Figure 7.3).⁸⁰ Despite having a population of more than 20 million, Yemen's GDP is comparable with that of Bahrain which has a population of less than a million. Yemen's physical and human resources infrastructure is far less developed, with an estimated 51 percent of the adult Yemeni population illiterate.⁸¹

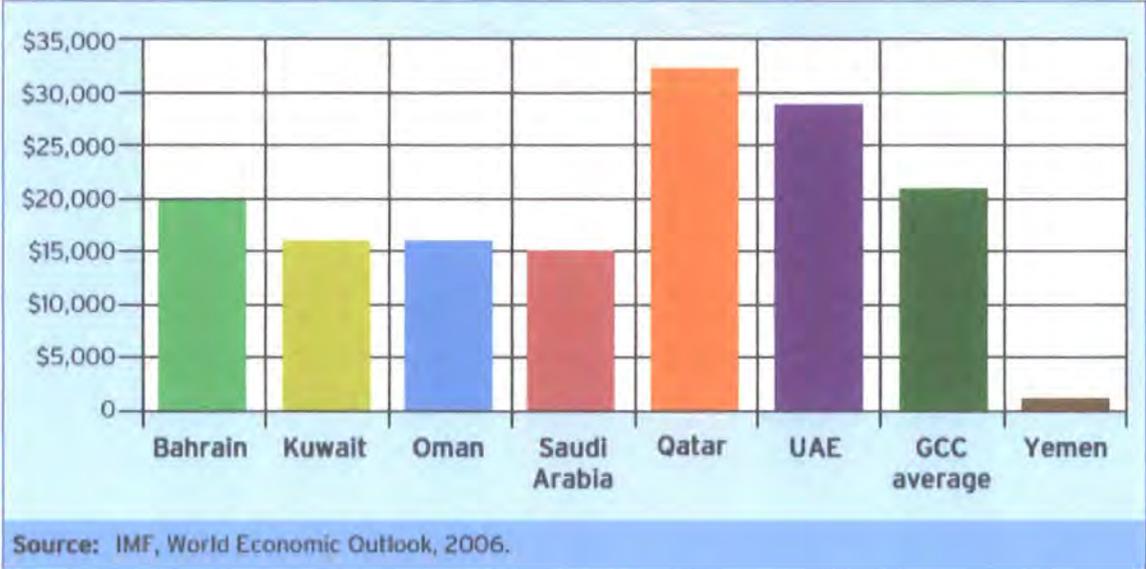
⁷⁹ Looney, R.E. "Economic Integration in the Gulf Region: Does the Future Hold More Promise than the Past?" Center for Contemporary Conflict, *Strategic Insight*, 1 March 2003.

⁸⁰ According to IMF, World Economic Outlook 2006, GDP per capita (PPP) in Yemen was \$751 in 2005, compared with the GCC average of \$21,258.

⁸¹ According to the UNDP Human Development Report, 2003.

Despite its position as a net oil exporter Yemen's proven oil reserves are limited and less than that of Oman, which along with Bahrain has the smallest oil reserves among the GCC states.⁸²

Figure 7.3: Per Capita GDP (PPP Adjusted) in the GCC and Yemen, 2005⁸³



There are also political differences between the GCC states and Yemen, unlike the six Gulf monarchies Yemen is a republic. Political relations between Yemen and the GCC states have been tense in the past with Yemen supporting the side of Iraq in its 1990 invasion of Kuwait. Furthermore, when Oman and Qatar sponsored Yemen's application for GCC membership in 1999, Saudi Arabia vetoed it. Despite past political differences, recently Saudi-Yemeni bilateral relations have improved markedly with high level visits taking place between the two states in May and June of 2006 in which the economic ties between the two were given high priority.⁸⁴

⁸² Yemen's proven oil reserves stood at 2.9 bn barrels at the end of 2005, according to BP Statistical Review of World Energy 2006. Oman's proven reserves stood at 5.6 bn barrels at the end of 2005.

⁸³ As was mentioned in chapter four, section 4.2.1, figure 4.3, the IMF World Economic Outlook data calculates Kuwaiti GDP per capita (adjusted for PPP) at below that of Bahrain and comparable to that of Oman. This is quite clearly counter intuitive to the economic prosperity in Kuwait compared with Bahrain and Oman and leaves questions about how the data has been calculated.

⁸⁴ Shirian, Daoud "Yemen is a Gulf State" *Al-Hayat*, 07 June 2006.

Notwithstanding the economic costs and political questions over Yemen's accession, the GCC could benefit from the improved security that allowing Yemen to join would bring. Through GCC grants and economic support the economic circumstances and living standards of Yemenis should dramatically improve following accession. As economic development takes place the likelihood of Yemen being a breeding ground for Islamic militants will be reduced considerably.⁸⁵ Thus, according to some regional analysts the GCC should be willing to endure some temporary economic burdens from Yemen's membership of the GCC in order to "realize priceless political and strategic goals."⁸⁶

In many ways expanding the GCC would provide the existing members, often characterized as resource rich-labour poor, with many opportunities, but expanding the role of the single currency to encompass economies such as Yemen may not be optimal. The GCC could however adopt a two-tier strategy where – like the EU – some members are core (the Eurozone) and others are peripheral (EU members that still retain their sovereign currencies).

7.6 Conclusion

The launch of the GCC single currency will present a number of potential benefits, both direct and indirect; yet realizing many of the economic gains will ultimately depend on the implementation of complementary economic reforms and the full establishment of the GCC Common Market. The successful launch of the single currency will be a signal of regional strength and will present an opportune moment for the GCC leaders to move to a more flexible exchange rate regime that will give them regional autonomy over monetary policy tools with which to direct their economies. Furthermore, an independent GCC currency, backed by the economic strength of considerable resources and financial assets, has the potential to become a regional anchorage and reserve currency, particularly if it is perceived as an 'Islamic' currency and used as the invoice currency for the region's oil sales.

⁸⁵ Rutledge, E. "Is Yemen Ready To Join The GCC?" in *Gulf Research Center Business Bulletin*, Dubai, 24-30 June 2006.

⁸⁶ Shirian, *op.cit.*

The potential efficiency gains from the CU are likely to be marginal at first, as intra-GCC trade (even as a proportion of non-oil trade) is currently relatively small compared to that of Europe prior to MU. The single currency is expected to promote intra-GCC trade but businesses see other micro level factors to be more important obstacles to the growth of their business rather than exchange rate related costs. The simplification of bureaucratic formalities and harmonisation of business regulations across the GCC are necessary reforms that must accompany the CU if the potential gain from the single currency in expanding intra-GCC trade is to be realised. In addition, the gains from increasing price transparency will only reduce future price discrimination across the region if there is increased arbitrage in the goods and services market brought about through a GCC Common Market.

On balance however, the effect of the CU on private sector confidence and the business climate is expected to be positive. According to the results of the business survey, a majority of GCC businesses are confident about the potential success of the CU and its impact on their businesses. This bodes well for future investment decisions and potential growth of these economies in the lead up to, and following the establishment of the CU. GCC capital market expansion will also be promoted by the single currency, as new investment opportunities arise in pan-GCC assets attracting a greater level of funds. With increased liquidity the region's Islamic bond market should benefit in particular, with increasing issuance and lower costs of borrowing for the region's companies.

Despite the substantial prospective gains of a single currency, the potential costs of the CU are also considerable. However, as this chapter has shown, these costs are essentially manageable and their magnitude will very much depend on the political commitment to the process. If the political will is concerted the costs are likely to be significantly reduced. In the political context of the GCC states, the main sacrifice is the loss of some sovereign control over economic policy making.

The loss of discretionary monetary policy will prove costly for some GCC states post CU in light of diverging inflation rates, monetary policy preferences and

economic development strategies. Agreement on the choice of monetary policy and exchange rate regime for the single currency will therefore require substantial compromises over national interests in favour of implementing the most appropriate exchange rate regime for the region as a whole. However, the potential macroeconomic costs of the common monetary policy should be ameliorated by the flexible adjustments of the GCC's labour market and increasing cross border capital flows.

Post CU the choice of exchange rate regime is uncertain and is likely to depend on the prevailing economic circumstances. The consensus opinion considers the optimal policy for the region would involve an active monetary policy and thus the choice of a more flexible exchange rate regime. But whether or not the GCC leaders can agree on detaching the single currency from the dollar is questionable, as is whether a switch to a free float or a peg to a trade weighted basket of currencies would be more beneficial.

In a CU the fiscal spending and borrowing of each nation will become a matter of common concern for all members and therefore the GCC states are expected to adopt fiscal discipline rules which will reduce the likelihood of future bail-outs of indebted members and strengthen investor confidence in the region. The experience of Europe's SGP has shown however, that if the fiscal rules are too rigid they are likely to be broken and consequently lose their credibility and effectiveness. The design of fiscal limits for the GCC must therefore take into consideration the region's hydrocarbon dependent economies in cyclically adjustable rules otherwise they are unlikely to work in ensuring fiscal discipline in the long run.

The costs associated with accepting restraints on fiscal policy and scrutiny of budgets by other member states are politically significant and agreement on the exact nature of the fiscal rules for the GCC CU has consequently, so far been hard to reach. Eventually, the fiscal rules determined may well be of a 'looser' nature than those of the SGP and adherence to them possibly open to some interpretation. This might soften the political cost incurred by the GCC leaders of

losing absolute fiscal sovereignty but only with firm political commitment to the process will the leaders eventually find common ground on this sensitive issue.

Once the constituent states are tied together in CU, the need for transparent and standardized budget reporting will be vital as all members will face the economic repercussions of any one government's excessive spending and borrowing. While in the long run this will undoubtedly prove to be beneficial for the GCC economies and their credibility, in the short run, this may be viewed as politically costly and could even act as a powerful deterrent to the CU project.

Finally, the successful establishment of the GCC CU should strengthen the GCC economically and politically. On aggregate the GCC states will have a much stronger voice in international disputes and negotiations which should expand their sphere of influence on the global stage. A unified regional bloc acting with one voice will also improve international cooperation and give the views of the GCC states greater weight in terms of US and EU foreign policy towards the Middle East.

Chapter 8 : The National Distribution of Costs and Benefits

8.1 Introduction

The previous chapter examined the costs and benefits of a CU for the GCC as a bloc, this chapter will attempt to assess the relative costs and benefits for each of the six GCC states individually. Although all the GCC states will to some extent experience the same costs and benefits of forming a CU they will do so to different degrees: in other words the precise 'weight' of particular costs and benefits will be experienced differently in each GCC state. Although conventionally perceived as broadly similar in economic composition, there are important differences in economic circumstances between the GCC states (as discussed in chapter four). By identifying the most significant prospective costs and benefits for each state individually GCC policy makers should be in a better position to manage them and to make preparations so as to minimize these potential costs, at the same time as maximizing the potential benefits of CU.

This chapter makes a first assessment of the prospective relative distribution of costs and benefits of CU across the GCC states based on the contemporary economic, political and institutional circumstances. The sources of costs and benefits for each respective member will depend upon the initial economic circumstances of each country, for example the degree to which they meet various OCA criteria and convergence criteria, as well as the other prerequisite conditions for CU.

It should also be mentioned, that as the date of CU approaches, progress on economic convergence may take place as the policy of integration is advanced. Such convergence should reduce the economic costs involved and improve the prospects for each GCC state, but obviously at this stage such convergence cannot be fully taken into account and the analysis of costs and benefits is therefore based only on the *existing* economic conditions in each GCC state.

The assessment presented here is partly based on the perceptions of our panel of regional experts reflecting contemporary political and economic conditions within the GCC states. In addition, we again utilize the findings of the GCC business survey which provides evidence and information as to the potential distribution of economic related costs and benefits on a country by country basis. Some of the questions put to experts and regional businesses specifically dealt with comparative advantages of one country over another, which are drawn upon in this chapter.

The arguments for and against joining a CU as set out by Mundell¹, in particular the political economy factors, are also highly relevant to the respective GCC economies. Several political economy factors will be considered by the leaders of each respective GCC state when weighing up the costs and benefits of CU accruing to them. Indeed, some of these political-economy factors may influence the decision of the GCC ruling elites as to whether they actually embark on CU. As we established in chapter seven, some of the potential costs of forming a CU will be costs to the existing ruling elites, such as the increased scrutiny of budget accounts and the reduced national autonomy over various aspects of economic policy making. Where appropriate, these political-economy considerations are therefore discussed in the country by country analysis which follows.

At the end of this chapter we shall attempt to establish a provisional 'qualitative cost-benefit' analysis of CU for each GCC state with the intention of indicating which countries will be net beneficiaries of CU and which (if any) will be net losers. Such an analysis should then assist political decision makers in adopting transitional policies and mechanisms leading to CU which will sensitively take into consideration the particular difficulties (or advantages) which some countries might face. A realistic appreciation of these facts can greatly smooth the process of moving towards CU even if they highlight seemingly difficult obstacles.

¹ Mundell, Robert A. "Updating the agenda for monetary union" in *Optimum Currency Areas: New Analytical and Policy Developments*, (Eds. Blejer, M.I., Frenkel, J.A., Leiderman, L., and Razin, A.) International Monetary Fund, 1997.

However, in the analysis of the costs of CU it is important to distinguish between those costs (economic or political) which will be experienced *if the GCC CU actually goes ahead* and those which would be so powerful as to stop the actualisation of CU (or the participation of a particular state in the CU). The former category of costs can be entered into the qualitative cost-benefit analysis of CU of the kind which we shall attempt to produce, but the latter – on logical grounds – should be clearly identified, but not, in our opinion, included in the cost-benefit analysis. In other words, if it is believed that the ruling elite in a particular state stand to lose so much domestic power as a result of e.g. CU fiscal transparency rules, that they will refuse to take part in the whole exercise, then there is little point in trying ‘balance’ this CU ‘cost’ against putative benefits which the country would receive if it did actually participate in the proposed CU.

Other potential economic and political gains from the future policy choice of de-pegging the GCC single currency and having an independent monetary policy, which were discussed in chapter seven, are also not taken into account in this chapter. This is because such gains can be expected to accrue to all the GCC members as a whole.

This chapter continues by reviewing the principal economic characteristics of the individual GCC states which constitute key parameters in assessing relative CU costs and benefits. Section 8.2 then goes on to address the question of whether the CU could be established without all six GCC member states participating. Following this, it examines in detail the cost – benefit case of each GCC state individually taking into account both economic and political economy considerations. Finally, in section 8.3 we attempt to measure the relative economic case for each GCC state for joining the CU. The specific economic benefits for each GCC state are weighed against the economic costs and the results are displayed graphically in a qualitative cost-benefit analysis. While this approach is necessarily somewhat subjective, given the impossibility of putting any meaningful quantitative weight on the items which enter into our politico-economic balance sheet, we believe that the exercise should provide some initial guidance to GCC decision makers as to the best way forward in tackling the real world challenges facing what may turn out to be one of the most significant political and economic events of the early 21st century.

8.2 Comparative Costs and Benefits

Certain key economic indicators are likely to be important parameters in assessing the likely costs and benefits of CU by GCC state. These include the relative size of the economy, natural resource wealth, competitive position, intra-regional trade and investment linkages as well as the degree to which each state meets various convergence criteria. Table 8.1 provides a snap shot of some of the economic characteristics of each of the GCC states.

Table 8.1: GCC Comparative Economic Indicators

	Bahrain	Kuwait	Oman	Qatar	SA	UAE
GDP (US\$bn nominal), 2004	11.01	48.50	24.82	28.45	250.56	104.20
GDP Per Capita (US\$ nominal) 2004	15,572	17,613	10,325	38,239	11,051	25,415
Population (mn), 2004	0.71	2.75	2.4	0.74	22.67	4.1
Proven Oil Reserves Per Capita (bbls), 2004	176	36,000	2,333	20,540	11,588	22,639
Life Expectancy of Proven Oil Reserves (years), 2004	1.3	111.9	19.5	42.1	68.0	100.5
Inflation Rate %, 2005	2.6	4.1	1.2	8.8	0.7	6
Reserve to Import Cover (months), 2005	2.9	7.3	5.5	5.3	5.5	2.8
Intra-GCC Non-Oil Exports as % of Total (average 1990-2002)	27.5	8.9	51.2	20.2	18.8	27.5
Intra-GCC Non-Oil Imports as % of Total (average 1990-2002)	12	9.5	30.6	13	2.9	5
Share (%) of total Intra-GCC Investment (1990-2003)	13.6	0.03	1.7	7.2	23.4	54.4

Source: Compiled by author from various sources².

² GDP, GDP per capita and population from national central bank sources, oil statistics calculated from BP Statistical Review of World Energy 2005, inflation rates from IMF IFS, reserve cover figures calculated from IMF Regional Economic Outlook and SAMBA, trade figures calculated from ESCWA External Trade Bulletins, Investment figures from Bolbol, Ali A. and Fatheldin, Ayten M. "Foreign and Intra-Arab Capital Flows in the Arab Countries, 1990-2003", *The World Economy* (Forthcoming).

In the OCA literature it is usually assumed that small and open economies tend to benefit from forming a CU because their currencies and markets are marginal and the single currency enables them to take advantage of the full benefits of the larger, Common Market.³ It is also generally agreed that when relatively poorer economies form a CU with richer ones then the process of economic convergence stands to benefit those poorer states by raising living standards and improving welfare in the catching up process. Prospective CU members with competitive business environments can also expect to benefit from access to an enlarged market without their businesses facing the adjustment costs of adapting to a more competitive business climate. Those GCC states with strong existing or potential intra-regional trade and investment links will stand to gain relatively more from the reduction in exchange rate related transaction costs and uncertainty. While those GCC states which have breached convergence criteria most frequently in the past will possibly face difficult adjustment costs from the CU. These relative economic costs and benefits are discussed on a country by country basis later in this chapter.

In addition to the cross country economic considerations there are a host of other national institutional and political economy issues that will influence the balance of costs and benefits per GCC state. The national perception of the costs and benefits accruing from CU will influence the decision to join the CU and therefore whether the CU goes ahead with all six GCC members. Despite the shared commitment to the Economic Agreement of 2001, according to the GCC Charter the choice of opting out is feasible but only under certain strict conditions. In the case of EMU, several European Union countries decided not to join, such as the UK and Sweden.⁴

The largest proportion of regional experts consulted felt that a GCC CU could not however, be established with less than the six GCC members. One Saudi Arabian government official commented "The decision has to be unanimous as we tried to go ahead with the customs union with only four or five states initially and the others later, but finally they agreed that they must move together. So

³ See for example, McKinnon, R. I., "Optimum Currency Areas" *The American Economic Review*, Vol. 53, No. 4, pp 717-725, September 1963.

⁴ In Sweden, the decision not to join was based on a public referendum.

based on past experience I don't think they will go ahead with less than six members." Another Saudi Arabian government official agreed with this sentiment, saying "Opting out will render the CU irrelevant. The strength of the CU and its potential benefits is in its comprehensive nature." Several experts felt that if the CU failed to include all the GCC states then it would be a dent to their credibility.

Of those experts that thought it was potentially possible for CU to proceed without all six GCC members, a few felt that it would depend on which GCC states were left out. Most felt that it would not be feasible to have the CU without Saudi Arabia's participation, but that if small states such as Bahrain or Oman were not included this would not be an obstacle to the formation of the CU. Bahrain's small economic size certainly limits the benefits for other members from its inclusion in the CU while relative to the other GCC states (except Bahrain) Oman is a resource poor country and arguably its economic structure is more akin to that of another Gulf neighbour, Yemen.

Nevertheless, the inclusion of Saudi Arabia in the prospective CU was not initially considered to be crucial by the other GCC states, nor for that matter by Robert Mundell, who was consulted on a plan for a Gulf CU several years before the formation of the GCC. In an interview with a regional newspaper in 1999 Mundell commented "I put forth the plan for a Gulf unified currency back in 1975 in response to a request from the Central Bank of Kuwait." Mundell went on to say "The idea then was to establish a unified currency between the small Gulf Emirates. The plan did not include Saudi Arabia nor the Sultanate of Oman."⁵

The benefits to small economies joining together in CU are commonly accepted. In fact, previously Qatar and Dubai (now one of the seven Emirates of the UAE) had formed a CU between 1966 and 1973.⁶ But the inclusion of Saudi Arabia in the GCC CU, whilst significantly increasing the market size for the other GCC

⁵ Al-Hajji, A. F., "A Special Interview with Robert Mundell - Nobel Laureate in Economics" *Al Watan*, (translated from Arabic) 1999.

⁶ The Qatar-Dubai Currency Agreement was signed on 21 March 1966 and introduced the Qatar and Dubai Riyal as the currency unit in both states, this arrangement lasted until 1973. See www.pjsymes.com/au/articles/QatarDubai.htm (accessed at 25/02/04).

members and therefore representing a significant gain to the union, also presents something of a challenge to its overall cohesion. Saudi Arabia's influential position in the future CU, as discussed in chapter seven (see section 7.5), is likely to be of some concern to the smaller GCC members and may impose some political costs upon them. As Mundell pointed out in his interview, "Broadly speaking, Saudi Arabia will wield palpable influence because it cannot be expected that the other GCC states will put forward fiscal and monetary policies that would go utterly counter to Saudi Arabia's interests."

Political instability in SA however, might be a potential problem for several other more stable GCC states and according to Mundell⁷, could influence those states against joining the CU. The emergence of militarised Islamist groups in Saudi Arabia in recent years has raised real concerns over the stability of the country. There have been a number of terrorist attacks on the country's infrastructure, in particular on oil installations, such an attack occurred early in 2006.⁸ Yet, subsequent raids by the Saudi security forces have captured or killed many of the perpetrators of these attacks.⁹ However, the World Bank's Governance and Anti-Corruption Index rates Saudi Arabia's political stability as lowest in the GCC at just 30.6 percentile rank (see Figure 8.1) and this ranking has fallen since 1998 from 51.5.¹⁰

There are also doubts about political stability in Bahrain, with the World Bank ranking its political stability second lowest in the region at just 50 percentile rank (see Figure 8.1). During the nineties there were periods of extreme civil unrest and the government heavily cracked down with political detentions and reports of human rights abuses. More recently, tensions between the ruling Sunni elite and the majority Shia population continue to run high. In 2006 calls for constitutional reforms from opposition groups were sidestepped by the ruling family who continue to dominate the political system.¹¹

⁷ Mundell, *op.cit.*

⁸ Staff writer "Saudis 'foil oil facility attack'" *BBC News*, 24 February 2006.

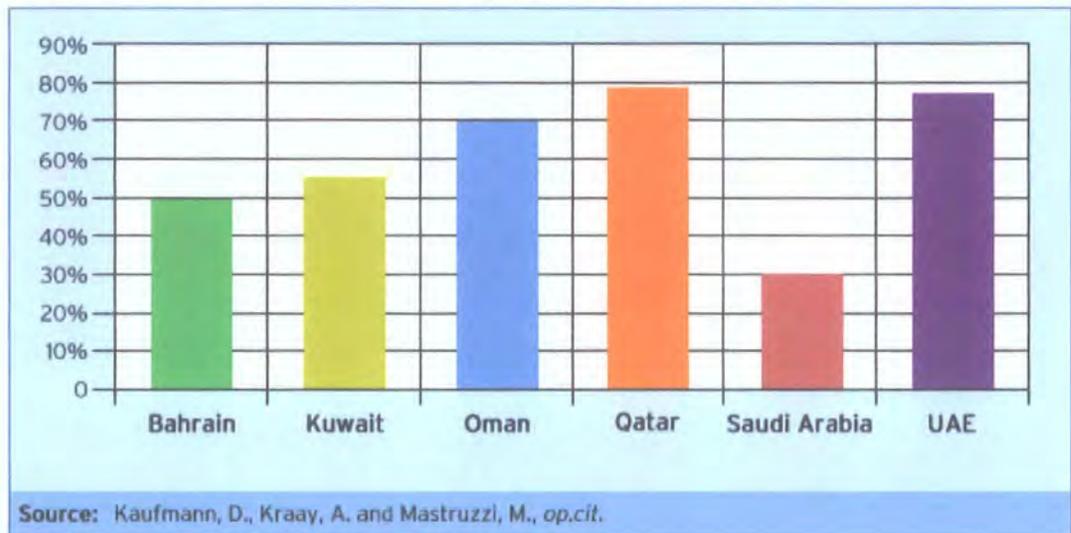
⁹ Staff writer "Saudi shootout kills '5 militants' Saudi forces battled suspected militants in gun battle" *CNN.com*, 27 February 2006

¹⁰ Kaufmann, D., Kraay, A. and Mastruzzi, M., "Governance Matters IV: Governance Indicators for 1996-2004", *World Bank Policy Research Working Paper Series No. 3630*, May 2005.

¹¹ *Economist Intelligence Report, Country Report, Bahrain*, March 2005.

For countries such as Qatar and the UAE, where political stability is much higher than that of Saudi Arabia and Bahrain, the potentially adverse political considerations of joining a CU dominated by Saudi Arabia might possibly outweigh the potential economic gains. Previous terrorist attacks in Saudi Arabia do not appear to have reduced confidence in the economic growth and stability of the UAE for example, or the attractiveness of Dubai as a tourist resort and ideal location for FDI in the region. However, once tied into monetary union, with common and jointly determined monetary and economic policies, the association between the members will be much closer and a crisis of confidence due to possible instability in one member state would be more likely to be contagious to others.

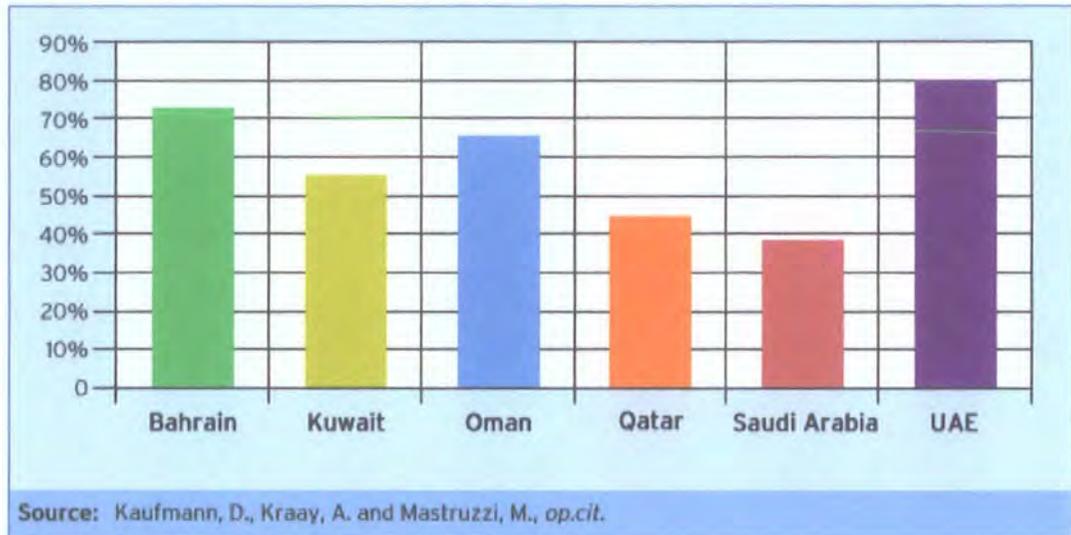
Figure 8.1: World Bank Ranking of Political Stability across the GCC



There are also variations in the degrees of national data transparency and the professionalism of national monetary authorities which are also factors which will impact the balance of costs and benefits for each GCC state. There are different degrees of institutional integrity across the GCC states which may also influence the decision of GCC states with a higher degree of institutional efficiency as to whether they wish to join the CU. For example, the Bahrain Monetary Authority, which is regarded by many as the region's most professional financial regulator, has substantial regional and international kudos. The UAE has also achieved a high level of institutional credibility. The World Bank's Governance and Anti-Corruption Index rates the regulatory quality

of the UAE, despite being a federal state, to be highest among the GCC states, followed by Bahrain.¹² While Saudi Arabia and Qatar have the lowest ranking among the GCC economies (see Figure 8.2).

Figure 8.2: World Bank Ranking of Regulatory Quality across the GCC



Therefore the institutional and regulatory credibility of the UAE and Bahrain could be jeopardised by joining the CU with members such as Qatar and Saudi Arabia. However, such potential costs could be mitigated in part by allowing the new GCC CU institutions to be established in these two states. Were Bahrain to host the newly established GCC central bank then the entire region could benefit from the BMA's excellent reputation. Yet as the GCC's second largest economy, not currently hosting any GCC institution, the UAE also has a good case to be the location of the future GCC central bank.¹³

We now turn to a country by country analysis of the anticipated costs and benefits of joining a future GCC CU. As stated in our introduction, to some extent all the GCC states will experience the same costs and benefits, but the different weights attached to each specific cost and benefit may vary considerably between one country and another. In what follows, we therefore

¹² In 2004, the UAE's percentile rank was 79.3, followed by Bahrain at 72.9, the ranking was based on 6-8 survey polls. See Kaufmann, D., Kraay, A. and Mastruzzi, M., *Governance Matters IV: Governance Indicators for 1996-2004*, World Bank Policy Research Working Paper Series No. 3630, May 2005.

¹³ In chapter 6, section 6.3.1, it was established that some Gulf newspapers have reported that the UAE has already been chosen as the location of the GCC central bank, however there has not been any official confirmation of this as yet.

concentrate on highlighting those specific costs and benefits which have a particular salience for each country in question and although a broader range of cost—benefit criteria will be also referred to, at the end of each country-section we will underline what we consider to be the most crucial cost-benefit issues for that particular country. It is these specific factors which will later (in Section 8.3) be incorporated into our qualitative cost-benefit analysis, leaving on one side those other issues – still unquestionably important – but which are somewhat more peripheral for each of the countries.

8.2.1 Bahrain

Bahrain's small economy, which constitutes only 2.4 percent of the GCC's aggregate GDP, stands to benefit considerably from joining the CU. Bahrain has limited oil reserves, with an estimated life expectancy for its 'proven' category of only 1.3 years¹⁴ (see Table 8.1). Bahrain's non-oil intra-GCC exports already constitute 27.5 percent of its total but joining the CU offers an important opportunity for Bahrain to diversify further through non-oil intra-GCC trade and investment.

Bahrain's businesses will benefit from an expanded market of an extra 32.6 million potential consumers providing considerable potential for new economies of scale to be exploited. As revealed by the GCC Business Survey, Bahrain's businesses are therefore understandably positive about CU. Although their approval rating (percent anticipating 'very good/good' consequences) is slightly lower than the GCC average it is still over 75 percent and it is also significant that no businesses considered CU would be 'very bad/bad' for the country (see Table 8.2).

¹⁴ As was pointed out in chapter 4, section 4.2.2, this calculation is based on 'proven' reserves which only refers to reserves for which there is a greater than 90 percent probability of their being commercially recoverable.

Table 8.2: National Business Expectations of Impact of CU

In which GCC state are you based?	What do you expect will be the overall effect of a GCC single currency in 2010 on your business?			
	Very Good/ Good	None	Very Bad/ Bad	Total
Bahrain	76%	24%	0%	100%
Kuwait	71%	19%	10%	100%
Oman	83%	14%	3%	100%
Qatar	88%	13%	0%	100%
Saudi Arabia	78%	22%	0%	100%
UAE	72%	26%	2%	100%

Source: GCC Business Survey on Currency Union, June-September 2005

Assuming that a GCC Common Market in goods and services is in place, Bahrain's successful banking and finance companies will be well placed to operate across the GCC and compete for business in the enlarged market. There is, of course, growing regional competition in this sector from Dubai and Qatar who are also establishing financial centres, but Bahrain was the first GCC state to establish itself as a financial hub and its off-shore banking sector is well developed.¹⁵ In December 2005 Bahrain won *The Banker* magazine's 'Financial Centers of the Future Award'. The award was based on a number of criteria, including the rate of growth of the financial services sector; regulatory quality and supervisory standards.

Bahrain's financial sector has also benefited from the regulatory supervision of the Bahrain Monetary Authority, which has gained substantial prestige as being efficient and professional. In 2005 for example, the BMA won the *Emerging Markets* Newspaper's award for Best Sovereign Deal in Local Currency.¹⁶ Bahrain is also a major issuer of Islamic bonds, or *sukuks* in the region, both corporate and sovereign, issuing 25 percent of the total GCC *sukuk* issuance in

¹⁵ The first offshore banking license was issued by Bahrain in 1975 and the Bahrain Monetary Authority – which has had supervisory authority over the entire financial system since 2002, has licensed some 364 financial institutions.

¹⁶ Rutledge, E. "GCC Economic Performance in 2005" in *Gulf Yearbook 2005-2006*, pp.109-128, Gulf Research Center, Dubai, 2006.

2005.¹⁷ Bahrain is establishing a secondary market in *sukuks* trading which will improve liquidity in the market. However, the largest ever issue of a *sukuk* was in 2006 by Dubai Ports World, for \$3.5bn,¹⁸ and is a sign of the growing competition from the UAE in terms of *sukuk* issuance. Nevertheless, new *sukuk* issues in the single currency will reduce exchange rate risks for regional investors and are likely to attract increased regional and international funds lowering the cost of capital for issuing countries and their companies, such as Bahrain.

Over the period of study, Bahrain would have had the least problem, of all the GCC states, in meeting the expected monetary and fiscal convergence criteria and therefore is unlikely to face significant costs from adjusting to CU (see chapter six, Table 6.4). However, one criterion which Bahrain would have broken on seven occasions and both in 2004 and 2005 was its foreign reserves cover to imports (see Table 8.1). Joining the CU will therefore benefit Bahrain in that other CU members, particularly Kuwait and Saudi Arabia have very large levels of foreign reserves which will provide much greater protection for Bahrain's future currency.

However, Bahrain's decision to sign a bilateral FTA with the US in late 2004 suggests that the Bahraini leadership may not be committed to placing regional interests above national ones.¹⁹ Without such political commitment however, Bahrain's inclusion in the CU is likely to be unsustainable and may eventually undermine the credibility of Bahrain's economic policies. The signing of the FTA suggests that the loss of national control over economic and trade policy – implicit in a CU - may be perceived as quite costly by the Bahraini leaders.

Until the signing of the bilateral US FTA Bahrain's relationship with Saudi Arabia had been on positive terms. The construction of a causeway linking the two states was funded by Saudi Arabia and completed in 1986. The causeway

¹⁷ Bahraini *sukuk* issue size was approximately \$2.37bn in 2005, while total GCC *sukuk* issue size was \$9.39bn in that year, according to The Liquidity Management Centre, July 2006, (accessed at <http://www.lmcbahrain.com/>)

¹⁸ Bokhari, Farhan, Khalaf, Roula and Tett, Gillian "Booming Gulf gives fillip to Islamic bonds" *Financial Times*, 10 July 2006.

¹⁹ Janardhan, J. and Rutledge, E., "U.S.-Bahrain trade deal exposes GCC chinks" *The Daily Star*, Beirut, 28 December 2004.

helped Bahrain's service sector benefit from Saudi visitors and strengthened ties between the two states. Furthermore, the ruling Sunni family in Bahrain has been given financial support from the Sunni leaders in Saudi Arabia, and to a lesser extent from Kuwait and the UAE, in part to avert any potential civil unrest²⁰ (Bahrain has a substantial working class Shia population). Prior to July 2004, Bahrain had also benefited from a 50,000 bpd oil grant from Saudi Arabia and the entire 143,000 bpd output from the Saudi Aramco run, but jointly owned, Abu Saafa oil field.²¹

However, following Bahrain's decision to sign FTA with the US, Saudi Arabia halted the oil grant and went back on plans to allow Bahrain to maintain a 100 percent share of oil extracted from Abu Saafa, following a doubling of the field's output in late 2004.²² The move illustrated the economic vulnerability of Bahrain and its dependence on Saudi Arabian patronage. The signing of the bilateral FTA seems to indicate Bahrain's desire to move away from Saudi domination onto a more independent economic footing.²³ There may therefore be valid concerns among the Bahraini leadership regarding the potential dominance of Saudi Arabia within the framework of the CU.

In summary, drawing on the material in this section as well as upon evidence in previous chapters, we can conclude that among the totality of benefits accruing from GCC CU, those which have the most weight for Bahrain are: savings of transaction costs in trade; the advantages of participation in a larger market and consequent scale economies; an existing sectoral comparative advantage in banking and finance which will be enhanced by CU; and the likelihood of additional foreign exchange reserves cover. The principal disadvantage from CU is the possibility of increased political domination over the country's economic decision making by the state which will inevitably play a dominant role in a future CU – the Kingdom of Saudi Arabia.

²⁰ Economist Intelligence Unit, *Bahrain Country Profile*, 2006.

²¹ *Ibid.*

²² *Ibid.*

²³ Staff writer "Drop FTA with US, GCC tells Bahrain" *Reuters*, 24 November 2004.

8.2.2 Kuwait

Kuwait has substantial oil reserves, with current proven reserves per capita the highest among the GCC states at 36,000 barrels per citizen and a reserve life expectancy of 112 years (see Table 8.1). At present Kuwait, is fairly economically independent from its neighbours and does not face any strong imperative to diversify its economy through increasing its non-oil intra-GCC trade. Previous intra-GCC trade analysis in chapter five (see section 5.2) revealed that Kuwait has relatively weak intra-GCC trade and investment linkages and frequently had the lowest Trade Intensity Ratios of all the GCC states. On average, between 1990 and 2002 Kuwait's non-crude oil intra-GCC exports as a proportion of total non-crude oil exports only amounted to 8.9 percent, less than any other GCC state (see Table 8.1). Also between 1990 and 2003 Kuwait attracted a negligible share of intra-GCC FDI. The 1991 Iraqi invasion of Kuwait is likely to have been a contributing factor in the low levels of inwards FDI during the early nineties but in recent years limited opportunities for private sector investment are more likely to be due to public sector crowding out.

It appears therefore that Kuwait would initially have less to gain economically from joining the GCC CU than other GCC states. In fact, embarking on CU with Saudi Arabia may initially be economically costly for Kuwait, considering the lack of economic integration between the two that currently exists. In chapter five (see section 5.6), econometric evidence indicated that Kuwait's economy did not follow a long run relationship with that of Saudi Arabia's. Therefore Kuwait could suffer from asymmetric national shocks which a GCC common monetary policy – one which will inevitably be largely influenced by Saudi Arabia – will not be able to address. In this respect, one Kuwaiti commercial banker felt “There are different future demands on the GCC economies and I wonder if the Kuwaitis will trust their future to the Saudis who will undoubtedly dominate the union.”

Furthermore, the business survey findings suggest that Kuwaiti businesses are least optimistic about the expected effect of the single currency on their business compared to business respondents based in other GCC states. According to the survey results, 10 percent of Kuwaiti businesses felt that the

effect of the CU on their business would be bad or very bad and a further 19 per cent saw no advantages in CU. Although a clear majority (71 per cent) favoured CU (rated its results 'very good/good'), this was the lowest approval rating among the six GCC states, (see Table 8.2). This finding may be due to the fact that until 2003 Kuwait had had a more independent exchange rate regime – compared to the other GCC states – where its currency was pegged to an undisclosed trade weighted basket of currencies which, it was felt, had served them relatively well.

Kuwait has had a good track record of relative fiscal discipline over the historical period of analysis, compared to most of its Gulf neighbours. Kuwait is the only GCC state that has not recorded a budget deficit since 1998. It has also built up substantial foreign reserve cover, which amounted to 7.3 months of imports in 2005 (see Table 8.1), and only in one year (1998) had less than the four months criterion (see chapter six, Table 6.4). Joining a CU with the other GCC states will not enhance Kuwait's fiscal position in fact it could be detrimental to its reputation for fiscal discipline.

In forming a CU with other states with a worse fiscal record than itself, Kuwait may be the victim of 'free-riding' where other GCC states take advantage of Kuwait's fiscal discipline in order to spend more freely themselves. In CU there is less incentive for fiscally loose states to control their spending as their fiscal irresponsibility is borne by the group as a whole, represented by higher interest rates on national debts reflecting the increased risk of default. While Kuwait does not issue much sovereign debt at present, this could however, represent a serious future concern for Kuwait in joining the CU. This was stressed by one Kuwaiti expert who said "It will be difficult for more prudent states, like Kuwait, to tie themselves to countries like Saudi Arabia."

In addition to the potential cost of fiscal 'free-riding' many of its neighbours' statistical data standards are also much more opaque and less reliable than that of Kuwait. Kuwait, along with Oman and Qatar²⁴, are the only GCC states currently participating in the IMF's General Data Dissemination System which

²⁴ Yet despite this Qatar's data provision is still seemingly very poor.

provides guidelines and principles for best international practice in compiling national statistics.²⁵ According to local media reports, the GCC Secretariat considers Kuwait's fiscal reporting to be more transparent than that of Saudi Arabia, Qatar and the UAE.²⁶ Unless all the GCC states agree to public scrutiny of their national budgets and accounts and to implement best practice statistical standards in order to create comparable statistics, then the potential for fiscal 'free-riding' within the union will be much higher and represent an even greater potential cost for Kuwait.

Kuwait will however face some adjustment costs in bringing inflation down to meet the monetary convergence criteria. Kuwait is characterized as a relatively high inflationary economy compared to its neighbours, Saudi Arabia, Oman and Bahrain, and would have broken the inflation rule on fourteen occasions over the past twenty five years (see chapter six, Table 6.4). Furthermore, the results of the business survey indicated that following the launch of the CU Kuwait will face additional inflation pressures. Of those Kuwaiti business respondents that thought the CU would increase their costs, 100 percent said that they would pass these costs onto customers in price rises (see Figure 8.3).

Figure 8.3: Potential Impact of CU on National Inflation



²⁵ Al-Mansouri, Abdulrahman K.L. and Dziobek, Claudia "Providing Official Statistics for the Common Market and Monetary Union in the Gulf Cooperation Council (GCC) Countries—A Case for "Gulfstat" *IMF Working Paper* WP/06/38, February 2006.

²⁶ See Staff Writer "Volatile oil is a headache for Gulf monetary union" *Gulf Times*, 30 October 2004.

Although the purely economic case for Kuwait joining a GCC CU is somewhat questionable, there are strong political factors favouring Kuwait's participation. Following the 1990 invasion of Kuwait by Iraq, Saudi Arabia played an important part in the coalition to liberate Kuwait, and bore a large proportion of the financial costs of the war reaching approximately \$16bn.²⁷ Considering the violent repercussions of the US led invasion of Iraq in 2003, Kuwait is likely to feel highly vulnerable until the security situation in Iraq is settled. In the mean time therefore, Kuwait will be keen to forge ahead with the economic and political integration process with its GCC neighbours in order to strengthen its regional political alliances for the purpose of national security.²⁸

In summary, drawing on the material in this section as well as upon evidence in previous chapters, we can conclude that among the totality of benefits accruing from GCC CU, those which have the most weight for Kuwait are exclusively in the political field – the likelihood that GCC participation will lead to a greater political and security integration between the GCC states and hence improve Kuwait's own national security.

Among the costs of joining the CU we would cite the possibility that the absence of cointegration between the economies of Kuwait and Saudi Arabia could imply that Kuwait will suffer asymmetric national shocks which cannot be ameliorated by a GCC monetary policy geared especially to the requirements of Saudi Arabia. Kuwait could also face painful adjustment costs in meeting inflation convergence criteria. In addition Kuwait, with an exceptionally sound fiscal position may become the victim of fiscal 'free-riding' by less prudent GCC member states.

²⁷ US Department of Defense, *Conduct of the Persian Gulf War, The Final Report to the US Congress*; Appendix P, April 1992.

²⁸ In his 1997 paper, Mundell mentioned this as a factor influencing the decision to join a CU. See Mundell, Robert A. "Updating the agenda for monetary union" in *Optimum Currency Areas: New Analytical and Policy Developments*, (Eds. Blejer, M.I., Frenkel, J.A., Leiderman, L., and Razin, A.), International Monetary Fund, 1997. In addition, Willet also concludes that a primary motivation for the process of economic integration in Europe was to achieve national security goals, see Willett, T. D. "Some Political Economy Aspects of EMU" *Journal of Policy Modeling* 22 (3), pp.379-389, 2000.

8.2.3 Oman

Oman is the poorest GCC state with GDP per capita at just \$10,325, 53 percent of the GCC average (see Table 8.1). It also has very limited oil and gas reserves. Oman's proven oil reserves have a life expectancy of just 19.5 years and its per capita oil reserves at 2,333 barrels per citizen are the second lowest in the region after Bahrain, (see Table 8.1). Oman could therefore stand to benefit considerably from joining a much larger economic bloc with considerable resource wealth and financial assets.

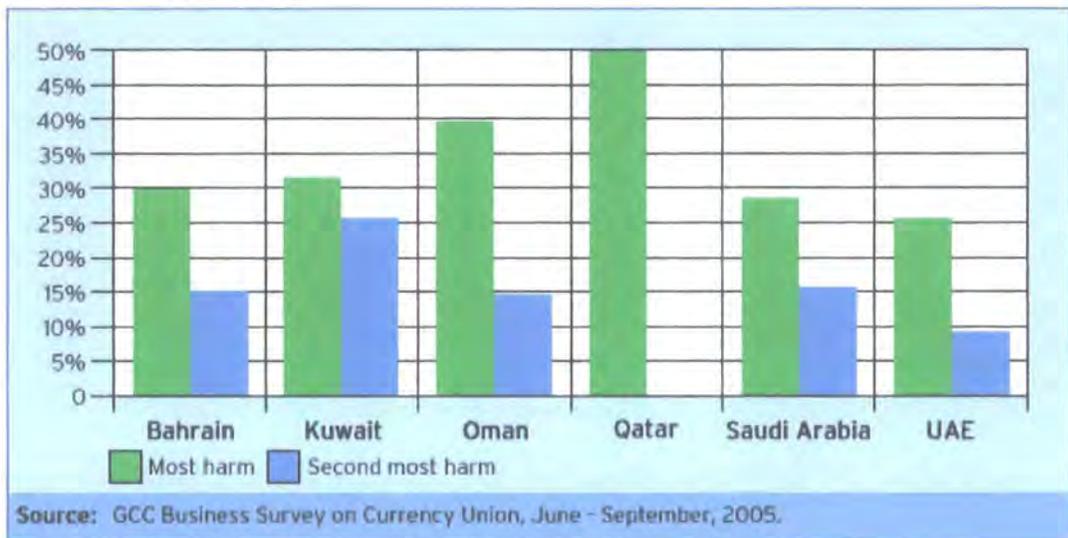
While convergence with the income per capita of GCC countries such as Qatar may be a very distant prospect, eventually poorer states such as Oman, can be expected to catch up with those better off GCC states. In the case of EMU for example, increased intra regional FDI as well as structural grants and subsidies stimulated the catch up process of lower income countries like the Republic of Ireland. For instance, if the GCC post CU were to provide structural grants to improve education standards Oman would benefit. It might be advisable for the GCC states to follow such a policy as in Europe although such issues have not yet been raised within the GCC and whether they would be economically acceptable to the richer GCC states such as Qatar and the UAE is open to question.

Oman has relatively strong trading links with some of the other GCC states and therefore should gain more than other GCC states from the removal of exchange rate transaction costs. Between 1990 and 2002, approximately 51 percent of Oman's non-crude oil exports were to other GCC states, higher than any other GCC state, and 31 percent of its non-crude oil imports were traded regionally (see Table 8.1). A large proportion of Oman's trade is with the UAE, which is reflected in the very high Trade Intensity Ratio of 29.6 in 2004.²⁹ As Oman's oil and gas reserves become depleted over the next two decades it faces the economic imperative to diversify into other economic activities. Non-hydrocarbon intra-GCC trade is likely to become more important for Oman and this will be facilitated by the single currency.

²⁹ See chapter 5, table 5.4.

However, despite the importance of intra-GCC trade for Oman, Omani businesses are less likely to be able to compete with those of other GCC states, such as the UAE and Saudi Arabia, at least initially. The results of the business survey carried out for this thesis indicate that increasing regional competition was a concern for Oman's business respondents, with 39 percent of Omani businesses citing 'increased competition' as the most harmful effect of the CU (see Figure 8.4). There may also be fear within the business community over the possibility that Oman's less competitive domestic firms might be taken—over by companies from other GCC states.

Figure 8.4: GCC Businesses Ranking Increased Competition as Most Harmful Effect of CU.



There is some evidence that certain sectors in Oman are somewhat vulnerable to greater GCC competition and/or foreign take-over, notably the banking sector. Compared to national banks in other GCC states the performance of Omani banks has recently been rather weak. For example, the National Bank of Oman has experienced problems with non-performing loans which resulted in the Commercial Bank of Qatar acquiring a 34.9 percent stake in The National Bank of Oman in 2005.

Oman does however, have a comparative advantage in its developing tourism industry as it has outstanding natural beauty and a great variety of eco-systems compared to other GCC states. While Oman cannot compete with the shopping

malls of Dubai in the UAE, which attract a large number of regional and international tourists, it has a diverse natural environment which will attract a different niche of visitors. 'Commerce and Tourism' is already the second largest sector in the Omani economy and is likely to grow further as the single currency should stimulate intra-GCC tourism.³⁰ The labour intensive tourism sector has been targeted for expansion by the Omani authorities as part of its 'Vision 2020 plan'. In June 2005, Oman unveiled the \$15bn 'Blue City' tourist development which will be built in the coastal region at Al Sawaidi. This massive economic development project will include hotels, apartments, leisure and healthcare facilities. The project is also expected to create 7,000 direct jobs and 25,000 indirect jobs.³¹

Based on past evidence, Oman is unlikely to face any serious difficulty meeting potential monetary convergence criteria: official inflation rates are low and currently stand at only 1.2 percent (see Table 8.1). In fact, Oman is the only GCC state not to have breached the inflation convergence criteria rule during the period of analysis (see chapter six, Table 6.3). However, between 1980 and 2005, Oman would have breached the fiscal deficit criteria in 18 of these years and its deficit reached a peak of 22.3 percent of GDP in 1986 when oil prices dropped dramatically³² (see chapter six, Figure 6.5). At that time Oman was heavily dependent on oil which formed 90 percent of total export receipts and the decline in oil prices also forced Oman to devalue its currency, the riyal, by some 10 percent against the US dollar.³³ Oman is somewhat less dependent on oil today, despite high oil prices, oil receipts accounted for 81 percent of total exports in 2004 (see chapter four, Table 4.5). However, Oman would have breached the reserves cover criteria in eight years during the period of analysis and would therefore benefit from the extra reserve cover for its future currency provided by other CU members (see chapter six, table 6.3).

³⁰ Tourism accounted for 12.5 percent of Oman's GDP in 2003, according to AMF National Accounts.

³¹ Staff writer "Oman's Blue City: tourism and jobs" *AMEinfo.com*, 13 June 2005

³² Despite the high levels of fiscal deficits to GDP Oman's public debt levels reached a high of only 16.4 percent of GDP in 2003, according to GCC Secretariat data. This is probably because Oman's official State General Reserve Fund & Oil Fund has been used to offset deficits in the past, rather than saving for future generations. It does however; raise the question of whether the revenues from such funds should be officially recorded as income in the government budget accounts.

³³ Central Bank of Oman, *25 Years of Central Bank of Oman – April 1975 to April 2000*, Muscat 2000.

Some evidence also suggests that Oman may have a more 'nationalistic' attachment to its own currency than other GCC states. Several interviewees mentioned that the Omanis have reservations about losing their national currency and were concerned about the erosion of their strong national identity as a result of entering into the CU. One Omani government official commented "The younger generations are happy about it but the older generation are less so because they are happy with the Omani riyal and see it as a national symbol." This view was echoed by one non-Omani expert. A government official in the UAE said "The loss of the currency as a national symbol could be a potential cost. For instance, the Omanis stress their currency as the Omani riyal, not just the riyal which is held by other GCC states." While another Emirati government official remarked "Oman had initially refused to enter CU because they wanted to protect their identity and culture."

While it is easy to deprecate such 'nationalistic' attachment to a particular currency, it should be noted that in the UK – ostensibly a highly developed and sophisticated country – there has been an equally strong aversion to losing the pound sterling which is seen as a powerful affirmation of the country's national identity.

The signing of a bilateral FTA with the US in late 2005 indicated Oman's desire to integrate further into the global economy and diversify its economic base. But the agreement revealed that Oman is unwilling to compromise what it perceives as its national commercial interests despite the potentially negative impact such bilateral FTAs will have on the finalization of the GCC customs union and regardless of the displeasure of other GCC states (Oman witnessed Saudi Arabia's reaction to Bahrain's bilateral FTA with the US). The FTA with the US suggests that the inherent loss of national economic policy making involved in forming a CU may be perceived as unacceptable by the Omani leadership.

In summary, drawing on the material in this section as well as upon evidence in previous chapters, we can conclude that among the totality of benefits accruing from GCC CU, those which have the most weight for Oman are similar to those of Bahrain. Oman will enjoy the benefits of transaction cost savings on trade,

the advantages of participating in a much larger market with associated economies of scale, and it will benefit from additional foreign exchange cover. In addition Oman enjoys a sectoral comparative advantage (in tourism) and, depending on the further negotiations on the final shape of the GCC CU and Common Market could benefit from the kind of internal income transfers which have been used in Europe to assist the 'catching-up' of the poorest members of the Community. On the cost side of the balance sheet, Omani companies do not consider themselves well prepared for the increasing regional competition that a single market and CU will bring about and there is evidence that ceding the national currency may be perceived as a weakening of Oman's national identity.

8.2.4 Qatar

Qatar's economy is unique. It has huge natural gas resources which amount to 14.3 percent of the world's proven gas reserves³⁴, second only to those of Russia and Iran. Because of the small size of its population, at 0.74 million citizens, Qatar has the highest nominal per capita income in the Gulf at \$38,239 in 2004 (see Table 8.1), almost double the GCC average per capita income and almost four times that of Oman. Moreover this advantage is likely to increase in future years as the country's major LNG projects continue to expand and new projects are brought on stream.

As the second smallest GCC economy in terms of economic mass and population, joining the GCC CU will give Qatar access to a much larger market and therefore potential economies of scale for Qatari businesses. While providing new business opportunities for Qatari companies, they will nevertheless need to adjust to the increasing regional competition, which according to the GCC business survey findings is a concern for an estimated 50 percent of Qatari businesses, higher than in any other GCC state (see Figure 8.4). This concern is likely to be due to the small size of the Qatar economy and the inexperience of many Qatari companies in competing in a large market.

³⁴ BP Statistical Review of World Energy, 2006.

Surprisingly, in spite of these concerns about the threat of competition, the business survey results provided evidence of strong optimism among Qatari businesses regarding the CU, with 88 percent of Qatari businesses expecting the CU to have a 'very good' or 'good' effect on their businesses, the highest approval rating in the survey, (see Table 8.2). Indeed, Qatari businesses are already making considerable progress in expanding their trading links with other GCC countries.

Qatar's Intra-GCC trade accounted for 13 percent of its total imports and 20.2 percent of its total exports between 1990 and 2002 (see Table 8.1). While the share of exports is not particularly high compared to other GCC states (such as Oman, the UAE and Bahrain), it must be said that Qatar has significant potential to increase its hydrocarbon exports to its neighbours. There is significant demand for Qatar's natural gas from Kuwait, the UAE and Bahrain for use in domestic electricity generation in order to free up valuable oil supplies for export. Qatar's hopes of establishing a trans-Gulf gas pipeline and supplying the domestic energy needs of its neighbours should be promoted by the region's full economic integration and from joining the GCC CU. The high level of Qatari optimism about the benefits of GCC CU – in spite of fears expressed about the threat of greater competition – may therefore be a reflection of the country's comparative advantage in gas production and its potential to establish a leading role in intra-GCC energy trading and supply.

However, this issue of intra-GCC energy trade brings to the forefront the centrality of political considerations to the advancement of a GCC CU. In January 2002 Kuwait signed a commercial gas deal with Qatar which involved building a pipeline to supply 1.4bn cubic feet per day (cu. ft/d) of natural gas. In December 2003 the Dolphin Project between the UAE and Qatar was agreed and involved the export 3.2bn cu. ft/d of natural gas to the UAE for the next 25 years.³⁵ A pipeline is also planned between Qatar and Bahrain in order to supply the latter with 300mn cu. ft/d initially, which will later rise to 500mn cu. ft/d.³⁶

³⁵ Economist Intelligence Unit, *Country Report for Qatar*, 2006

³⁶ *Ibid.*

Unfortunately, political opposition from Saudi Arabia compromised the Kuwaiti pipeline plan which was abandoned in 2006 after the Kingdom refused to give its permission for the pipeline to go through Saudi territory. Then in mid 2006, after significant progress in the development of the Dolphin Project, Saudi Arabia also raised objections to the project saying that the pipeline would cross its territory throwing uncertainty over the finalization of the project.³⁷

The frosty relations between Qatar and Saudi Arabia are costly for Qatar and for the development plans of the other smaller GCC states. Consequently, Qatar may be concerned about the political implications of joining a CU with Saudi Arabia which is likely to have significant influence in the decision making of the economic bloc. Saudi Arabia's repeated objections to Qatar's economic integration with its GCC neighbours bode ill for Qatar's future position within the more tightly knit framework of GCC CU unless there is a political rapprochement between Qatar and its much larger GCC neighbour.

Qatar may also have fears about the degree of fiscal discipline in a future GCC CU since its economic development plans are heavily dependent on debt financing. Qatar's economic growth and diversification strategy is centred on developing its natural gas reserves and diversifying into downstream industries where value can be added, such as Liquefied Natural Gas (LNG), Liquefied Petroleum Gas (LPG) and Gas to Liquids (GTL). Qatar is on track to become the world's largest supplier of LNG and GTL by 2012.³⁸ In order to fund the massive investment needed to expand its LNG production capacity it has encouraged FDI but it has also issued large amounts of external sovereign debt, which amounted to an estimated 38 percent of GDP in 2004/5.³⁹ In 2006, Moody's long term sovereign rating which reflects the risk of default was Aa2 for Qatar's external debt, only the UAE achieved such a high sovereign rating and Saudi Arabia was rated two ranks lower at A1 and Bahrain 6 ranks lower than Qatar at Baa2 (see Table 8.3).

³⁷ Hoyos , Carola and Khalaf, Roula "Saudi Arabia upsets UAE pipeline plans" *Financial Times*, July 11 2006

³⁸ Economist Intelligence Unit, *op.cit*

³⁹ Amwal Finance, Presentation by Sheikha Hanadi Nasser Bin Khaled AL Thani, The 2nd Turkish - Arab Economic Forum, June 9th, 2006.

As a major issuer of sovereign bonds, the fiscal behaviour of other GCC states will have significant ramifications for Qatar and therefore the nature and implementation of the fiscal policy rules as part of CU will be in Qatar's interest. Excessive spending and debt accumulation by other GCC states such as Saudi Arabia could drive up the interest rates on the region's sovereign debt due to the increase in the perceived risk of debt default. Higher interest rates would then increase the cost of servicing debt at a high price to Qatar which relies heavily on foreign debt to invest in its industrial development. It will be in Qatar's interest therefore to push for the implementation of fiscal discipline rules within the framework of the CU and a mechanism for enforcement in order to avoid the negative spillover effects from the loose fiscal policies of some of its GCC neighbours. This may run counter to Saudi Arabia's own, much 'looser', fiscal objectives.

Table 8.3: Sovereign Debt Rating of GCC States, 2005

Position	Moody's Investment Grade	GCC State	Assessment of Risks
1	Aaa		Obligations rated Aaa are judged to be of the highest quality, with minimal credit risk.
2	Aa1		Obligations rated Aa are judged to be of high quality and are subject to very low credit risk.
3	Aa2	Qatar/UAE	
4	Aa3	Kuwait	
5	A1	Saudi Arabia	Obligations rated A are considered upper-medium grade and are subject to low credit risk.
6	A2	Oman	
7	A3		
8	Baa1		Obligations rated Baa are subject to moderate credit risk. They are considered medium-grade and as such may possess certain speculative characteristics.
9	Baa2	Bahrain	

Source: Middle East Economic Digest and Moody's Investor Services

The precise nature of the fiscal discipline rules in a future GCC CU will also be of crucial importance to Qatar's economy. If a European style SGP is imposed that does not distinguish between current and capital expenditure then Qatar's expansion of its downstream natural gas industries may well be restricted at great cost to Qatar's future economic development. A European style debt to

GDP limit is unlikely to be appropriate for an economy like Qatar in the midst of industrial development and structural reform. Therefore, there is a strong case for adopting a form of fiscal rules, similar to that recommended by the UK Treasury, which recognizes the importance of public investment and excludes net investment from the budget balance.⁴⁰ However, to date, there appear to be diverging views among GCC leaders with regard to the adoption and nature of the appropriate fiscal discipline rules.

Qatar has experienced cyclical periods of high inflation in the past coinciding with high oil prices and during the current oil price boom (2002 to the time of writing) annual inflation has reached a high of 8.8 percent in 2005 (see Table 8.1). A large part of the rising inflation stems from the housing market, where rents have increased considerably. However, having introduced a law preventing landlords from increasing rents by more than 10 percent per annum the Qatari authorities expect that inflation will be at more manageable levels of around 4-5 percent by the time the CU is launched.⁴¹ But without implementing tighter monetary policies to reduce such inflationary pressures Qatar's competitive position and its ability to attract FDI may be eroded.⁴²

Qatar's inflation track record is an issue of concern which will increase Qatar's adjustment costs to CU especially if based on Maastricht-type criteria for price stability. During the period of analysis between 1980 and 2005 Qatar's inflation rate would have breached the convergence criteria limit in sixteen years – on more occasions than any other GCC state (see chapter six, Table 6.4). The country's inflation rate is diverging from other GCC states such as Saudi Arabia, Oman and Bahrain where inflation remains low. Therefore, once tied into CU, a common monetary policy with a bias towards Saudi Arabia would be costly for Qatar's economy because monetary policy would be too loose to ensure sufficient price stability.

⁴⁰ HM Treasury, *The Stability and Growth Pact: A Discussion Paper*, March 2004.

⁴¹ Economist Intelligence Unit, *op.cit.*

⁴² Although Qatar's monetary policy tools are somewhat limited, it could have recently done more to limit inflation by increasing bank reserve ratios and limiting credit growth. In January 2006 for example, amid concerns over the sustainability of the GCC stock market boom, Qatar decided to allow banks to leverage investors for the purpose of buying stocks, a move that was likely to inflate asset prices even further. See Gulf Research Center, *GCC Economic Report*, Issue 6, Dubai, January 2006.

Finally, Qatar's statistical provision would be improved indirectly as a result of joining the CU. An important requirement of the CU is the provision of timely and reliable statistical data which is comparable across the GCC states. Compared to other GCC states, data for Qatar is often non-existent, for example Qatar does not publish official data on constant GDP, only for current GDP at market prices.⁴³ The provision of such data is however, important in assessing the costs and benefits for Qatar from joining the CU and Qatar may therefore benefit from sharing the skills and practices of other GCC statistical institutions in improving the provision of such national and regional data.

In summary, drawing on the material in this section as well as upon evidence in previous chapters, we can conclude that among the totality of benefits accruing from GCC CU, those which have the most weight for Qatar are transaction cost savings on trade, the benefits of participation in a larger market and accompanying economies of scale, a sectoral comparative advantage (gas supply) and improved statistical transparency and reporting.

The costs which Qatar will face post-GCC CU include difficult adjustments to meet convergence criteria, the possible impact of greater competition upon some of Qatar's non-hydrocarbon industries and companies and the possibility that Qatar, like Kuwait, may become a victim of fiscal 'free-riding'. Finally, we note that the current state of relations between Saudi Arabia and Qatar, which is threatening the advancement of Qatar's key development projects to establish itself as regional gas supplier as well as a major gas exporter, also constitutes a major 'cost' for Qatar in joining the CU.

8.2.5 Saudi Arabia

The potential impact of the CU on Saudi Arabia – and Saudi Arabia upon the CU – is particularly important given the size of its GDP and population as a proportion of the future CU. Saudi Arabia's economy constitutes 54 percent of the GCC total and its population 68 percent of the total GCC market (calculated from Table 8.1). The prospective economic costs and benefits of CU for Saudi

⁴³ Consequently it was not possible in chapter 5 to carry out the cointegration analysis between Qatar and Saudi Arabia and assess the long term relationship between the two.

Arabia will therefore be the determining factor as to whether the CU project goes ahead or collapses.

The GCC CU and full economic integration with the other GCC states is perceived as a positive step by the Saudi Arabian business community. The majority of Saudi businesses surveyed, more than three quarters (78 percent), thought that the single currency would have either a 'very good' or 'good' effect on their business (see Table 8.2). In addition, 81 percent of Saudi businesses felt 'very optimistic' or 'optimistic' about the expected success of the CU and only 3 percent were 'pessimistic' or 'very pessimistic' (see Table 8.4).

Table 8.4: National Business Expectations about Likely Success of CU

In which GCC state are you based?	How do you feel about the 2010 currency union and its likely success?			
	Very Optimistic/ Optimistic	Neutral	Very Pessimistic/ Pessimistic	Total
Bahrain	76%	24%	0%	100%
Kuwait	68%	23%	10%	100%
Oman	89%	11%	0%	100%
Qatar	75%	13%	13%	100%
Saudi Arabia	81%	16%	3%	100%
UAE	67%	24%	8%	100%

Source: GCC Business Survey on Currency Union, June-September 2005

As the largest and dominant economy in the region, Saudi Arabia has the advantage that it has well established large companies particularly in the petrochemical and manufacturing sectors. For example, SABIC is a large diversified manufacturing company with more than 16,000 employees and annual revenues of more than \$18bn⁴⁴; it is also one of the largest global suppliers of ethylene and polyethylene. Furthermore, businesses are likely to consider the regional integration process as part of the opening up of the Saudi

⁴⁴ See <http://www.sabic.com/>

economy following on from the Kingdom's accession to the WTO in 2005 and therefore to look upon it favourably.

As the largest market in the GCC, Saudi Arabia can expect to see increasing levels of investment from other GCC states following the launch of the CU. The survey asked businesses which GCC state had the greatest potential for new business opportunities following the launch of the CU and 30 percent chose Saudi Arabia, second only to the UAE (see Figure 8.5). Specifically, Bahraini and Kuwaiti businesses felt that Saudi Arabia would offer them the most new business opportunities. Between 1990 and 2003 Saudi Arabia received almost a quarter of the total intra-GCC investment (see Table 8.1). The single currency should enhance this trend as it is likely to facilitate cross border investments (as was discussed in chapter seven, section 7.2.4) which will undoubtedly benefit the Saudi economy. However, if the Saudisation policy of nationalising the workforce continues at its current pace, then Saudi Arabia may become a less competitive location for regional FDI compared to the UAE, where the Emiratization process is slowing down and has been much less rigorous.⁴⁵

Figure 8.5: Business Responses to Survey Question Eleven.



Despite the potential gains to the Saudi economy from further regional integration, there may be political reservations which impede this process. Saudi Arabia is a highly conservative society and is the least liberal of the GCC

⁴⁵ Ezz Al Deen, Mohammad "No more emiratization quotas soon" *Gulf News*, 12 July 2006.

states and therefore with greater economic integration between the GCC countries it may eventually come under increasing pressure to open up further and become more tolerant, particularly with regard to women's rights. This may prove to be controversial to certain sectors of society and be perceived as a threat to Saudi Arabia's cultural and religious identity.

Over the period of analysis Saudi Arabia has experienced repeated budget deficits and subsequently it had accumulated high levels of domestic debt. Between 1980 and 2005 for example, Saudi Arabia experienced fiscal deficits in all but seven years. In those seven years, the average surplus was 10 percent of GDP, but of the eighteen deficit years, the deficits were often very large, sometimes reaching as high as 25 percent of GDP, as was the case in 1987 (see chapter 6, Figure 6.5). Saudi Arabia would have breached the Maastricht style convergence criteria limit on the fiscal deficit to GDP ratio on sixteen occasions during the period of analysis and the debt to GDP criteria, on eight occasions between 1997 and 2005, more than any other GCC state (see chapter six, Table 6.4).

Continued dependence on oil income, which forms approximately 75 percent of government revenues leaves Saudi Arabia particularly vulnerable to fluctuations in the oil price. In the current high oil price climate, fiscal surpluses amount to 17.5 percent of GDP and fiscal debt is being repaid. Yet, in the future if Saudi Arabia does not diversify its income streams then it could face great difficulty in meeting fiscal discipline criteria should oil prices fall. Estimates of unemployment in Saudi Arabia start as high as ten percent;⁴⁶ therefore the transition costs from cutting public expenditure to keep within fiscal discipline rules could be particularly high.

Given the highly cyclical nature of Saudi Arabia's government budget, and to a lesser extent those of the other GCC states, the adoption of cyclically adjusted fiscal discipline rules, would make economic sense and reduce the potentially large adjustment costs of adhering to inappropriately designed fiscal rules.

⁴⁶ Estimates of unemployment in Saudi Arabia range from 10 percent to 30 percent of the national working age population, see staff Writer "Tackling Unemployment In Saudi Arabia Is National Priority, Says Qusaibi" *Middle East Economic Survey*, Volume 48, Issue 5, 31 January 2005.

However, it is in Saudi Arabia's economic interest that fiscal discipline rules are not so loose as to be meaningless. What is important is to ensure that over the economic cycle the rules do not force the authorities to cut back on current spending when the economy is already in recession due to low oil prices. For example, fiscal rules based on the non-hydrocarbon budget balance would help to ensure the credibility and sustainability of public finance discipline over the entire economic cycle.

According to Mundell one potential reason against joining a CU would be if the respective country wished to protect the secrecy of its statistics.⁴⁷ As was discussed in chapter seven (section 7.3.2) for Saudi Arabia the increased public scrutiny of its budget, which will undoubtedly be necessary in order to monitor adherence to fiscal policy rules, may be considered as an unacceptable intrusion. The lack of transparent budget reporting in Saudi Arabia and insufficient legislative supervision of spending by the ruling family has been described in a number of critical – and in some cases hostile – accounts of Saudi Arabia's recent history.⁴⁸ However the IMF has also drawn attention to these problems and called upon the regime to speed up economic reform, in particular improving government accountability and transparency.⁴⁹

It must be acknowledged that increasing budget transparency may well increase the political vulnerability of the Saudi regime and it could well be perceived by the House of Saud as too high a price for joining a CU. However, in the long run, if joining a CU encourages changes in behaviour and stimulates and empowers progressive elements in the ruling elite and the CU thereby acts as a catalyst to improved data transparency in the Kingdom, CU will undoubtedly be beneficial to Saudi Arabia's economy.

Also, within the sphere of political considerations it may be necessary to offer Saudi Arabia a proportionately large role in determining the region's monetary policies, as was discussed in chapter six (see section 6.3.1). Unlike in the EMU

⁴⁷ Mundell, *op.cit.*

⁴⁸ See for example, Holden, D. and Johns, R. *The House of Saud*, Sidgwick and Jackson, London, 1981 and Aburish, Said, *The Rise, Corruption and Coming Fall of the House of Saud*, Bloomsbury Publishing, London, 1995.

⁴⁹ Khalaf, Roula "Saudi Arabia urged to speed up economic reform" *Financial Times*, 23 October 2002.

where economic size did not determine the country's influence over monetary policy decision making, with Germany being granted a only a single vote on monetary policy, a different approach may be necessary if Saudi Arabia is to be encouraged to participate fully in the CU project.

In summary, drawing on the material in this section as well as upon evidence in previous chapters, we can conclude that among the totality of benefits accruing from GCC CU, those which have the most weight for Saudi Arabia are transaction cost savings on investment, a sectoral comparative advantage in downstream hydrocarbon industries, and – provided this does not prove an obstacle to actually joining a CU – the benefits of greater transparency in all aspects of financial and economic reporting which, in the longer term, can only be of great assistance to the country's progress in economic and social development.

On the other hand Saudi Arabia may face quite serious costs of joining a CU in terms of having to make difficulty adjustments to meet convergence criteria and, like Oman (but in a different form) the country may see its national political and religious identity compromised as it becomes further integrated with other, more liberal GCC countries. Whether this proves to be a cost which the country can bear, or whether it is too painful to warrant participation in a CU remains to be seen.

8.2.6 United Arab Emirates

The UAE is expected to benefit from the CU because of the dynamic nature of its economy, its progress in terms of economic diversification and its position as a re-export hub. The UAE central banker, Sultan bin Nasser Al Suwaidi, remarked "We believe that the UAE is in a very good position. Some activities like tourism, real-estate, and high quality education already attract a lot of GCC nationals. Our society has proved to be remarkably flexible in adopting reforms. We can seize on these advantages to be a main beneficiary of the CU." Furthermore, several expert interviewees perceived the UAE to be well placed to benefit from the single currency, one AMF official remarked "those GCC economies with a head start, such as the UAE, at openness and diversification

will have initial advantages that might make it more attractive for foreign and regional investors.”

The UAE is a re-export hub for the Gulf region and therefore has strong trading links with some of the GCC states. The UAE’s non-oil intra-GCC exports have accounted for approximately 28 percent of its total non-oil exports (see Table 8.1). In particular, the UAE has a strong trading relationship with its neighbour Oman, illustrated by the very high TIRs of up to 45 in the period of analysis.⁵⁰ In 2004, the UAE’s TIR with Oman reached 30, compared to an average of 3.2 with its other GCC neighbours.⁵¹ The close commercial relationship between Oman and the UAE was mentioned by a few regional experts, who felt that the single currency would enhance this relationship.

However, while the UAE may have a strong relationship with Oman its links with Saudi Arabia, the largest GCC economy, appear to be much weaker. Our analysis in chapter five revealed the UAE – Saudi trade ties to be quite weak with a TIR of just 2 in 2004.⁵² In addition, econometric evidence in chapter five (see section 5.6) indicated the absence of a long run integrating relationship between the two economies. Indeed, the two economies have been on diverging inflationary paths, with an average inflation differential over the period of analysis at 3.1 percent, spreading to 5.3 percent in 2005.

In one area, however, there are signs of increasing integration with Saudi Arabia’s economy. The UAE has substantially increased its capital investment in the Kingdom, so that it is now the major source of FDI in Saudi Arabia. This cross border investment if it continues could increase the economic interdependence between the two states and by holding claims on Saudi Arabia’s economic output the UAE could mitigate the potential effects of future national shocks. This may initially prove to be a useful hedge against national shocks for the UAE that are unlikely to be corrected by the common monetary policy over which Saudi Arabia is likely to have considerable influence. In addition to this, it appears as though there is a significant movement of

⁵⁰ See chapter 5, section 5.2.3, table 5.4.

⁵¹ *Ibid.*

⁵² *Ibid.*

nationals from Saudi Arabia to the UAE for purposes of tourism and retail investments.⁵³

Capital flows have also taken place in the opposite direction. The UAE has been a large importer of GCC capital in the past, receiving 54 percent of total intra-GCC investment between 1990 and 2003 (see Table 8.1). Regional capital inflows are likely to increase further following the introduction of the single currency and the elimination of exchange rate uncertainty for investors from the fixed arrangement. When businesses were asked which GCC state had the greatest potential for new business opportunities following the launch of the CU, the largest share of 34 percent chose the UAE (see Figure 8.5). This response indicates that the UAE will be most likely to benefit from new investments following the launch of the CU, with Omani businesses considering the UAE best placed in this respect.

Despite the potential gains and opportunities for the UAE economy arising from the CU, the GCC business survey found that UAE businesses are most likely to be indifferent with regard to the effect of the impending CU on their business compared to other GCC businesses, with 26 percent expecting no effect from the single currency (see Table 8.2). Furthermore, 24 percent of Emirati business respondents were also apathetic with regard to the overall success of the CU (see Table 8.4). This may be attributed to the fact that UAE businesses are already operating in a fairly diversified and vibrant economy with numerous free trade zones (FTZs) where businesses can locate and benefit from a liberal business environment. Therefore, some UAE businesses may consider the returns from CU to be marginal for them at present.

During the period of analysis the UAE's inflation rate has been higher on average than any other GCC state, with peaks in official inflation reaching 7.1 percent in 1992 and 6 percent in 2005 (see chapter six, figure 6.1). There has been a notable divergence between relatively high inflation countries such as the UAE from those of low inflationary states, such as Oman, with the UAE's inflation rate averaging 3.6 percent but only 0.43 percent in Oman since 1991

⁵³ See for example, Carvalho, Stanley "Dana Gas public offer heading for record oversubscription" *Gulf News*, 25 September 2005.

(see chapter six, table 6.2). Inflation data is only available for the UAE from 1991 onwards, but since then the country would have breached a Maastricht style inflation convergence criterion annually (see table 6.3, chapter 6). This evidence suggests that the UAE would face great difficulty in meeting the inflation convergence criterion and that there will be transition costs of bringing inflation down to converge with the lower inflationary states.

Since the sustained oil price rises began in 2002, the fiscal policies of both Qatar and the UAE have remained fairly prudent: rather than spending the majority of their surplus oil revenues which would have pushed inflation they have saved the largest proportion, more than any other governments in the region.⁵⁴ Nevertheless, like Qatar, the UAE has recently experienced increased inflation as a result of rising oil prices. With flexible labour markets, much of the price rises have been felt in asset markets, with property prices and rents rising in particular.

The IMF has recommended that the GCC states should adjust to permanently high oil prices either through nominal exchange rate appreciation or structural reforms. They advise that subsidies must be cut back in the goods market to restrain rising costs and improve efficiency including implementing structural reforms to boost the competitiveness of the non-oil sectors. Furthermore, the government could mop up surplus liquidity in the economy by issuing longer maturity fixed income securities or by restricting the growth of credit lending.⁵⁵

Without such measures inflation may become more entrenched in the high inflation economies of the region, like Qatar, the UAE and to a lesser extent Kuwait, at a cost to their future competitive position within the CU. However, an appreciation of the Emirati Dirham would leave non-oil exports much less competitive, which would be a setback for the country's efforts to diversify its export base away from hydrocarbons. According to one report the UAE central

⁵⁴ IMF, World Economic and Financial Surveys, Middle East and Central Asia, May 2006.

⁵⁵ For example, in 2005 the UAE Central Bank issued 5 year Certificates of Deposit in order to "drain liquidity from a booming economy" See staff writer "Central Bank plans debt issue to control inflation" *Gulf News*, 13 August 2005.

bank is said to be undertaking a cost-benefit analysis of revaluing its nominal exchange rate against the dollar peg.⁵⁶

In addition to the existing inflation problems in the UAE, the results of the business survey indicate that businesses are likely to pass on the increase in their costs from the introduction of the single currency to their customers. This suggests that there will be price rises following the launch of the single currency, as occurred in several EMU member states. The majority of Emirati business respondents said they would pass on any increase in their costs, a greater proportion than in any other GCC state apart from Kuwait (see Figure 8.3). However, in light of the existing inflationary pressures in the UAE economy, additional price rises, even if short lived, would further erode its competitiveness which the UAE can ill afford.

Another convergence criterion which the UAE would have problems meeting is that of foreign reserve cover to imports. During the period of analysis, the four month cover criterion would have been broken nine times by the UAE, more than any other GCC state (see chapter six, Table 6.3) and as recently as 2005 (see Table 8.1). Therefore the UAE can expect to benefit from the additional foreign reserve cover provided by the other GCC states once tied into in CU.⁵⁷

An important prerequisite condition of the CU, which has been emphasised by the IMF, is the provision of timely and reliable national statistics partly in order to monitor fiscal policy rules. In its 2006 Article IV Consultation with the UAE, the IMF criticized the current state of statistics in the UAE, commenting that "the UAE's economic and social statistics continue to suffer from numerous structural weaknesses with respect to data quality, coverage, periodicity, timeliness and inter-sectoral consistency."⁵⁸ As a result of joining the CU the UAE will be under even greater pressure to make improvements to its budget

⁵⁶ Staff writer "Should UAE Follow Kuwait Suit and Revalue?" *Zawya*, 5 July 2006 (accessed at: <http://www.zawya.com/>)

⁵⁷ Agreement has yet to be reached about control over and management of foreign exchange reserves. According to Sturm and Siegfried *op.cit.*, reserves could be transferred either totally or partially to the supranational monetary institution, or left in the hands of the national central banks depending on the desired degree of centralization/decentralization with regard to monetary policy implementation.

⁵⁸ International Monetary Fund, United Arab Emirates: 2006 Article IV Consultation, No. 06/257, July 2006.

accounting which has been unreliable in the past, failing to record large revenues from overseas investment income.

Over the past 25 years the official UAE budget has recorded successive budget deficits during times of low oil prices but in reality these would have been offset by revenues from investment income that were not included in the government's budget. The UAE is therefore unlikely to have breached the kind of fiscal discipline rules implicit in a CU as frequently as the historical data suggests and therefore stands a better chance of adhering to the actual fiscal discipline rules which a CU might impose. However, for comparative purposes and in order to avoid being penalized for fiscal indiscipline, the UAE authorities will be pressed into improving their data provision which will ultimately benefit them.

In summary, drawing on the material in this section as well as upon evidence in previous chapters, we can conclude that among the totality of benefits accruing from GCC CU, those which have the most weight for the UAE are transaction cost savings in both trade and investment, a sectoral comparative advantage in a wide variety of service sector industries, the benefits of greater foreign exchange cover and the advantages which will accrue to the country from better financial reporting and data transparency. On the negative side of the cost-benefit balance, the UAE may encounter difficult adjustments to meet convergence criteria and be somewhat vulnerable to asymmetric national shocks.

8.3 Conclusion

We shall now attempt to draw together this considerable array of evidence in presenting a qualitative cost-benefit analysis of joining a CU for each country – qualitative because it is not possible to attach a meaningful numerical value with an appropriate weighting to each and every advantage and disadvantage some of which, as we have seen, are essentially political in nature. The best we can do is to simply enumerate the costs and benefits for each country, sum them and present a 'net' balance. As we acknowledged earlier there is bound to be an element of subjectivity in this exercise, but as far as possible, our judgments as to which particular costs/benefits are most salient for which particular country

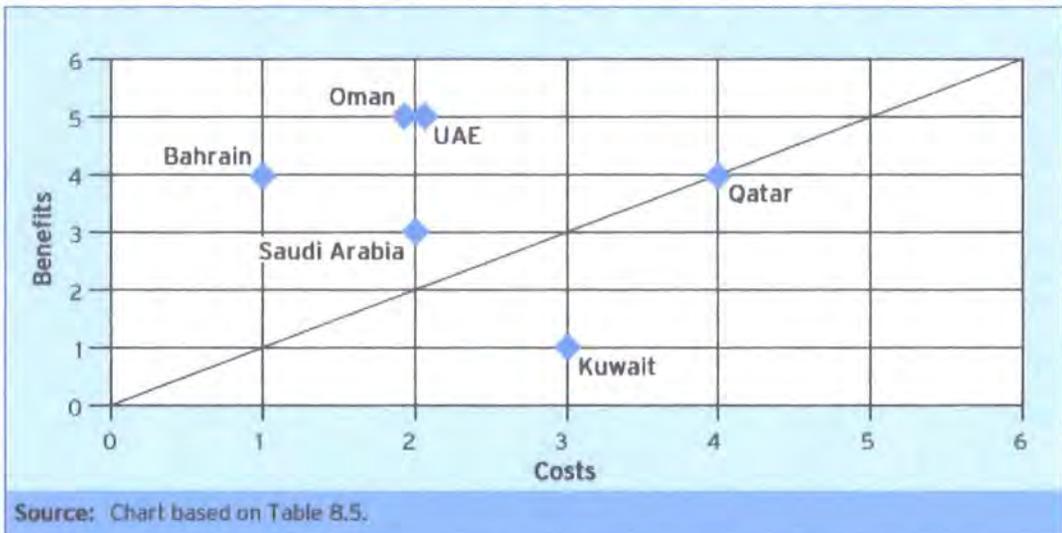
have been based on the empirical evidence collected during our period of research in the Gulf and recorded in this and previous chapters of the thesis.

The potential costs and benefits of the CU for each individual GCC state, which have already been discussed in detail in the sections above, are summarized in Table 8.5. The total costs and benefits per GCC state are summed in the table and this result is then presented graphically in Figure 8.6.

Table 8.5: Summary of Potential Benefits and Costs of CU per GCC State

	Bahrain	Kuwait	Oman	Qatar	SA	UAE
Transaction cost savings on trade	✓		✓	✓		✓
Transaction cost savings on investment					✓	✓
Larger Market/Economies of Scale	✓		✓	✓		
Sector Comparative Advantage	✓		✓	✓	✓	✓
Extra foreign reserve cover	✓		✓			✓
Income transfers to aid poorest states			✓			
Improved statistical transparency and reporting				✓	✓	✓
Greater national security		✓				
TOTAL BENEFITS	4	1	5	4	3	5
Difficult adjustments to meet convergence criteria		✓		✓	✓	✓
Asymmetric national shocks		✓				✓
National companies not prepared for regional competition			✓	✓		
Potential victim of fiscal 'free-riding'		✓		✓		
Weakened 'national identity'			✓		✓	
Political domination by Saudi Arabia	✓			✓		
TOTAL COSTS	1	3	2	4	2	2

Figure 8.6: Contemporary Balance of Costs and Benefits per GCC State



According to our analysis four of the six GCC states potentially stand to gain net economic benefits from joining the CU, while one state, Qatar will breakeven. Kuwait is the only GCC state which is likely to face more costs than benefits from its membership of the CU based on its contemporary economic circumstances.

Despite only breaking even, for Qatar the opportunity cost of staying out of the CU would be potentially high. Qatar has high hopes of establishing a trans-Gulf gas pipeline and supplying the domestic energy needs of its neighbours which would be greatly facilitated by the establishment of a Common Market and single currency. Furthermore, staying out of the CU would limit the potential for a diplomatic political rapprochement between Qatar and Saudi Arabia.

Compared to the other GCC states, Kuwait stands to gain little in economic terms from its membership of the CU. Like Qatar, its unique economic circumstances driven by its vast hydrocarbon reserves indicate that these two states will face future economic challenges very different to those of their GCC neighbours. However, the importance of securing national security goals should not be underestimated in Kuwait's decision to join the CU.

In contrast, based on the existence of significant net economic benefits, there is a strong case for Bahrain, Oman and the UAE to join the CU. These small,

open, diversified and regionally integrated economies will be well placed to enter into a CU and to capitalize on the potential benefits.

This analysis has established that significantly, there will be net economic benefits accruing to Saudi Arabia from the CU. In addition, there will also be considerable political gains from its role in the CU. The Kingdom's influence over its smaller neighbours will undoubtedly increase once tied into the CU framework and it is likely that the Kingdom's role as the representative for the GCC in international negotiations and disputes will also be strengthened. There is also a political and economic case for Saudi to be given a dominant role in determining the monetary policy of the region. While such political factors may initially prove to be unpalatable to the smaller GCC states, if they are to gain many of the economic benefits of the CU (see Table 8.5) then they will have to be prepared to cede some of their monetary policy sovereignty to the region's economic powerhouse.

The presence of net benefits for most GCC states, along with the importance of the national security issue in Kuwait and the significant opportunity cost that not joining represents for Qatar, provides strong reasoning that all six GCC states should endeavour to join the CU. In particular, the prospect of net benefits accruing to Saudi Arabia from CU membership provides a strong rationale for the Kingdom to drive forward the integration process and achieve the goal of CU as scheduled.

Chapter 9 : Conclusion

As of July 2006, the GCC has yet to enact many of the policies that this thesis considers necessary for it to be able to successfully adopt a CU. In recent years, and no doubt partly as a result of the current oil-price boom, the GCC's impetus to forge ahead with its economic integration agenda seems to have waned. A recurrent danger of oil-price booms is that economic reforms, often viewed as vital during times of low oil prices, are deferred. There is arguably still enough time, but if a concerted effort is not made in the coming few years a GCC CU is not likely to be in place by 2010.

The objective of this research was not however, to speculate on the likelihood of a GCC CU coming into fruition by 2010 or to gauge the level of political commitment to the CU project *per se*, but to determine the appropriateness of CU for the GCC economic bloc and its implications. It has done this by assessing the GCC against OCA criteria, determining the extent to which associated prerequisite policies are in place and by analysing the potential costs and benefits.

This thesis has shown that there are indeed economic and political-economy advantages from a GCC CU, both for the bloc and its constituent states. There is therefore, a cogent case for the GCC to continue through with their ambitious CU plan. Whilst the transition and future monetary arrangement will not be cost free, if there is sufficient political will and if all of the necessary prerequisite reforms are acted upon, these costs can be effectively managed and minimized.

At the start of this thesis, five research questions were set out and have been addressed in subsequent chapters. We now return to these and summarize the findings; for convenience they are repeated here:

1. To what extent have existing exchange rate regimes been appropriate for the GCC economies in enabling them to meet their economic policy objectives?

2. How appropriate is CU for the GCC economies and to what extent do they meet the OCA criteria?
3. Are the GCC states taking adequate steps to adopt and implement the prerequisite policies for the establishment of a successful and sustainable CU?
4. What are the potential costs and benefits, both direct and indirect, of a GCC CU?
5. Will CU bring net benefits for each GCC member state or will there be losers as well as winners?

The following sections of this conclusion will deal with each of these questions in turn. The final part of this chapter will recommend issues for further research and provide a summary of the prospects for GCC CU.

9.1 Existing Exchange Rate Regimes and Economic Policy Objectives

Research question one was addressed in chapter four. It was established that while the *de facto* pegs to the US dollar had assisted in facilitating a low inflationary environment for much of the period of study, it has meant that GCC central bank's have not been able to actively use independent monetary policy tools. Consequently during periods of low oil prices, (1986-1989 and 1994-1999) economic growth stagnated and could not be stimulated by an expansionary monetary policy. During the current oil-price boom (2002 to present), some states have been experiencing high rates of inflation (for example reaching 8.8 percent and 6 percent in Qatar and the UAE respectively in 2005) and have not been able to use interest rate increases to control them.

This thesis concludes that being tied to US interest rates is therefore a sub-optimal policy choice for the GCC states as monetary policy set by the US Federal Reserve is tailored for the needs of the US economy, not those of the GCC. Moreover, a common view expressed by a panel of GCC experts

interviewed for this research was that the dollar peg had outlived its usefulness and that a switch to a more flexible exchange rate regime would now be the optimal choice.

9.2 The Extent to which the GCC States meet the OCA Criteria

Chapter five of this thesis focused on research question two. Using a combination of quantitative techniques and qualitative analysis it assessed the extent to which the GCC satisfy the five OCA criteria: a high level of intra-regional trade, labour market mobility, capital market mobility, economic diversification and economic synchronization.

Our analysis has revealed that while the GCC economies are moving towards satisfying the OCA criteria, they do at present sufficiently meet *all* of them, therefore they cannot strictly be considered an OCA. We will now turn briefly to look at each of the five criteria.

In terms of intra-regional trade, this is one criterion where the GCC states could do better. Analysis of the trade data revealed that we should be wary of measuring the extent of intra-GCC trade solely by reference to its share of total trade (including oil) and that intra-GCC non-oil trade shows a considerably higher level of regional trade integration. In addition, primary evidence from the business survey indicates that intra-GCC trade is particularly significant for SMEs, which form a large part of the GCC business community. Nevertheless, we must conclude that, with intra-regional trade shares reaching only a fifth of total trade at most, so far this criterion for an OCA remains insufficiently satisfied.

Despite the removal of legal barriers to the mobility of the GCC *national* labour force and gradual improvements in the *national* skills set, the GCC national labour market is not deemed to be particularly mobile. Nevertheless, in terms of meeting the OCA labour market mobility criterion the GCC currently scores well. This is due to the presence of a large and flexible expatriate workforce in the GCC states, which is highly responsive to national economic shocks and is

available at internationally competitive prices from populous South Asian countries.

While the degree of capital market mobility and integration is presently rather limited and therefore this OCA criterion is not satisfied, there is however, evidence to suggest that the GCC are moving in the right direction. Our analysis of the empirical evidence indicates few cross-listings between GCC capital markets, and that up until 2003 intra-GCC investments had been weak. Nevertheless, anecdotal evidence suggests this is now changing. GCC citizens are increasingly willing to cross borders to invest in neighbouring IPOs, there is significant cross border cooperation on the issuance of *sukuks* between financial institutions and corporations and intra-GCC FDI fueled by high oil prices is expanding.

Although it was established that the GCC states are not economically diversified, the fact that they are *undiversified in the same manner*, negates somewhat the importance of this criterion. This criterion is based on the concept that if prospective members of a CU had diversified economic structures they would be less likely to suffer from asymmetric shocks. In fact, the GCC's shared oil dependence implies that the GCC economies are likely to suffer from the same exogenous shock and as such, it could be addressed with a common monetary policy without causing problems for any one state in particular. However, the GCC constituent members need to diversify their economies for other reasons (e.g. employment creation). The CU project requires that in doing so, they should avoid specialization and adopt a broad range of industries and services even if this implies competition between GCC states.

Using econometric techniques, the GCC economies were tested for long run synchronisation; the findings revealed some national disparities. On aggregate the region's economies appear to be synchronised, but testing for pair-wise cointegration between the largest regional economy, Saudi Arabia and the smaller GCC states showed that some countries are less suited to joining a CU in which Saudi Arabian economic conditions are likely to dominate monetary policy decisions. In particular, the econometric evidence revealed only a weak

cointegrating relationship between the two largest economies, Saudi Arabia and the UAE, and between the former and Kuwait.

Failing to meet all of the OCA criteria might mean that CU is not 'optimal' but, as EMU demonstrates, it does not necessarily mean that the GCC states cannot form a viable CU. In fact, the process of forming a CU itself may lead to economic convergence among the members and the establishment of a single currency could substantially boost intra-regional levels of trade and promote further capital market integration.

If the successful launch of the euro has provided any lessons for other region's establishing CU, not encompassed in the OCA theory, it is that several important preparations and prerequisite conditions must be in place in order to establish a stable and sustainable CU, not least of which are the institutional capabilities and the political will of the union.

9.3 Policy Prerequisites and Preparations for CU

Research question three was addressed in chapter six. It argued that in order to achieve many of the benefits of CU considerable policy prerequisites and preparations are required. To date, evidence presented in chapter six indicates that the GCC have some way to go in this regard. Our analysis not only considered the pace of preparations taking place and compared this with the experience of EMU, but it also took into account the views of a panel of regional experts interviewed for this thesis, a large proportion of which, in light of the limited policy progress so far, doubted whether CU was achievable by 2010.

Outstanding preparations include: establishing a common market, agreeing to, and meeting, the fiscal and monetary convergence criteria, deciding upon the mandate, structure and location of a new GCC central bank, creating a supranational data organisation and preparing the private sector.

Although regional central bankers are said to have broadly agreed upon convergence targets similar to those of the Maastricht Treaty, these have yet to be officially adopted. In terms of meeting the provisional convergence targets

and fiscal rules, table 6.4 in chapter six showed that each of the GCC states would have broken the criteria at some point, but that the UAE followed by Qatar would have breached the criteria most frequently during the historical period of analysis. It was concluded that there would have to be significant policy changes in order to be able to meet such convergence criteria in the future.

In addition, the GCC have yet to agree on the policy of setting up a statistical organisation, similar to that of the EMU's Eurostat, in order to collate GCC wide economic data, yet without such an organisation it would be hard to envisage how future monetary decisions could be reached. While the GCC leaders have agreed to establish a supranational central bank, preparations have yet to be made in this regard despite the fact that its timely establishment will be critical to the effective functioning and credibility of the CU.

This thesis therefore recommends that GCC leaders should take meaningful steps in the coming years to implement the prerequisite policies. Failing to do so will either mean deferring the CU or going ahead with it regardless, but under less than optimal circumstances.

9.4 The Potential Costs and Benefits of a GCC CU

Chapter seven of this thesis focused on the potential costs and benefits of a CU for the GCC as a bloc, addressing research question four. Based on the assumption that the necessary preparatory steps are taken, the economic case for forming a CU is favourable for the GCC as a whole. The launch of the GCC single currency will present a number of benefits for the GCC states, both direct and indirect.

For instance, the single currency will allow for greater price transparency of goods, but consumers will only benefit fully from this if price discrimination is eliminated through increased goods market arbitrage by way of a common market. Furthermore, if the single GCC currency is to effectively promote intra-regional trade then the remaining non-exchange rate related barriers to trade must be removed likewise through the establishment of a common market.

This thesis has identified GCC capital markets as a key beneficiary of a future CU (as was the case in the Eurozone). Growth in capital market liquidity and reduced cross border risks will improve the mechanisms for an efficient allocation of capital across the region and beyond. The benefits for the region's capital markets are also important for the broader economic development of the region. The region's fast growing sovereign and corporate Islamic security, or *sukuk*, market, in particular, is expected to benefit from increased regional and international investor demand.

The effect of the single currency on private sector confidence and the business climate is expected to be positive. The GCC business survey indicates that businesses are supportive of the policy decision to establish a CU which suggests the costs of adjustment for the private sector will be relatively low. The business sector is also confident about the potential impact of CU on their businesses which bodes well for future investment decisions and potential economic growth both in the lead up to and following the establishment of the CU. However, this thesis contends that businesses attitudes may change and become more skeptical if concrete preparatory steps do not begin to take place in the coming year or so.

Chapter seven also discussed the choice of the future exchange rate policy. Assuming the successful launch of a GCC single currency, there are potentially significant indirect economic benefits to be gained from moving to a flexible exchange rate arrangement. Critically, it would allow the GCC states to operate an independent monetary policy that is predicated on the region's economic circumstances and not those of the US' domestic economy.

The consensus view held by experts considers the optimal policy for the GCC post CU would involve an active monetary policy and thus the choice of a more flexible exchange rate regime. Many experts felt that either a float or a trade-weighted basket would be more appropriate for the GCC economies going forward. This view seems also to be shared by the UAE's central bank governor, Sultan Bin Nasser Al-Suwaidi, who recently said that post CU the

GCC single currency "will have a bigger weight on the international arena, so it will have to be floated then".¹

An independent exchange rate policy would also allow the single GCC currency to take on a wider role and potentially become a regional anchorage and reserve currency. Should the GCC states choose to invoice their oil sales in the common currency then this would not only provide the region with significant seigniorage revenues but would more than likely also result in increasing capital retention within the region. Under such a scenario, the GCC currency 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.

A key political-economy benefit of the successful launch of the GCC CU would be to strengthen the bloc as a political entity. The GCC will undoubtedly have increased international bargaining power in future negotiations and disputes. Therefore, the CU project should also be seen as a means to enhancing the bloc's standing, not just within the MENA region; but in the international arena.

Turning to the costs of CU, this thesis has identified several. The divergence in GCC inflation rates could mean that the common monetary policy could lead to macroeconomic instability in higher inflation economies such as the UAE, Qatar and Kuwait. Furthermore, econometric analysis indicated a lack of economic cointegration between Saudi Arabia and the UAE and between Saudi Arabia and Kuwait suggesting that a common monetary policy might be more costly for the UAE and Kuwait, than for other GCC members initially. However, the potential macroeconomic costs of the common monetary policy should be ameliorated by the flexible adjustments of the GCC's labour market and increasing cross border capital flows.

In light of existing differences in national monetary policies and economic development strategies, chapter seven concluded that the post CU policy choice of exchange rate regime is likely to be an issue of future controversy as

¹ Khalaf, Roula "UAE shifts 10% of its reserves into euros", *Financial Times*, 13 July 2006.

it will require compromises over national interests in favour of implementing the most appropriate regime for the region as a whole. Furthermore, this thesis contends that it will only be possible to manage a free-float or a trade-weighted basket if there is a strong and credible GCC central bank in place. If the GCC does not set up a GCC central bank with adequate decision making powers and institutional capabilities, then the dollar-peg is likely to remain in place.

Another potential cost will arise if the GCC does not have a clear set of fiscal rules to follow and adhere to post CU. It is important that the monetary stability of the CU is not jeopardized by any fiscal indiscipline of member states. This thesis contends that several states will face large adjustment costs in meeting fiscal rules of the kind embodied in the Euro zone's SGP.

Analysis in chapter seven shows that limits on fiscal spending and increased scrutiny of national public budgets (which in turn will require greater transparency) are likely to be considered by some GCC ruling elites as an diminution of their powers and a 'loss of fiscal sovereignty'. Yet, for the region's private sectors, improvements in data transparency and fiscal accountability will undoubtedly be beneficial.

9.5 Cost-Benefit Analysis for Individual GCC States

A qualitative cost-benefit analysis of the case for each GCC state joining the CU was undertaken in chapter eight, addressing the final research question. The chapter identified the most significant prospective costs and benefits for each state individually, in order to establish the presence, or otherwise, of sufficient incentives to ensure the participation of each country. While previous CUs (and CU plans) among the GCC states have not included all of the countries, it was the consensus opinion among our panel of regional experts that the 2010 CU could not be established without all six members. Saudi Arabia's participation, in particular, was deemed as vital.

Chapter eight concluded by summarizing the major costs and benefits of CU for each GCC state in table 8.5. The chapter concludes that, relatively speaking, the net economic benefits from joining the CU would be greatest for Bahrain,

Oman and the UAE, which would stand to gain relatively more from the process of economic integration. Not only are these economies extremely open with strong existing intra-regional links, but as they are also relatively well diversified and have existing comparative advantages in service sector activities such as banking and finance or tourism, areas which should do well from the launch of the single currency.

In contrast, both Kuwait and Qatar are currently much less regionally interdependent. Their imperative to diversify through increasing non-oil intra regional trade and investment has been much less acute due to their high oil (and gas) per capita reserves. However, this does not mean that there are not substantial incentives, both economic and political, for both Kuwait and Qatar to join the CU. For Kuwait, further integration with its Gulf neighbours, particularly with Saudi Arabia, is likely to be considered important for its national security in light of the ongoing turmoil and instability in Iraq. While Qatar's aim of building a trans-Gulf natural gas pipeline with which to supply the domestic energy needs of many of its GCC neighbours, will be facilitated by its inclusion in the CU.

Importantly, this thesis established the presence of a strong case for Saudi Arabia to join the CU, arguably a condition critical to the success of the CU project itself. Saudi Arabia is a major beneficiary of significant GCC direct investment and Saudi businesses, particularly those in the manufacturing sector, are well placed to enter other more lucrative GCC markets. As well as the net economic benefits accruing to Saudi Arabia, there will also potentially be political gains from its membership of the CU, such as additional political leverage over the smaller GCC states and consolidating its position as the leader of the GCC.

9.6 Recommendations for Further Research

In the course of this thesis, two specific areas worthy of future research have become apparent. From the analysis in chapter seven, it was established that the exact nature and limits of fiscal discipline rules adopted by the GCC states had implications for the costs and benefits of the CU project. While it is currently expected that the GCC leaders will adopt fiscal policy rules similar to those of

the Maastricht criteria, there are many other options that need to be fully considered if the most appropriate rules for the GCC economies are to be adopted.

The Eurozone's experience with SGP has demonstrated that if fiscal discipline rules are too strict they are unlikely to be workable. Any fiscal discipline rules for the GCC states should therefore be designed to take into account the high degree of fiscal dependence on oil and the pro-cyclicality of GCC budgets. Future research should explore the options for fiscal rules, as well as the mechanism through which to enforce the rules, which will be equally critical to the fiscal credibility of the CU. Although this issue has been touched upon in several chapters of this thesis we believe it deserves further exploration.

Another area which warrants further research concerns the technical details of invoicing oil in the new currency, such as the nature of the invoicing – whether in long term oil contracts or on one of the region's nascent energy bourses. A related issue is to estimate the size of the economic gains from this, e.g. the size of the seigniorage revenues which would accrue to the GCC states. These topics, whilst related to our cost-benefit analysis of CU, were tangential to our central research themes, and could not be considered in sufficient detail. It is however, an issue which this thesis points towards being an important area for further research.

9.7 Prospects for the GCC CU

The evidence presented in this thesis along with its contextually based findings have established that the GCC can expect to accrue significant economic benefits from entering into a CU. Realising these benefits however, will be conditional on sufficient preparations being made in advance. It is the contention of this thesis that if the necessary prerequisite conditions are not fully in place prior to 2010 two outcomes are likely: the first and most probable, will be the deferral of the project, the second will be a loosely managed joint currency that is less likely to result in significant benefits, especially indirect ones.

As many of the preparations are considered to be primarily in the political-economy domain they require concerted political commitment. These include more power being devolved to the GCC Secretariat, a GCC central bank and other regional institutions. At the national level, the reliability of statistics will need to be improved as will budgetary and fiscal transparency (allowing for greater public scrutiny of government spending).

We contend that such political economy factors will be harder to overcome than any purely economic costs incurred in the lead up to and post CU. Nevertheless, we argue that the potential benefits, both economic and political, should provide ample incentives for changes to take place at the national level. It is not inconceivable that the region's ruling elites may consider the loss of some autonomy to be a price worth paying.

Appendix A: List of Expert Interviewees

	Name	Organisation	Position	GCC State	Cat.
1	Dr. Ahmed Abdulkareem Saif	Gulf Research Center	Political Scientist and Research Manager	UAE	5
2	Dr. Belaid Rettab	Dubai Chamber of Commerce and Industry	Research Director	UAE	1
3	Buti Khalifa Bin Darwish Al Falasi	Dubai Islamic Bank	Chief Executive Office	UAE	3
4	Dr. Nasser Al Kaud	GCC Secretariat	Director of Finance and Monetary Integration	KSA	2
5	Prof. Yousif Khalifa Al Yousif	UAE University, Al Ain	Professor of Economics	UAE	4
6	Dr. Ibrahim Kursany	Department for Economic Development (DED)	Economic Development Advisor	UAE	1
7	Mr. Essa Kazim	Dubai Stock Exchange	Director General	UAE	1
8	Prof. Khalifa Hassanain	UAE University, Department of Economics,	Assistant professor	UAE	4
9	Dr. Hamad Albazai	Ministry of Planning	Deputy Minister	KSA	1
10	Michael Sturn	European Central Bank	Economic Consultant to GCC	Germany	5
11	Dr. Ali Sadik	Independent Economist (Previous AMF Director)	Economist	UAE	5
12	Dr. Abdulrizak Al Faris	UAE University, Professor and Director of Labor market research, Tanmia	Director	UAE	4
13	Sultan Bin Nasser Al Suwaidi	UAE Central Bank	Central Bank Governor	UAE	1
14	Dr. Jassim Al Manaii	Arab Monetary Fund	Director General	UAE	2
15	Dr. Ali Bolbol	Economic Policy Institute, Arab Monetary Fund	Division Chief	UAE	2

	Name	Organisation	Position	GCC State	Cat.
16	Mukesh Gandhi	National Bank of Abu Dhabi	Manager – Investment Marketing	UAE	3
17	Dr. Nasser Saidi	Ministry of Finance and Industry	Economic Advisor	UAE	1
18	Dr. Nabil Dahdah	Economic and Technical Dept, Arab Monetary Fund	Senior Economist	UAE	2
19	Abdulla Ahmed Al Saleh	Ministry of Economy	Under Secretary for Economic Affairs and International Cooperation	UAE	1
20	Manish Agrawal	ABN AMRO	Senior Dealer, Rates Markets	UAE	3
21	Dr. Ali Hamdan	Central Bank of Oman	Senior Research Manager	Oman	1
22	Dr. Fahim Al Marhubi	Sultan Qaboos University	Head of Economic Dept	Oman	4
23	Dr. Hatem Al Shanfari	Sultan Qaboos University	Finance Dept	Oman	4
24	Mustafa Alawati	National Bank of Oman	Foreign Exchange	Oman	3
25	Mr. Shailesh Dash	Global Investment House	Head of Research	Kuwait	3
26	Mrs. Wafa Al Rashid	Kuwait Stock Exchange	Technical Director	Kuwait	1
27	Dr. Yousef Al Ibrahim	Prime Minister's Office	Advisor to Prime Minister	Kuwait	1
28	Dr. Randa Azaar	National Bank of Kuwait	Chief Economist	Kuwait	3
29	Dr. Ali Shihab	Central Bank of Kuwait	Head of Research	Kuwait	1
30	Dr. Nadim Burney	Kuwait Institute for Scientific Research	Researcher	Kuwait	5
31	Dr. Imad Moosa	Gulf University	Dean	Kuwait	4
32	Fawzy Al Thunayan	Central Bank of Kuwait	Manager, Foreign Ops	Kuwait	1
33	Dr. Belkacem Laabas,	Arab Planning Institute	Economist	Kuwait	5
34	Mr. Ahmed Bumtaia	Bahrain Monetary	Director of	Bahrain	1

	Name	Organisation	Position	GCC State	Cat.
		Agency	Economic Research		
35	Dr. Majid Al-Moneef	Member of Shura Council	Saudi Arabia Governor to OPEC, Member of Shura Council	KSA	1
36	Dr. Manhal Shotar	University of Qatar	Associate Professor	Qatar	4
37	Dr. Abdel Aziz Abu Hamad Aluwaisheg	GCC Secretariat	Minister Plenipotentiary Director - Economic Integration Department	KSA	2
38	HE Fahad Faisal Al-Thani	Qatar Central Bank	Deputy Governor	Qatar	1
39	Dr. Abdulrahman Al-Hamidy	Saudi Arabian Monetary Authority	Deputy Governor for Technical Affairs	KSA	1
40	Paul Tempest	The Qatar and Dubai Currency Board	Former Manager	UK	5

Category Key	
ID	Institutional Background
1	Government and Central Bank officials
2	GCC Secretariat and AMF officials
3	Commercial bankers
4	Academics
5	Independent researchers

Appendix B: Interview Letter Sent to GCC Experts



Dr. Jassem el Manai
Director General
Arab Monetary Fund
P.O. Box 2818 , Abu Dhabi
United Arab Emirates
Fax: 02 6332089

Mrs. Emilie Rutledge
P.O. Box 46689
Dubai, United Arab Emirates
Mob: 050 8822854
Email: e.j.rutledge@durham.ac.uk

March 9th 2005

Re: Request for interview on the subject of GCC currency union (PhD research purposes).

Dear Mr. Manai,

It was a pleasure to meet with you at the AMF/IMF seminar in Abu Dhabi on 23-24 February. At the seminar I enquired about the possibility of interviewing you for my doctoral research and I am very grateful for you giving me the opportunity to speak with you.

I am a doctoral research candidate at the Institute for Middle Eastern and Islamic Studies (IMEIS, University of Durham, UK). My doctoral research is on the proposed 2010 GCC currency union, examining the preparations, appropriateness and future prospects of a single GCC currency. I am currently based at the Gulf Research Center, Dubai, from where I am carrying out fieldwork which involves interviewing regional decision makers and experts on their opinion of the implications of the impending currency union.

I appreciate fully your busy schedule but an opportunity to interview you at any time during the coming weeks would be of great benefit to my research. The purpose of the interview would be solely for academic purposes and to better enable me to understand first hand regional views and opinions on the issues surrounding the proposed currency union.

I attach the list of interview questions which I hope to put to you during our meeting. I am interested in your personal responses to the questions and your general views on the issues.

I look forward to hearing from you,

Yours sincerely

E. J. Rutledge

Emilie Rutledge, PhD Candidate,
University of Durham, UK

Appendix C: Interview Questions

No.	Question
1.	What do you think is the main motivation behind the decision of the GCC leaders to establish a Currency Union (CU) in 2010?
2.	Do you think the GCC states constitute a cohesive economic bloc, well suited to CU?
3.	What, in your opinion, will be the most significant costs and benefits of CU?
4.	Do you think that some GCC states will benefit from CU more than others? Which ones and why?
5.	Which areas of this country's economy do you think will be most affected by the CU? In what ways?
6.	How important do you think CU is to the economic development and diversification of the GCC states?
7.	Do you think that forming a CU will make the GCC economically and politically stronger?
8.	Do you think forming a CU is in the best interests of the GCC citizens?
9.	In your view how do GCC citizens perceive the forthcoming CU and are they being prepared for it?
10.	Do you think the pace of monetary and institutional preparations being made towards CU is sufficient?
11.	What do you think are the biggest obstacles to GCC CU? How likely is it that these can be overcome?
12.	Do you think that CU could be established with less than 6 member GCC states?
13.	Do you believe the CU will be established as scheduled in 2010?
14.	Do you think continuing the peg to the GCC currencies to the US dollar and following US interest rates is appropriate for their economic cycles? Or has it led to greater boom and bust swings?
15.	Following CU what do you think is the likelihood of the GCC states switching from the existing US dollar peg to an alternative more independent exchange rate arrangement?
16.	Do you think there would be advantages from switching to an alternative exchange rate regime?
17.	Do you think it is likely that the single GCC currency could become an anchorage and reserve currency held by other central banks in the wider region?
18.	What factors do you think will most heavily influence the single currency's ability to become an anchorage and reserve currency?
19.	Can you foresee the GCC states invoicing oil in a currency other than the US Dollar? Such as the new GCC currency or the Euro?

Appendix D: Letter Sent to GCC Businesses

Gulf Research Center
Knowledge for All



مركز الخليج للأبحاث
المعرفة للجميع

Emilie Rutledge
Gulf Research Center
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303 Sheikh Rashid Road
P.O.Box 80758, Dubai, UAE
Telephone: +971-4-3247770 ext 437
Fax: +971-4-3247771
Email: emilie@grc.ae

May 2005

Re: Request for participation in business survey on GCC Currency Union.

Dear Sir/Madam

The GCC is due to form a currency union in 2010. To date there has been little research into the likely impact of this new monetary system on GCC businesses. The Gulf Research Center is carrying out an extensive survey of business views on the implications of currency union. The results of this survey will be presented to senior GCC economic policy makers and it is therefore important that your company makes known its views on the issue. We guarantee that all information is strictly confidential and your name and other information will never be associated with your responses.

Ideally someone involved in the management, finance or strategic planning at your company should complete the survey as soon as is convenient. The survey is a simple two page questionnaire that can be completed within 5 minutes. We would appreciate it if you could return the survey to us before 21st May when we will be collating all the responses. We will be happy to notify you of the results of the survey.

After completing the survey, kindly fax it to +971-4-3247771.

Alternatively you may complete the survey on-line: <http://www.gcc-economics.com>

Many thanks for your cooperation.

Yours sincerely

Emilie Rutledge
Economist, Gulf Research Center

187 برج عود ميثا، الطابق 11، شارع الشيخ راشد، ص.ب 80758، دبي، الإمارات العربية المتحدة. هاتف: +971 4 324 7770، فاكس: +971 4 324 7771، البريد الإلكتروني: info@grc.ae
187 Oud Metha Tower, 11th Floor, 303 Sheikh Rashid Road, P.O. Box 80758, Dubai, United Arab Emirates. Tel: +971 4 3247770, Fax: +971 4 3247771, E-mail: info@grc.ae

www.grc.ae

Appendix E: Questionnaire Distributed to GCC Businesses

Questionnaire (Page 1)

Contact **Emilie Rutledge**
 Fax **+971 4 3247771**
 Telephone **+971 4 3247770 (ext. 437)**
 Email **emilie@grc.ae**
 Website **www.grc.ae**

مركز الخليج للأبحاث
 الممرفنة الجمرفنة
Gulf Research Center
 Knowledge for All



Business Survey on GCC Currency Union

Name of business / GCC state

Your name / Position

Telephone / Email

Questions:

01) Approximately what are the annual sales (turnover) of your business?

- Less than US\$1 million US\$1 million - US\$10 million US\$11 million - US\$50 million
 More than US\$50 million Unable to disclose

02) Approximately how many people does your business employ?

- Less than 10 11 - 50 51 - 100
 101 - 250 251 - 500 501 - 1000
 More than 1000 Unable to disclose

03) In what field is the main activity of your business? (Tick all that apply)

- Manufacturing Hotels/restaurants/tourism Construction/Real estate
 Agriculture/Foodstuffs Oil/gas/Petrochemicals Transport/Communications
 Retail/Wholesale trade Banking/Financial services Other: _____

04) On a scale of 1 to 4 where 1 = "most" and 4 = "least" please indicate which region you export most to? (Rank "0" if a particular region is not exported to)

- USA Asia Not applicable
 Europe GCC States Other: _____

05) Approximately what proportion of your exports is to other GCC states?

- 0 - 10% 11 - 40% More than 40% Not applicable

06) Approximately what proportion of your imports is from other GCC states?

- 0 - 10% 11 - 40% More than 40% Not applicable

07) What do you expect will be the overall effect of a GCC single currency in 2010 on your business?

- Very good Good None Bad Very bad

08) How do you feel about the 2010 GCC currency union and its likely success?

- Very Optimistic Optimistic Neutral Pessimistic Very pessimistic

09) On a scale of 1 to 4 where 1 = "highest potential" and 4 = "least potential" please indicate which areas you think GCC currency union has the most potential to benefit your business?

- Increasing sales Reduced exchange rate risk New business opportunities
 Reducing transaction costs None Other: _____

page one of two

10) On a scale of 1 to 3 where 1 = "most harm" and 3 = "least harm" please indicate in which ways you think a GCC single market and currency is most likely to harm your business?

- Increased competition Costs of changing payments system
 Increased economic uncertainty None

Other: _____

11) Which GCC state do you think offers your business the greatest potential to find new business opportunities? (Please choose one answer)

- Bahrain Oman Saudi Arabia
 Kuwait Qatar UAE

12) In your opinion what is currently the main obstacle to the growth of your business within the GCC? (Choose all that apply)

- Restrictive regulations Exchange rate related costs Lack of clear property rights
 Protective tariffs and trade restrictions Lack of appropriately skilled labour Lack of access to credit from banks and financial service companies
 None/Unsure Other: _____

13) Is your business currently making preparations for currency union in 2010?

- Yes No Planning to do so at a later stage

14) If you answered 'Yes' to Q13 please explain your business's preparations

15) Has your business been advised or assisted in preparing for the currency union?

- Yes No If 'Yes', by who: _____

16) Do you feel that the government should be providing assistance and information on preparing for the currency union?

- Yes No Yes but closer to 2010

17) If your business operates in more than one GCC state, post currency union do you expect to charge the same price for identical products across all GCC states?

- Yes No

18) If you answered 'No' to Q17 why are you not expecting to charge the same price?

- Price will reflect demand in the local market Price will include the transportation costs to other GCC states

Other Reason: _____

19) Do you expect the introduction of the single currency to increase your costs?

- Yes No Not sure

20) If you answered 'Yes' to Q19 do you intend to pass on any increase in your costs to your customers?

- Yes No

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 المعرفة للجميع
Gulf Research Center
 Knowledge for All

Contact: **Emilie Rutledge**
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 Telephone: +971 4 3247770 (ext. 437)
 Email: emilie@grc.ae
 Website: www.grc.ae

Business Survey on GCC Currency Union

Business Details

Name of Business: GCC State:

Your Name: Your Position:

Business Telephone: Business Email:

Questions

Q1: Approximately what are the annual sales (turnover) of your business?

Q2: Approximately how many people does your business employ?

Q3: In what field is the main activity of your business? (Tick all that apply)

Manufacturing Hotels/restaurants/tourism Construction/Real estate
 Agriculture/Foodstuffs Oil/gas/Petrochemicals Transport/Communications
 Retail/Wholesale trade Banking/Financial services Other:

Q4: On a scale of 1 to 4 where 1 = "most" and 4 = "least" please indicate which region you export most to? (Rank "0" if a particular region is not exported to)

USA Asia Not applicable
 Europe GCC States Other:

Q5: Approximately what proportion of your exports is to other GCC states?

Q6: Approximately what proportion of your imports is from other GCC states?

Q7: What do you expect will be the over all effect of a GCC single currency in 2010 on your business

Q8: How do you feel about the 2010 GCC currency union and its likely success?

Q9: On a scale of 1 to 4 where 1 = "highest potential" and 4 = "least potential" please indicate which areas you think GCC currency union has the most potential to benefit your business?

Increasing sales Reduced exchange rate risk None
 Reducing transaction costs New business opportunities Other:

Online Questionnaire (continued)

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Address http://www.gcc-economics.com

Go

Q10: On a scale of 1 to 3 where 1 = "most harm" and 3 = "least harm" please indicate in which ways you think a GCC single currency is most likely to harm your business?

Increased competition Costs of changing payments system

Increased economic uncertainty None Other:

Q11: Which GCC state do you think offers your business the greatest potential to find new business opportunities?

Q12: In your opinion what is currently the main obstacle to the growth of your business within the GCC?
(Choose all that apply)

Restrictive regulations Protective tariffs and trade restrictions Lack of clear property rights

Exchange rate related costs Lack of appropriately skilled labour Lack of access to credit from banks and financial service companies

None/Unsure Other:

Q13: Is your business currently making preparations for currency union in 2010?

Yes No Planning to do so at a later stage

Q14: If you answered "Yes" to Q13 please explain your business's preparations:

Q15: Has your business been advised or assisted in preparing for the currency union?

Yes No If "Yes", by who:

Q16: Do you feel that the government should be providing assistance and information on preparing for the currency union?

Yes No Yes but closer to 2010

Q17: If your business operates in more than one GCC state, post currency union do you expect to charge the same price for identical products across all GCC states?

Yes No

Q18: If you answered "No" to Q17 why are you not expecting to charge the same price?

Price will reflect demand in the local market Price will include the transportation costs to other GCC states

Other Reason:

Q19: Do you expect the introduction of the single currency to increase your costs?

Yes No Not sure

Q20: If you answered "Yes" to Q19 do you intend to pass on any increase in your costs to your customers?

Yes No

THANK YOU FOR COMPLETING THIS SURVEY

Appendix F : Principal Economic Characteristics of GCC Business Survey Respondents

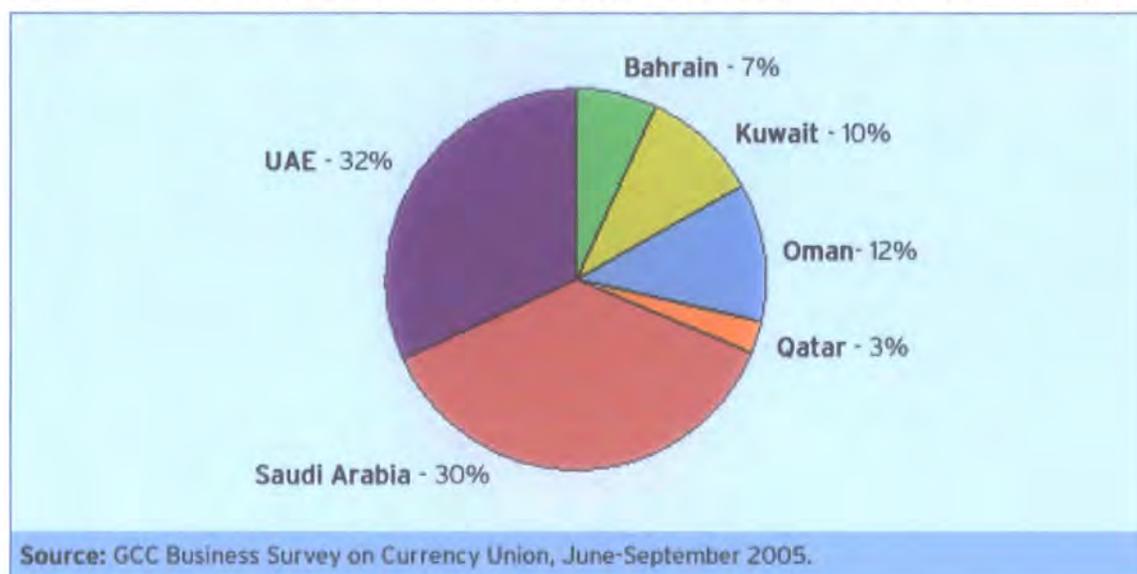
This annex examines the principal economic characteristics of the business respondents to the first, and to date only, GCC business survey focusing on GCC CU. It was carried out during the period June 2005 to September 2005. The analysis in this thesis has drawn upon many of the findings of the business survey.

The business survey methodology was discussed in depth in chapter three of this thesis. To briefly summarise, the contact details of GCC businesses with email addresses, as well as fax and telephone numbers, were collated from regional business databases. Following a pilot survey, the questionnaire was sent to more than eleven thousand businesses across the GCC states and was conducted predominantly by email but also by telephone and fax. The low response rate, at approximately 2.7 percent, was not unanticipated considering the general lack of consultation with businesses by policy makers and research bodies in the region traditionally, the absence of financial incentives (frequently used by commercial polling agencies in the Middle East of late) and the generally poor response rates to surveys carried out predominantly by email and the internet. Furthermore, regional contact databases of businesses in the public domain are not comprehensive and are often outdated.

While the sample frame of the survey could not be established due to the absence of GCC industrial censuses it can be said that the number of responses, which amounted to 307, is not an insignificant number from which to ascertain the views of businesses on the impending GCC CU and the economic implications for GCC businesses. However, as was discussed previously in chapter three, care must be taken in interpreting the results of the survey due to the potential presence of sampling error, although in a number of cases where we were trying to identify whether or not a simple majority (>50 percent) view prevailed, we calculated 95 percent confidence intervals to confirm the statistical significance of the results.

The largest proportion of the 307 business respondents, 37 percent, were based in Saudi Arabia while Qatar had the smallest proportion of business respondents at only three percent (see Figure F.1). The responses per GCC state are broadly consistent with the relative economic size of each state.

Figure F.1: Proportion of Business Sample Respondents by GCC Country



However, in order to assess more precisely to what degree the survey responses were representative of the GCC business community in the absence of national industrial censuses, weightings based on GDP, population size and Foreign Direct Investment were calculated (see Table F.1).

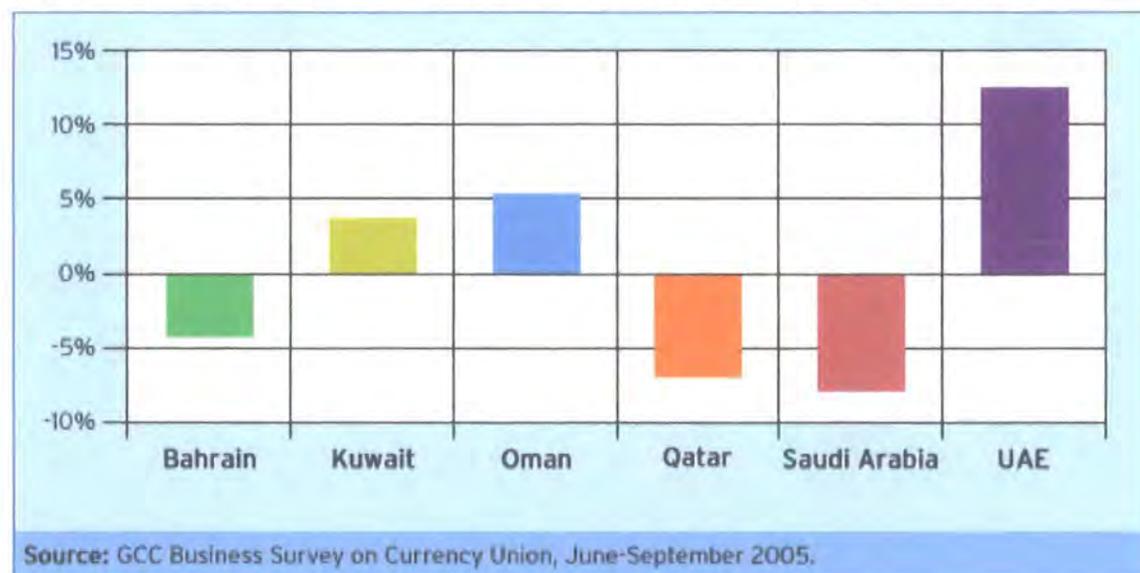
An average weighting per GCC state was calculated and represented an ideal target for the distribution of responses. When the actual distribution of responses was compared to the target weightings the maximum deviation from target was 12 percent. It was evident from the deviations that the views of businesses in the UAE, Oman and Kuwait were all somewhat over-represented in the survey results while those in Saudi Arabia, Bahrain and Qatar were rather under-represented, (see Figure F.2).

Table F.1: GCC Business Survey Weights and Responses

	Bahrain	Kuwait	Oman	Qatar	SA	UAE	GCC
GDP 2003 (US\$ bn)	9.61	41.75	21.59	20.43	214.46	79.82	387.65
GDP Weight	2.5%	10.8%	5.6%	5.3%	55.3%	20.6%	100%
Population 2003 (mn)	0.69	2.55	2.34	0.64	22.67	4.04	32.92
Population Weight	2.1%	7.7%	7.1%	1.9%	68.9%	12.3%	100%
FDI 2003 (\$mn)	517	67	138	400	208	480	1810
FDI Weight	28.6%	3.7%	7.6%	22.1%	11.5%	26.5%	100%
Average Target Weight	11.0%	7.4%	6.8%	9.8%	45.2%	19.8%	100%
Actual responses	21	31	36	8	113	98	307
Actual weight	6.8%	10.1%	11.7%	2.6%	36.8%	31.9%	100%
Target Weight difference	-4.2%	2.7%	5.0%	-7.2%	-8.4%	12.1%	0%

Source: GCC Business Survey on Currency Union, June-September 2005, GCC National Accounts and United Nations Conference on Trade and Development, World Investment Report 2004.

Figure F.2: Difference between Country Weight and Survey Responses

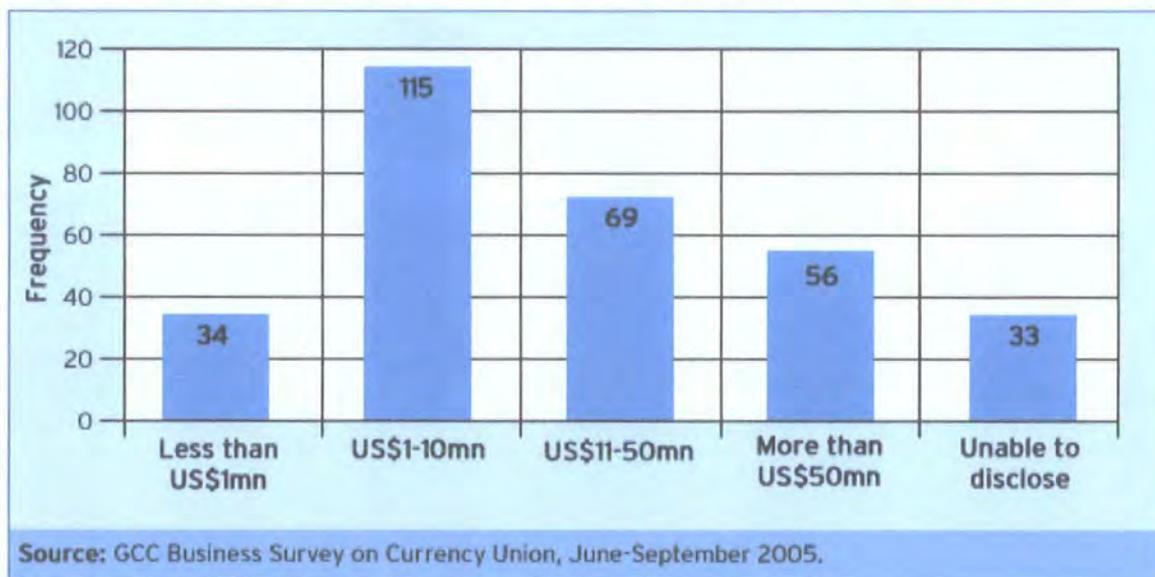


Questions one to three of the business survey (see Appendix E) provided information on the size profile of the business sample and the sector distribution of these businesses. The responses to these questions are discussed below.

Question 1: Approximately what are (is) the annual sales (turnover) of your business?

The majority of businesses – 37.5 percent – that responded had an annual turnover of between US\$1 – \$10 million. The next largest group – 22.5 percent – of had a turnover of between US\$11 – \$50 million. Approximately 10.7 percent of the business respondents were unable to disclose this information. The response to this question was positively skewed with SMEs forming the largest part of the business sample at 54 percent of the total (see Figure F.3). Considering the preponderance of SMEs in the GCC economies it is likely that in this respect the survey sample was representative of the size of GCC businesses.

Figure F.3: Business Responses to Survey Question One

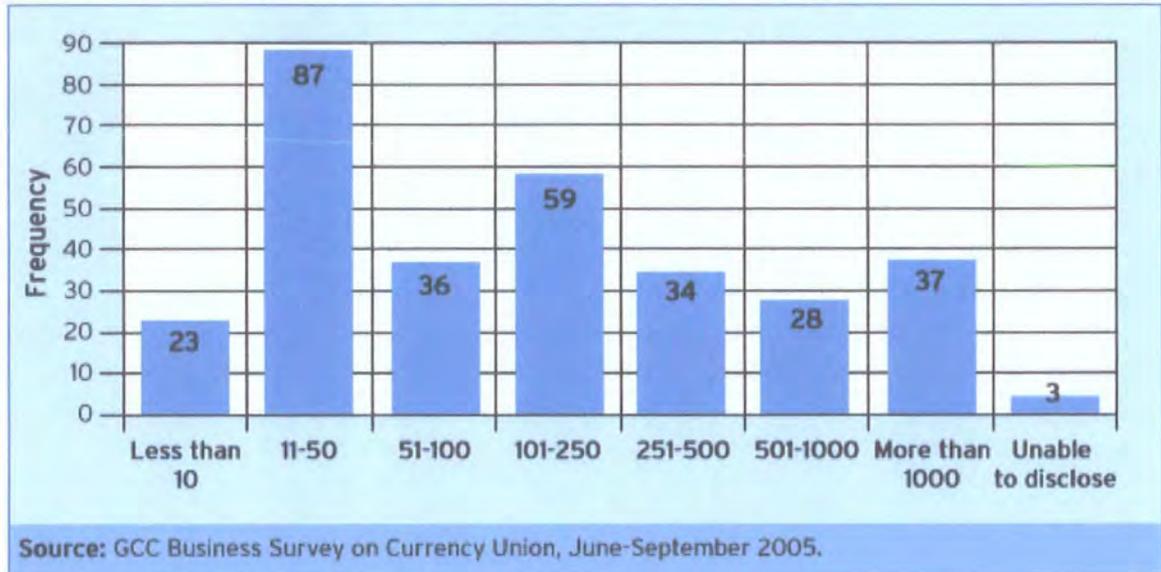


Question 2: Approximately how many people does your business employ?

Again SMEs represented the largest group of respondents to the survey questions, with the number of employees between 11 and 50, forming 28.3 percent of the total. The profile of business employees represented in the results of this question

are consistent with the findings of question one where the majority of respondents had an annual turnover of US\$10 million or less (see Figure F.4).

Figure F.4: Business Responses to Survey Question Two



Question 3: In what field is the main activity of your business?

Businesses in the manufacturing sector formed the majority of respondents at 26 percent of the total, this was followed by the construction/real estate sector at 19 percent – an expanding area for business operations in the GCC, and then the retail/wholesale sector at 17 percent (see Figure F.5). The sector distribution of business sample respondents is broadly consistent with the sector composition of GDP in most GCC states, (see Table F.2). Following public sector dominated activities such as oil and gas production and government services which constitute the largest economic sectors in the GCC, manufacturing is the largest sector with private sector involvement, and this is followed by the commerce/trade sector and then construction, which is consistent with the main sectors represented in the business sample.

Figure F.5 Business Responses to Survey Question Three

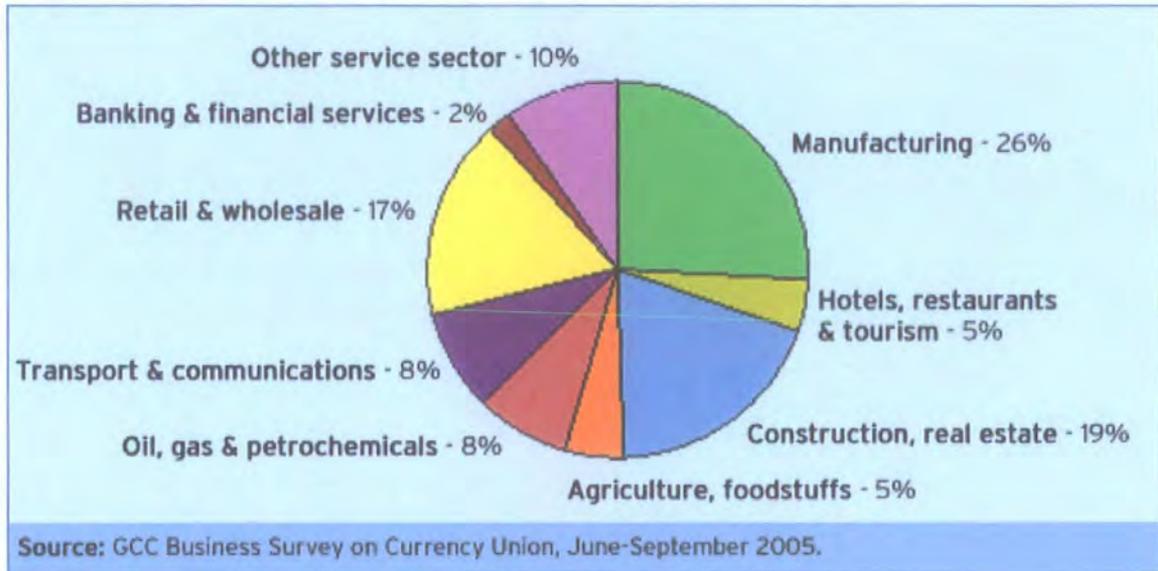


Table F.2: Sector Composition of GCC GDP in 2004

2004	Bahrain	Kuwait	Oman	Qatar	SA	UAE	Average
Agriculture, Fishing & Forestry	0.6%	0.4%	1.7%	0.2%	4.0%	2.6%	2.8%
Mining, Quarrying & Fuel	28.2%	47.7%	42.4%	62.2%	42.2%	32.8%	41.4%
Manufacturing	10.2%	8.0%	8.1%	6.3%	10.1%	12.6%	10.0%
Construction	3.3%	2.2%	3.0%	5.2%	5.4%	7.5%	5.3%
Elec. Water & Gas	2.0%	1.9%	1.5%	2.2%	1.1%	1.8%	1.4%
Commerce, Rest. & Hotels	8.2%	7.0%	13.0%	5.0%	6.2%	12.1%	7.8%
Transport, Comm. And Storage	7.0%	4.3%	7.0%	3.3%	3.8%	7.1%	4.8%
Finance, Ins. & Banking	9.4%	6.7%	1.2%	1.6%	2.9%	3.9%	3.5%
Housing	8.8%	...	3.6%	2.5%	5.1%	7.7%	4.9%
Govt. Services	15.0%	..	9.0%	9.6%	15.4%	8.4%	11.3%
Other Services	3.7%	25.0%	8.7%	1.3%	2.8%	2.4%	5.5%
Net Indirect Taxes	3.6%	-3.3%	0.7%	0.6%	0.9%	1.0%	1.3%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Source: AMF, *Al Taqir al Iqtisadi al Arabi al Muwahhad*, 2005.

Note: GDP at current prices.

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