ECONOMIC AND MONETARY INTEGRATION IN THE GULF COOPERATION COUNCIL (GCC): A KUWAITI PERSPECTIVE

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ABSTRACT

The State of Kuwait is has been a member of the Gulf Cooperation Council (GCC) since its establishment in 1980. Kuwait is a geographically small but oil-rich country, whose economic development in recent years is the result of an increase in both the production and prices of oil, which now accounts for almost 90% of exports. Meanwhile Kuwait imports almost all its local market needs from abroad. In 2010 the Kuwaiti government passed a development plan which was intended to diversify the Kuwaiti economy and promote non-oil economic sectors.

Kuwait has an open economy, and is an ally of its GCC neighbours and the West. It is a member of the World Trade Organisation, which helps to enhance the country's exports and imports. At the same time Kuwait is committed to advancing Economic and Monetary Integration with the GCC countries, and put into practice the guidelines which will make the Currency and Economic Union successful.

This study will extend the literature on Economic and Monetary Integration in the context of the GCC monetary union. A literature review of the theory of Optimum Currency Areas (OCA) examines the development of exchange rate policy and monetary unions. Investigating and assessing Kuwait's national interest in joining the GCC currency union is the main objective of this thesis. The study applies both quantitative and qualitative approaches to estimating the likely costs and benefits. In the study annual published data is used to analyse the country's main economic structure and indicators, and semi-structured interviews are used to ascertain the opinions of Kuwaiti nationals working in financial institutions concerning monetary union.

The conclusion of our study is that Kuwait is ready to join the GCC monetary union, the benefits of membership outweighing the costs. Having an oil-based economy like that of other GCC countries will make it easier for Kuwait to join the GCC monetary union. In addition, Kuwait imports products from abroad to meet local demand and controls inflation through its exchange rate regime. The Central Bank of Kuwait (CBK) is the sole authority managing the country's monetary policy and the financial sector. However, GCC monetary union will subordinate the CBK to the Gulf Central Bank and reduce its flexibility to use its own monetary tools.

DECLARATION

I solemnly declare that none of the content of this thesis has been used to fulfil any form of requirement in completing any university degree in any other discipline or academic institution.

STATEMENT OF COPYRIGHT

LIST OF ABBREVIATIONS

Afristat	Statistical Organizations in Africa
AUD	Australian Dollar
B/D	Barrel per day
CAP	Common Agricultural Policy
CBK	Central Bank of Kuwait
CFA	Communauté Financière Africaine
CHF	Swiss Franc
CIP	Covered interest rate parity
CPI	Consumer Price Index
CU	Currency Union
EA	Economic Agreement
EMU	European Monetary Union
EPU	European Payments Union
EUR	Euro, the official currency of the Eurozone
Eurostat	European Union
FOB	Freight on board
FX	Foreign exchange market
GATT	General Agreement on Tariffs and Trade

GBP	British Pound Sterling
GCC	Gulf Co-operation Council
GDP	Gross domestic product
IMF	International Monetary Fund
JPY	Japanese Yen
KD	Kuwaiti Dinar
KSE	Kuwait Stock Exchange
LOOP	Law of One Price
M1	Currency in circulation with the public + sight deposits (private deposits in KD). 'Money' means money supply in its narrow definition (MI).
M2	Money supply, including savings deposits with banks
M3	Money supply, including inter-bank deposits
NZD	New Zealand Dollar
OCA	Optimum Currency Area
OECD	Organization for Economic Co-operation and Development
OEEC	Organization for European Economic Co-operation
PPP	Purchasing Power Parity
QM	Quasi-money savings deposits (in KD) + time deposits (in KD) + foreign currency deposits + CDs (in KD). The private sector maintains quasi-money components with local banks.
RER	Real exchange rate
SITC	Standard International Trade Classification
SWOT	Strength, weakness, opportunities, and threat

UIP	Uncovered interest rate parity
WEC	Wisconsin Energy Corporation
WPI	Wholesale Price Index
WTO	World Trade Organization
USD	United States Dollar

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GLOSSARY

Ask price. The price at which potential seller is willing to sell a security. In foreign exchange markets, the value of a currency (in terms of another currency) at which a seller is willing to sell the currency.

Base currency. The first currency quoted in a currency pair on the foreign exchange. It is also typically considered the domestic currency or accounting currency. For accounting purposes, a firm may use the base currency to represent all profits and losses.

Bid price. The price a potential buyer is ready to pay for a security. In foreign exchange markets, the value of a currency-buying price against another currency.

Bretton Woods Agreement. A landmark system that was established in 1944 for the monetary and exchange rate system. The Agreement was developed at the United Nations Monetary and Financial Conference held in New Hampshire. There were several outcomes of the signed Bretton Woods Agreement, such as the creation of the International Monetary Fund and the International Bank of Reconstruction and Development; the most important outcome was the introduction of the adjustable pegged foreign exchange system. Before the introduction of the new system, currencies were pegged to gold and the IMF was the only authority permitted to intervene when an imbalance of payment arose.

Custom union. Members agree to a common external tariff.

Common Market. Free movement of goods, factors of production, including labour and capital between member states.

Cross rate. The currency exchange rate value between two currencies, when neither is the official currency of the countries involved. The term is also used

when is a quote is given for a currency which does not involve the US dollar, regardless of which country the quote is given in.

Current account. The difference between the country's total exports of goods, products or services and its total imports of goods, products or services.

Demand. This term is used in economics when there a need or desire to buy or own any goods or services, and the ability to pay for them. Thus the term implies the ability to buy a particular product or service at a given point of time.

Depreciate. In foreign exchange terms, when the exchange rate for a particular currency is decreased or reduced, by a government or through weakening of the underlying economy in the floating exchange rate regime. It is also called *devaluation*, the opposite being *appreciation* or *revaluation*.

Direct currency quotation. A foreign exchange quote based on the *base currency*, which is the US dollar, the other currency being the counter-currency that changes against it. The US dollar, as the base currency, remains constant equal to 1 while the other currency can change in value in relation to it.

Discount rate. An interest rate set by the central bank charged to depository institutions that borrow reserve from it through the central bank discount window.

Durable goods. Goods or products which do not quickly wear out; alternatively, products which can be utilized or consumed completely on one occasion. Items such as jewellery or bricks can be considered durable goods since they never wear out.

Economic integration. The process of eliminating all barriers, such as tariff and non-tariff barriers, so as to allow goods, services and factors-of-production to flow between groups of countries.

Endogeneity. The term is used in the econometric model when there is a correlation between two variables or between the parameter and the error term. This may occur because of a measurement error, an auto-regression error along with autocorrelation errors, simultaneously omitted variables, or sample

selection errors. In general, a loop of causality between independent and dependent variables of a model leads to endogeneity.

Exchange rate. The foreign exchange rate between two currencies specifies how much one currency is worth in terms of the other currency. The value of a foreign country's currency in terms of the domestic currency.

Expansionary policy. A government implements an expansionary policy when it seeks to expand the money supply in order to encourage economic growth or combat inflation. One such policy is fiscal policy, which takes the form of reducing taxes and increasing government spending. Expansionary policy can also occur via central banks increasing the money supply in the economy.

Exports. Products, goods and services that are produced domestically but purchased for use in the international market to meet domestic demand in the other countries or regions.

Fiscal budget. This occurs when a government or a country's total expenditure exceeds the revenues that are generated from its external transactions.

Fiscal policy. A country's macroeconomic policy tools, which are used by the government to control the total level of economic activity within the country. They will include setting the level of government expenditures and revenues. Fiscal policy refers to the overall consequence of the country's budget outcomes on economic activities. There are three types of fiscal policy stance: contractionary, expansionary and neutral.

Fixed exchange rate. An exchange rate system, used by countries or central banks, in which the value of the country's currency is fixed in relation to another currency, and is maintained by a fixed conversion rate through central bank intervention. This is the opposite of a floating rate system (see below).

Floating exchange rate. An exchange rate system that allows a currency value to be determined by the interplay of market forces and participants. Supply and demand will determine the value of the exchange rate. All central banks and governments try to defend their country's currencies at certain rates by selling or buying the country's currency at certain rates.

Forward price. The forward price, or as it is sometimes called the forward rate, is the agreed price at which a certain security or asset to be sold in the future.

Imports. Products, goods and services that are produced abroad but purchased for use in the local market to meet domestic demand.

Indirect currency quotation. A foreign exchange quote based on a base currency which is not the US dollar, but (e.g.) the GBP, EURO, NZD or AUD. In this case the base currency is constant against the US dollar.

Inflation. The general increase in the level of prices of goods and services in the economy over a period of time. As a result of inflation, each unit of currency will buy fewer goods or services according as the value of money decreases. The measure of inflation is the inflation rate, that is, the annualized percentage change in the general price index (which is usually the Consumer Price Index).

Interest rate. The amount charged expressed in percentage terms; a percentage charge on the principal amount given by the lender to the borrower. An interest rate is normally charged on an annual, semi-annual or monthly basis.

International monetary system. The system, required as a result of dealing in the foreign exchange market, which produced a set of rules to manage international trade and allow it to take place between nations all over the world.

Interventions. These occur when the government or central authority intervenes in the market to stabilize a country's exchange rate, interest rate, or any given monetary policy, which requires a certain price or value set by the government.

Investment. The action of laying out money or capital to purchase financial instruments or other assets with the expectation of gaining profit in the form of interest, inflows, or a value added to the asset. Investment policy is influenced by considerations of risk, management, finance and political stability.

Labour. Work which is conducted by human beings. It is usually contrasted with other factors such as production, capital and land.

Mint parity. The precious-metal content of coinage, as established by law. The ratio between different countries' currencies, as set by the legally established content of gold or silver in their coinage.

Monetary policy. The action via which a central bank or government authority, or a currency board or any other authorized regulatory committee, determines the level and rate of growth of the money supply. This action will have a direct impact on interest rates. It is achieved by increasing the interest rate, or by changing the amount of money banks need to keep as a reserve requirement.

Monetary policy. The practice a central bank or monetary authority uses to manage the money supply, liquidity and the cost of money. A country's central banks and monetary authorities usually use monetary tools to protect that country's economy from economic crises and to control inflation. In the event of it entering into a monetary union, a country will give up its own monetary policy and will follow the union's policy of monetary convergence.

Monetary union. This occurs when two or more countries unite to operate a single currency, or when different countries decide to operate among themselves a fixed exchange rate which is monitored and controlled by one central bank with the co-operation of the monetary policies of the other central banks.

Money supply. The total amount of money available in the economy at a particular time. Money can be defined in several ways, for example as currency in circulation or as deposits in financial institutions.

Nominal interest rate. A term used by economists and financial institutions to indicate the rate of interest before the effect of inflation or any other effect is taken into consideration.

Quasi-money. High liquid assets that can easily be converted into cash.

Real exchange rates. The purchasing power of one currency relative to that of another currency, the two different currencies possibly holding different values in the foreign exchange market. Products in different countries do not have the same price, owing to different economic situations, and different inflation rates, interest rates, and other major economic indicators.

Reserve requirements. The amount of funds that banks must hold in reserve against deposits made by their customers. The money can be stored in the bank's vaults, or at the central bank.

Semi-durable goods. Perishable goods and goods that are not long-lasting, such as clothes or furniture.

Spot market. This (sometimes called the cash market) is the place where commodities or securities are sold for immediately effective cash delivery.

Supply. The term is used in economics when there is a specific amount of products which a producer is willing to produce and able to sell at a given price, all other factors being held constant. Supply is normally plotted as a curve showing the relationship between supply and demand.

Surplus budget. A situation which occurs when assets exceed liabilities, income exceeds expenditure, exports exceed imports, or profits exceed losses.

Tradable goods. Goods or services which can be sold in another country or location distant from where they were produced. Goods or services which cannot be sold in another location are called non-tradable goods.

Trade. The commercial exchange involved in buying and selling on both domestic and international markets. Trade may involve the exchange of goods, services or both between two parties or countries.

Unemployment. This appears when people are actively searching for employment and are unable to find work. Economists usually look at the unemployment rate in order to measure the health of an economy. It is calculated by dividing the number of unemployed persons by the number of persons in the labour force.

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Chapter 1 INTRODUCTION

1.1 INTRODUCTION

The Gulf Cooperation Council (GCC) was established in 1980 and consisted of the six member states Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates. In November 1981 the GCC leaders signed an Economic Agreement (EA) defining the terms of the economic relationship between the member states and establishing the GCC Free Trade Area. The Economic Agreement was signed just a few months after the establishment of GCC cooperation. The objectives of the EA were to enhance economic activities among the GCC Members, taking into consideration the economic circumstances of the member states at the time.

The GCC countries abided by the EA for almost two decades in order to strengthen the ties between their economies. But then, recognizing the changes in economic circumstances both regionally and globally, the Supreme Council decided that the original Economic Agreement of 1981 needed to be revised. The decision was taken to review and amend the EA in order to enhance economic ties, and harmonize their economies, financial and monetary policies, commercial and industrial laws, and customs regulations. They aimed to fulfill these objectives by forming a GCC customs union, a common market, integration of development, and an economic and monetary union.

On November 1999 the Supreme Council instructed the Secretariat General to review the Economic Agreement, prepare a draft of a new agreement, and submit it to the GCC member states. After a review of the EA by the different technical authorities' within the member countries, a final draft of a new agreement was issued to the Supreme Council for approval. The GCC leaders signed the revised EA on 31 December 2001, after which its implementation by the member states was put into motion. Reflecting the directions of the Supreme Council, the new revised agreement included seven chapters

which covered the following seven topics: a customs union, a common market, economic and monetary union, development integration, human resources development, cooperation in the field of scientific and technical research, and transportation, communication and infrastructure.

The Supreme Council made sure that the new EA did not only specify cooperation between the member states but determined the path to full economic integration. The GCC committees and the Secretariat General will monitor the implementation of the new EA.

The GCC countries have made an effort to implement and enforce the new EA, including the establishment of a monetary union. In 2001 the decision was made to establish such a union with a single currency by the end of January 2010.

The new Economic Agreement (2001) has shifted from economic cooperation to full economic integration, which requires certain procedures set by the Supreme Council. The agreement has also become more inclusive and covers the following areas of integration:

- The GCC customs union.
- The GCC countries' international relationships with other economic groups and countries.
- The GCC common market.
- Monetary and economic union.
- Promotion of investment in member states.
- Integrated development among the member states in the different fields of industry, oil and gas, natural resources, agriculture, environment and joint projects.
- Development of human resources.
- Development of scientific and technical research.

- Integration of infrastructure areas.
- In addition, the EA includes the procedures and mechanisms to implement and follow up any dispute that may arise among the member states as a result of the implementation process. Since the agreement was signed, the GCC countries have achieved some of the objectives set by the EA, the main ones being as follows:
  - Adopted the GCC monetary union agreement to introduce a single currency (Decembers 2008).
  - Launched the GCC common market (December 2007).
  - Established the Free Trade Area among the member states (1983).
  - Established the GCC customs union (January 2003).
  - Concluded the GCC economic agreement (2001).
  - Adopted common strategies and policies to help the national policies of member countries.
  - Unified laws, regulations and procedures in the economic field.
  - Established GCC joint institutions.
  - Coordinated policies in the area of international economic activity.
  - Cooperated in joint projects in different fields, such as road, communications and telecommunications.
  - Cooperated at different levels in the economic sector, such as banking technology, monetary and fiscal matters, statistical surveys, industry and business conferences, and the oil and gas industry.

Since the establishment of the Supreme Council and the introduction of the Economic Agreement, the GCC members have succeeded in some of their objectives. GCC put the establishment of the monetary union and currency as one of their highest priorities.

The Council has taken the necessary steps towards realizing full economic integration by creating a free trade area, a customs union, and a common market and economic union. The necessary cooperation in the relevant areas has been achieved through the formation of various specialized committees whose goals have been to implement the guidelines of the main constituent bodies of the GCC (the Supreme Council, the Ministerial Council and the Secretariat General).

The free trade zone was established in 1983, and the customs union in 2003, when members agreed to establish a customs tariff of five per cent. In addition, in a decision to move ahead with the next phase of integration, the GCC leaders agreed to adopt a common peg for the different currencies of the member states as a preliminary step to adopting a single currency, considered a cornerstone for achieving full economic integration.

In voting to create a single currency by 2010, the GCC leaders also agreed to use the United States dollar as a common peg for their currencies before the end of 2002. In their desire to achieve monetary integration and a common currency, the GCC countries expressed their common belief that the complete integration of product and factor markets required the elimination of transaction costs and uncertainties associated with the existence of separate currencies.

The GCC abandoned the initial 2010 deadline, which was not met, and a new deadline for launching a common currency has not been specified. Most analysts and government officials predict 2015 as a likely date. However, the United Arab Emirates and Oman have dropped their decision to be part of the single currency project, but they are still participating on the technical board of the monetary union. Both UAE and Oman are supporting the project by being active GCC members, and it is predicted that they will rejoin at some time in the future. Meanwhile, four Gulf countries – Bahrain, Kuwait, Qatar and Saudi Arabia – are pursuing monetary union, and launched the Gulf Central Bank in March 2010.

The benefits of establishing a common currency have been tested against several benchmarks established by the theory of optimum currency areas (OCA), which was developed by Mundell (1961), McKinnon (1963) and Kenen (1969). Many refinements

of the theory of OCA, and the development of a more sophisticated formal verification of the optimality of many currency union (CU) experiences in the world, have allowed a deeper analysis and evaluation of such experiences. Using these perspectives, I propose in this study to develop a general framework to assess the preparedness of the GCC countries for CU, with special emphasis on whether it is in the national interest of Kuwait to participate in economic and monetary integration with the GCC.

Kuwait is pursuing its decision to join the GCC monetary union. Since Kuwait and the other GCC countries made this decision there has been much debate in evaluating it and predicting its effects at various levels. In this study, we are interested in investigating the opinions of Kuwaiti nationals about Kuwait's decision to join the monetary union.

1.2 OBJECTIVES OF THE STUDY

The main objective of the study is to investigate the economic benefits of monetary integration with the GCC from a Kuwaiti perspective. While the political aspects of joining the GCC monetary and currency union will be touched upon, our main focus will be on the economic effects. Using formal and informal criteria, we will try to answer the following questions:

1. Is Kuwait ready to join an optimum currency area (OCA)?
2. If so, what are the benefits and costs to Kuwait?
3. Would the state of Kuwait experience any internal or external disturbances?
4. What is the opinion of Kuwaiti nationals?
5. What would it cost Kuwait in respect of economic sovereignty?

This study will consider some of these questions in an attempt to suggest what may be in the best interests of Kuwait. Certain crucial policies and measures to ensure the success of GCC monetary union remain to be implemented prior to 2010. Fasano and Schaechtler (2003) compare conditions for creating a successful GCC monetary union

with those of other monetary unions already in existence (for example, the Euro Zone, the CFA Franc Zone). These authors emphasize the need to develop an institutional framework. A crucial step in the formation of a currency union is choosing an appropriate rate regime.

Currently the GCC countries are pegging their currencies to the dollar as a first step towards a monetary union. The dollar peg might have adverse effects on the stability of GCC imports and exports owing to the fluctuations in exchange rates between the GCC currencies and the major currencies other than the dollar. Therefore, there may be merit in pegging to a basket of currencies instead of pegging to a single currency. In this study we will examine alternative exchange rate pegs for the GCC monetary union, with a view to ensuring external stability and competitiveness.

1.3 BACKGROUND

Many authors have examined the different aspects of the costs and benefits of joining a currency union. Barro (2001) reviews the analysis based on the optimum currency area theory. The author finds that countries entering a monetary union benefit from improving trade in goods, services, and financial exchange. The advantage comes from adopting a single currency, eliminating transaction costs, reducing the cost of obtaining information on prices, and encouraging commerce. Barro explains that the disadvantage of a currency union is that it precludes the use of independent monetary policies by member countries. By entering into a monetary union, member countries will eliminate almost all barriers to trade freely amongst the union. This will provide a higher potential for trade, and more competition.

Because GCC economies depend largely on oil, Jadresic (2002) concludes in his discussion paper that GCC countries will enhance their economic efficiency and develop the region's non-oil economy by forming a monetary union. The author cautions that GCC monetary union should be looked at as one component of a much broader integration, and that therefore GCC countries should diversify from oil to non-oil economies. This means the removal of domestic and cross-border distortions, which

will increase intra-regional trade, investment and capital flow, and create higher market capitalization.

One of the key issues in entering a currency union is deciding the exchange rate regime to adopt. Abed, Erbas and Guerami (2003) look at the alternative exchange rate regimes for the GCC common currency, such as a dollar peg, or a dollar-euro basket peg. As the GCC countries' exports and external financial assets become more diversified, a more flexible exchange rate regime may be necessary for competitiveness and stability. In their conclusion, they found that a dollar peg will do as a well as a dollar-euro basket peg.

Looney's (2003) study presents an optimistic outlook for the landmark customs union and free trade zone among the member states. GCC countries would gain from the single currency, which would reduce transaction costs, reduce barriers, promote pricing transparency and consequently increase competition.

Laabas and Limam (2002) test whether the GCC countries are an optimum currency area. They conclude that the GCC countries have yet to fulfil the necessary preconditions for the establishment of a currency union based on the OCA criteria. In addition, they conclude that currency union can expand intra-industry trade among the GCC countries from its present state of weakness.

When a country joins a single currency and monetary union, it has to recognize that there are certain costs attached. One of the major costs is the loss of an independent monetary policy. Magdalenam and Mustafa (2001), members of staff of the Arab Bank, discuss the similarities between the economic and monetary union of the GCC unified currency agreement and the economic and monetary union of the European Monetary Union (EMU). The authors look at the EMU experience and raise two major issues that must be solved by the GCC countries before entering into a union. First is the transition itself from a nationally centred monetary system to a common system, and second is how to minimize the probability that an asymmetric shock will take place and how to maximize the new system's ability to absorb and neutralize such a shock.

Fasano and Iqbal (2002) point out that GCC monetary union would create an important regional entity with an estimated combined GDP of $335 billion, an average per capita income in nominal terms of $12,708, and 45% and 17% respectively of the world's oil and gas reserves. As we see from this review of literature, there have been many previous studies of monetary union. These include the costs and benefits of monetary union and economic integration, which have particular relevance to the present study.

My own experience as an investment manager with the Kuwait Investment Authority and as a foreign exchange and money market dealer with the Central Bank of Kuwait have particularly benefited me in the pursuit this study. The first-hand knowledge of finance and banking that I have gained through my work have provided an excellent basis for my research and have given me many invaluable contacts in the financial world of Kuwait. These contacts have been of great assistance in the qualitative aspects of the study.

1.4 STUDY METHODOLOGY

1. This study includes comprehensive statistical and empirical analysis of monetary, exchange rate and trade data.

2. Semi-structured interviews were undertaken with decision-makers in the Central Bank of Kuwait and relevant ministries, as well as with investments banks and private companies.

1.5 ORGANIZATION AND OUTLINE OF THE STUDY

Chapter 1 introduces the subject of the thesis.

Chapter 2 reviews the literature concerning issues related to this research. This chapter also surveys the various aspects of monetary, financial, and exchange rate cooperation, reflected in the expanding literature in theory and practice, in order to draw inferences for the prospects and challenges of greater monetary cooperation in the GCC. The

chapter discusses and identifies weaknesses in previous work and explains how this study fills the gaps in the literature.

Chapter 3 will review the exchange rate's development, and the foreign exchange market. Also in this chapter, we will explain how the foreign exchange market works. We will study both the direct and indirect currency quotation, followed by the behavior of exchange rates in the financial market. The chapter will include a discussion of the theory of purchasing power parity, and both covered and uncovered interest rate parity theories, in order to understand the determinants of exchange rate fluctuations. Then we will review the development of the Kuwaiti dinar and the choice of the exchange rate policy for the KD. The history of the KD and its value against the United States dollar and other world major currencies will also be analysed in this chapter.

Chapter 4 will review the development of the monetary system in Kuwait and the role of the Central Bank of Kuwait, including its responsibilities and objectives. We will consider how the Central Bank of Kuwait uses monetary tools to control inflation and liquidity. Since supervising the financial system in Kuwait is one of the bank's main purposes, we will review the Kuwaiti financial market, and how the bank controls and influences the level of borrowing in the financial sector.

Chapter 5 discusses Kuwait's external transactions, and looks at the country's exports, imports and invisible transactions such as the earnings of overseas investments. The chapter will investigate oil as the country's main trading commodity, and what is the country's main source of income, as well as the percentage of total revenues derive from oil. We investigate how Kuwait uses its oil revenues, and what is the trend of the country's investment activities when oil prices increase or decrease. We will investigate who are Kuwait's main trading partners, and where most of Kuwait's exports go. In addition, we will find out if the Kuwaiti dinar exchange rate policy has any affect on revenues.

Chapter 6 describes the methodology of using semi-structured interviews to discover the different opinions of Kuwaiti nationals regarding a monetary union. This chapter surveys include the literature on qualitative analysis, and particularly semi-structured interviews. It investigates the advantages and the disadvantages of this kind of

interview. The processes to carrying out semi-structured interviews and the selection process for the sample group will also be described here. Finally, this chapter will include an account of how to prepare a questionnaire which can be used in semi-structured interviews.

Chapter 7 is a continuation of Chapter 6. It includes the responses received during the semi-structured interviews in answer to questions on various subject, such as monetary policy, fiscal policy, trade, investment, the labour market, and other general issues. The qualitative data collected from our sample group provides a broad picture of the costs and benefits to Kuwait of joining the GCC monetary union.

Chapter 8 analyses Kuwait's monetary and fiscal policies on the basis of the economic convergence criteria set by the GCC council. It also considers whether the State of Kuwait is ready to join the GCC single monetary union.

Chapter 9 provides concluding remarks. Other studies on the subject of monetary integration have not focused on Kuwait and have not used a qualitative approach to their research topic. We therefore expect this thesis to offer a unique contribution to the study of economic and monetary integration in general and of the State of Kuwait's perspective on such integration in particular.

Chapter 2 LITERATURE REVIEW

2.1 INTRODUCTION

After the Second World War, the number of independent countries in the world increased considerably, and most of them adopted a currency of their own. But there are only a few major currencies, namely, the US dollar, the euro, British sterling, the Japanese yen and the Swiss franc, which are the currencies mainly used for trading. Some currencies are hardly traded in at all on the financial markets, either because they are not stable or they are the currencies of non-industrial or politically unstable countries.

If we look at the countries with what are called major currencies, we will realize that most of them are industrialized, and have goods or services to trade. Some countries have a large financial market, which takes care of most of the world's daily transactions. Countries with political and economic stability have an advantage over those that do not.

Owing to various factors affecting the value or stability of their own currencies, some small countries use another country's currency. Some African countries use the French franc as a local currency even though they have their own currency, and some Caribbean islands use the US dollar because of its stability and value.

As a result of globalization people nowadays are more connected with each other across the world than they used to be, and trade is easier. If we look at the GCC countries as an example, we can see that most of their trade is priced in dollars, pounds and euros, even though these countries are oil producers. However, they are still not industrialized countries, despite their oil and some light industries. Consequently they have to use the major currencies to execute transactions abroad.

Since countries trade between each other to import or export goods and services, and exports are a major component of their balance sheets, they have to deal with different currencies and take some risks by having other currencies in their accounts to meet their commitments towards other countries. Also, transaction costs and currency fluctuations are major issues that countries have to face in trading with other countries. Therefore most industrial and export-based countries try to have currency price competitiveness, so as to increase their export level and enhance employment, investment and income.

In this chapter we will try to answer the following questions. Why was the international monetary system was created? What are the different exchange rate regimes? What is monetary union and economic integration? What are the different monetary unions? Have all created monetary unions succeeded? What does the literature tell us about issues relating to economic integration and to the GCC in particular?

2.2 THE INTERNATIONAL MONETARY SYSTEM

Before going through the history of the International Monetary System, we would like to discuss why there was a need to establish such a system. Historically, there was a need to establish an International Monetary System to govern and organize trade between different countries. Trading is one of any country's major activities, and countries trade between each other to fulfil their needs and meet the local demand for products. Each country has its own currency, and countries need to value their currencies against other currencies for the purpose of exchange.

International trade among countries is part of the business of daily life. People from different parts of the world use products that they cannot produce or provide themselves. International trade requires the use of different currencies. Countries produce different kinds of products at different costs. Each country will benefit from the cost reduction that other countries may offer on the products it needs. So, if a country can only produce a particular product at a higher cost than another country can sell it, then it is better off importing it.

International trade involves the buyer and the seller in a transaction, and some sort of payment has to take place. That is why there is a need to create a system that will deal with this aspect of the business. In the following paragraphs we will explore the International Monetary System and the exchange rate regimes.

The International Monetary System was created to facilitate transactions among nations, and is used where international transactions such as the import and export of goods and services can take place. It is important that we discuss the principal of the International Monetary System that has been developed by the nations over the past decades, and the stages it has gone through from the time of the Gold Standard until the present. The International Monetary System has evolved through different periods, and has reflected the economic situation and needs of the time.

We will review the history of the International Monetary System starting from the International Gold Standard 1879 until the creation of the European Monetary System on 1999. To review and analyze the history of the International Monetary System we will use the organized sequence that is described by Richard M. Levich (2001), who extended the work done by Ronald McKinnon (1993). McKinnon defined seven different eras, but Levich included the European Monetary System as the eighth.

2.3 THE INTERNATIONAL GOLD STANDARD, 1879–1913

During the period of the gold standard, most countries had their currencies converted to gold and used the gold standard system. Until then gold was used to convert currencies. But after World War I (1914–18), some European countries allowed their currencies to be exchanged for gold or any other currency.

The gold standard system is based on the ‘mint parity’, where countries would fix their currency in terms of gold ounces. Using the gold standard would allow countries and nationals to exchange currencies by converting from gold to another currency. Central banks, on the other hand, linked their currencies to gold. The rules that were set during the gold standard are as follows (Levich, 2001):

I. Fix an official gold price or 'mint parity' and allow free convertibility between domestic money and gold at that price.

II. Impose no restrictions on the import or export of gold by private citizens, or on the use of gold for international transactions.

III. Issue national currency and coins only with gold backing, and link the growth in national bank deposits to availability of national gold reserves.

IV. In the event of a short-run liquidity crisis associated with gold outflows, the central bank should lend freely to domestic banks at higher interest (Bagehot's Rule).

V. If rule I is ever temporarily suspended, restore convertibility at the original mint parity as soon as practical.

VI. As a result of these practices, the worldwide price level will be endogenously determined on the basis of the overall world demand and supply of gold.

During the gold standard era monetarists from different parts of the world used the same exchange rate regimes and the value of currencies were set in terms of gold. Most central banks adopted the gold standard arrangement to value their local currencies, which helped prices to stabilize. Exchange rate fluctuation between countries was less sensitive, and currency issuance had to be backed with gold to prevent inflation. Gold was the only definite value for currencies, and countries freely exported and imported goods with no restrictions. The downside of the gold standard system was the lack of liquidity, which was linked to the availability of the supply of gold, with the result that prices of goods were tied directly to the supply of gold. Consequently the system of the gold standard broke down by 1914 and was replaced by the Bretton Woods Agreement, which we will discuss in the next section.

Because most central banks were using the same monetary policy during the gold standard, exchange rates were stable, and prices of goods did not differ much from one country to another.

2.4 THE BRETTON WOODS AGREEMENT, 1945

The collapse of the gold standard introduced a new system which became known as the Bretton Woods Agreement after a meeting held at the Bretton Woods Resort in New Hampshire, at which a new set of rules was adopted by the International Monetary Fund (IMF). These rules allowed currencies to fluctuate within a very narrow band of 1 per cent in the short-run. Below are the rules for the Bretton Woods Agreement (Levich, 2001):

I. Fix an official par value for domestic currency in terms of gold or a currency tied to gold.

II. In the short run, keep the exchange rate pegged within 1 per cent of its par value, but in the long run leave open the option to adjust the par value unilaterally if the IMF concurs.

III. Permit free convertibility of currencies for current account transactions, but use capital controls to limit currency speculation.

IV. Offset short-run balance of payments imbalances by use of official reserves and IMF credits, and sterilize the impact of exchange market interventions on the domestic supply.

V. Permit national macroeconomic autonomy: each member pursues its own price level and employment objectives.

The Bretton Woods agreement allowed countries to set their currency's value by pegging it against gold or another numeraire currency. So countries were allowed to peg their currencies to another currency of their choice or to gold. During the Bretton Woods era countries had more flexibility to set their own economic agendas than during the gold standard era. Prices were different among countries owing to the different exchange rate systems adopted by each country. Even though countries had their own macroeconomic agendas, they still used capital controls to impose limits on speculation on currencies, and to maintain the target exchange rate parity.

The IMF was created with the aim of stabilizing exchange rates throughout the world, and supported the Bretton Woods system. The IMF has at some stages helped countries to stabilize their currencies by short-term borrowing. The international reserve with the IMF allows any cyclical or seasonal imbalance to be redressed. The Bretton Woods system was operated by most countries around the globe until the 1950s, when another system was introduced which was called the fixed-rate dollar standard.

2.5 THE FIXED-RATE DOLLAR STANDARD, 1950–1970

The fixed exchange dollar standard was adopted by most countries except the United States. Countries pegged their currency value against US dollars. Capital controls were also used to prevent the fluctuation of the currency. Industrialized countries kept their exchange rates fixed for quite some time during this period. In addition, they found it convenient to rely on the United States. Industrialized countries and the United States both had their own sets of rules during this period, which were as follows (Levich, 2001).

*Industrialized countries other than the United States***:**

I. Fix an official par value for domestic currency in terms of the US dollar, and keep the exchange rate within 1 per cent of this par value indefinitely.

II. Permit free convertibility of currencies for current account transactions; use capital controls to insulate domestic financial markets, but begin liberalization.

III. Use the US dollar as the intervention currency and keep official reserves in US Treasury bonds.

IV. Elevate the importance of maintaining the fixed exchange rate; make domestic monetary policy subordinate to this target as well as to the price level of traded goods in the United States.

V. Limit current account imbalances by adjusting national fiscal policy (government expenditures minus tax revenues) to offset imbalances between private savings and investment.

United States:

VI. Remain passive in the foreign exchange markets; practice free trade without a balance of payments or exchange rate target.

VII. Keep US capital markets open for borrowing and investing by private residents and foreign sovereigns.

VIII. Maintain an international creditor's position in dollar denominated assets, and limit fiscal deficits.

IX. Pursue an independent monetary policy that establishes a stable price level for tradable goods. (Levich, 2001)

Other countries fixed their exchange rates against the US dollar, and the United States had to accept this rate in return, which put the US in what is called a 'redundancy problem'. This arose as a result of several countries adopting the dollar fixed exchange rate. Most countries used the fixed-rate dollar standard during the 1950s, because they relied on the United States to provide prices stability and wanted access to the US financial market.

Countries continued to use the fixed-rate dollar standard, and then Europe introduced the Marshal Plan payments union, according to which the US dollar was used as a unit of account and means of settling payments. Japan introduced the Dodge Plan, which also used the US dollar as a basis for price stability. Both regions were using a US dollar based currency, and were not encouraging any minor changes which might result in movements of capital.

During the 1950s many countries continued to accumulate US dollar reserves, and invest in US dollar interest-bearing notes, which drove US liabilities very high. These countries thought that building a dollar reserve during the 1950s would not be harmful, as long as market participants were able to gain interest on US financial assets rather than accumulate gold reserves which bore no interest. In addition, during the 1960s Europe and Japan had concerns about movements of capital, and therefore did not welcome any changes in exchange rates.

In 1960s Robert Triffin pointed out that if the United States continued to dominate the world reserves and other countries continued to purchase the US dollars notes, the US would at some point reach a very high level of liability, which might be even greater than its gold reserves. Thus foreign investors could put the US in what was called at that time the 'Triffin dilemma'. The United States faced economic changes during the 1960s owing to its expansion, and the acceleration of US inflation which had been brought about by the Vietnam War. Inflationary pressure made the United States drop its commitments to Rule IX, which required the US to stabilize prices on tradable goods. This act opened the window for other countries to violate the agreed rules.

The beginning of the 1970s was the end of the fixed dollar standard, owing to world economic changes at that time, the United States' abandonment of its commitment to control tradable goods, the decision made by some industrial countries, such as the United Kingdom and Canada, to allow their currencies to float in the market to find their equilibrium, and the devaluation of the US dollar, announced by President Richard Nixon, from $35 to $45 per ounce of gold. This opened the way for the new exchange rate system to develop which is the floating-rate dollar standard.

2.6 THE FLOATING-RATE DOLLAR STANDARD, 1973–

The collapse of the fixed dollar exchange rate regimes did not prevent the US dollar from continuing to dominate most of the world's transactions. Currencies were still quoted in US dollar terms, most commodities were also priced in dollars, and countries still used the US dollar as a base currency for most of their transactions on the international markets. US dollars continued to be the most valuable currency for other countries to use its store value and unit of account. At the same time, financial transactions in the offshore market continued to be traded in US dollars.

The floating-rate dollar standard was introduced but still did not change the fact that monetarist economists still looked at the exchange rate value as one of the most important tools for giving encouragement to economies. And exchange rate regimes were still used as a tool to stabilize economies and prevent inflation. For this reason

monetarists allowed currencies to float freely on financial markets because of the importance of the currency value to the economy.

The IMF recognized the importance of the exchange rate regimes to any economy. It therefore stepped in and produced a set of rules that would prevent economies from being affected by currency fluctuation. This set of rules, which is still in effect, is as follows:

I. Countries have an obligation to intervene to prevent "disorderly conditions" in the foreign exchange market.

II. They should avoid manipulating exchange rates to prevent balance of payments adjustment or gain an unfair competitive advantage in trade.

III. They should take into account the interests and policies of other members when setting their own intervention policies. (Levich, 2001)

These guidelines ensured that countries maintained a certain consistency of exchange rate for their currencies, and intervened in the market in order to do so. Countries were not allowed to take advantage of other participants in the market to make gains by currency manipulation, and were obliged to protect other currencies and investors.

These rules required countries to choose whether to fix or float their currencies, according to what was feasible for their economies. Also, countries had no obligation to set their exchange rates on the basis of gold, and the official price of gold was abolished. The IMF had the power to step in when it felt that a particular country was breaking the rules by influencing the exchange rate in the financial markets, and could impose another exchange rate policy.

Different countries adopted fixed or floating exchange rate policies. Fixed exchange rate regimes involved fixing a currency to that of one of the major industrial countries on the basis of the level of trade enjoyed with that country. A fixed exchange rate had to be maintained on a daily basis. Particular central banks had to intervene every day in the financial market to maintain the exchange rate set for the currency it represented.

Some countries adopted fixed exchange rate regimes because they wanted to stabilize their economies, and currency fluctuation as a result of pegged exchange rate regimes was almost abolished. On the other hand the central banks had to maintain the cost of intervention on the financial market to keep the exchange rate within its price targets.

Where a floating exchange rate is adopted, a central bank will choose one that is determined according to market forces. Most industrialized countries would prefer a floating exchange rate regime, and use some economic indicators to watch their currency value. Central banks with floating exchange rate regimes have no commitments to intervene on the financial markets. The value of the country's currency is usually set at a target rate, and intervention is sometimes used to move the currency value towards the target rate.

2.7 MONETARY UNION AND ECONOMIC INTEGRATION

As the above discussion makes clear, exchange rate arrangements went through different stages, and over the past decades different types of exchange rate regimes have been developed. But most of these aimed to stabilize the currencies and protect the countries' economies from speculators. Thus a new monetary system was introduced which was called monetary union. Moreover, countries worked towards what was called economic integration.

We will first define a monetary union, and then look at economic integration in order to show the differences between them. A monetary union is formed when two or more countries join together to agree to use the same set of monetary tools and policies, and have a single unified currency with an agreed fixed price, which will replace their old national currencies. Countries joining a monetary union will have to abolish their national monetary independence in favour of the union monetary policy.

In a monetary union member countries have to adopt a single currency, single exchange rate, and single monetary policy. A monetary union involves full financial market integration, with no restrictions. This means that member countries will be able to move

funds freely between them. A single currency and financial market integration are the main two requirements of a monetary union. Without them it would not exist.

Historically there have been other monetary unions, some of established in Europe has existed for quite some time, and every now and then new members join.

Xavier de Vanssay (1999), in his working paper 'Monetary Unions, Historical Perspective' discusses two real examples of monetary unions. He cites the German monetary union as one which succeeded, and the Scandinavian monetary union as one which did not. De Vanssay suggests three basic minimum requirements for a monetary union to be established. First, a single currency must be issued or a fixed exchange rate set for converting one currency to another. Second, within the union there must be some sort of regulation regarding the level of money held by commercial banks. Finally, there has to be control over the international reserve within the union.

In addition, de Vanssay summarizes the studies into monetary unions in the nineteenth and the twentieth century's. He notes that different models have been tried, with different institutional arrangements, and different minimum standards required of the member countries. The author includes three possible scenarios. First, a monetary union could have a supra-national union-wide currency, as the Euro Monetary Union (EMU) does. Another possibility is a national union-wide currency, as is the case with Switzerland and Liechtenstein, where both countries use the Swiss franc and the Swiss National Bank is their monetary authority. The third option is to have a fixed exchange rate between the member countries, which nevertheless maintain their own central banks. Such is the case of Belgium and Luxembourg, which have had a fixed exchange rate for quite some time.

De Vannsay examines the history of some monetary unions. The United States and Panama have the oldest monetary union, which dates back to 1904, when Panama chose to fix its currency (the balboa) to the US dollar. In Panama they used the US dollar as the official currency, and it represents the larger share of the money in circulation. The monetary union between Belgium and Luxembourg began as an economic union and then developed into a monetary union. The Belgian Central Bank has control of the monetary policy of both countries, and the arrangement has worked as well as it could, except when the Belgian Central Bank devalued its currency against the Luxembourg

franc. Although the Luxembourg Central Bank was created later on, monetary policy is still with the Belgian Central Bank.

In the Communauté Financière Africaine (CFA) franc zone six African countries have adopted a fixed exchange rate against the French franc. In this case the countries already had a monetary union before they decided to form an economic union.

These are some examples of successful monetary unions that have been created in the past. The most recent one is the European Monetary Union, which started with eleven member countries in 1993 but since then has gained five more which have adopted the euro as their currency.

Table 2.1 Successful Monetary Unions

Monetary union	Single multiple currencies	Money supply under control of	Money restrained by
Belgium/Luxembourg	Multiple	Belgium	Belgium
CFA Franc Zone (14 countries)	Single	Multinational banks	France
EMU (11 countries)	Single	ESCB	ESCB
France/Monaco/Andorra	Single	France	France
Italy/San Marino/Vatican	Multiple	Italy/Vatican	Italy
Switzerland/Liechtenstein	Single	Switzerland	Switzerland
US/Liberia	Single	United States	United States
US/Panama	Single	United States	United States
West Germany/East	Single	(West) Germany	(West) Germany
Zollverein	Multiple	National banks	Prussia

Source: Adopted from Xavier de Vanssay, adapted from Graboyes (1990)

The above monetary unions have led de Vanssay to conclude that German monetary unification and Scandinavian monetary unification are different from each other. German monetary unification was established as a result of political and economic unification, whereas the Scandinavian was not.

German monetary unification was established slowly, and was followed by the customs unions led by Prussia. German monetary unification took place before the final political unification. De Vanssay points out that in both German and European monetary unions a customs union was an important step towards monetary and economic integration. Regarding the Scandinavian monetary unification, de Vanssay found that monetary unification requires the establishment of a supra-national central bank to act in the interests of both countries. But that was not the case for the Scandinavian monetary union, in which each country tried its own tools and acted separately. Eventually, after lasting for almost forty years, the Scandinavian monetary union began to disintegrate, which makes it difficult to predict if the European Monetary Union or any other will last forever.

Economic integration is another term we need to consider. It has been defined as the removal of all the trade barriers and the free movement of production between member states. Economic integration should lead to monetary stability, the survival of some sectors, and assistance to underdeveloped regions within the integration. The Treaty of Rome (1957) laid down the framework for economic integration between the European countries which were signatories. and the main objectives of the signatories to the Treaty of Rome were:

1. To ensure the economic and social progress of their countries and to take common action to eliminate the barriers which divide Europe.

2. To strengthen the unity of their economies and to ensure their harmonious development by reducing the differences existing between the various regions and the backwardness of the less-favoured regions.

3. To pool their resources to preserve and strengthen peace and liberty, and call upon the other peoples of Europe who share their ideal to join in their efforts (Hansen, 2001).

There are three important economic integrations which have taken place in history: the General Agreement on Tariffs and Trade, the Organization for European Economic Cooperation, and the European Payments Union.

1947 witnessed the first initiative of the General Agreement on Tariffs and Trade (GATT). The main purpose of GATT was to reduce tariffs between industrialized countries, including countries beyond Europe. GATT eventually became the World Trade Organization (WTO), which continued with the same aim of reducing tariffs on trade between countries.

1948 saw another similar initiative – the establishment of the Organization for European Economic Cooperation (OEEC), which organizes financial help for European countries under the Marshall plan. The OEEC succeeded in effecting the removal of trade barriers among member countries by granting loans to the member countries and imposing reductions on trade barriers in the region. The global Organization for Economic Cooperation and Development (OECD) approved the OEEC for the successes it achieved. Another step was taken with the introduction of the European Payments Union (EPU) in 1950. The Europeans introduced the EPU to secure the convertibility of foreign currencies by the member states within Europe.

If we consider all the above organizations or economic integration agreements, they all aim to ease trade transactions by removing all trade barriers and developing stable trade tariffs between countries. Economic integration in Europe has focused on the free movement of goods and services within the union. The Treaty of Rome ensures the creation of a market with no barriers. The purpose of the Amsterdam Treaty is to provide an area without internal frontiers in which the free movement of goods, services, persons and capital is ensured (Article 14). The creation of markets without any barriers in Europe has increased trade between the member countries. Free movement of goods and services within the European states has increased competition in Europe. Firms have restructured their products and improved the quality of goods or services. Economic integration in Europe has increased the accessibility of products to consumers in Europe, and led to a more innovative economy.

European economic integration has also focused on the agricultural sector with the Common Agricultural Policy (CAP). The CAP ensures price competition and regulation

in the food sector, while a competition policy has been introduced to control the level of competition among competitors.

Monetary policy and exchange rates within the union are important components of economic integration. Since its establishment in 1979, the European Monetary Union has successfully worked towards the stabilization of exchange rates within the union.

Free movement of capital and a single currency reduces the interest differentials between members. But although there are some gains from joining a monetary integration, it can, however, be difficult sometimes to adopt the monetary policies of the central bank, which may not provide adequate solutions for each country.

2.8 OPTIMUM CURRENCY AREAS AND MONETARY UNION

The optimum currency area model was introduced by the Nobel prize winner Robert Mundell (1961). By means of this theory he shows how a single currency can benefit a number of countries, but also explains the costs those countries may have to bear. The theory of optimum currency areas shows how a country can adopt exchange rate regimes and explains the likely costs and benefits**.**

Mundell analyses both fixed and floating exchange rate regimes and the costs and benefits of each. He recommends a system of national currencies connected with a flexible exchange rate, which, for a country with an external balance deficit, will allow depreciation to reduce unemployment and appreciation to eliminate inflationary pressure. He argues that countries joining a single monetary and currency union should allow their currencies to fluctuate or create a single currency area for their national currencies.

I. Currency Areas and Common Currencies

Two or more countries are unified when they give up their national currencies to adopt a single currency and create a single central bank that controls the issue of currency and the supply of money. An interregional central bank will influence the member countries'

central banks, which will not have the right to expand their liabilities beyond those of other central banks within the union. Thus central banks within the union will make their own different adjustments within the union. Mundell explains his view as follows:

> Consider a simple model of two entities (regions or countries), initially in full employment and balance-of-payments equilibrium, and see what happens when this equilibrium is disturbed by a shift of demand from the goods of entity B to the goods of entity A. Assume that money wages and prices cannot be reduced in the short run without causing unemployment, and that monetary authorities act to prevent inflation. Suppose first that the entities are countries with national currencies. The shift of demand from B to A causes unemployment in B and inflationary pressure in A, to the extent that prices are allowed to rise in A. The change in the terms of trade will relieve B of some of the burden of adjustment. But if A tightens credit restrictions to prevent prices from rising, all the burden of adjustment is thrust onto B. What is needed is a reduction in B's real income, and if this cannot be effected by a change in the terms of trade – because B cannot lower, and A will not raise, prices – it must be accomplished by a decline in B's output and employment. The policy of surplus countries in restraining prices therefore imparts a recessive tendency to the world economy fixed exchange rates or to a currency area with many separate currencies. (Mundell 1961, p. 658)

Mundell argues that in the world of national currencies, where each country has its own national currency, a country with a deficit balance account would raise the level of employment by the willingness of other countries with a surplus account balance to accommodate some level of inflation. On the other hand, in a currency union where national currencies are fixed to a single currency, inflation is controlled by the region's central bank, and the central bank's policy allows some unemployment in countries with a deficit account.

Therefore where there are two exchange rate regimes, unemployment and inflation can be controlled by a currency's relation to other national currencies, but if a region has adopted a single currency, inflation and unemployment cannot be controlled.

II. National Currencies and Flexible Exchange Rates

Flexible exchange rates, as we discussed before, have certain advantages and disadvantages. Countries with their own national currencies have to pay the cost of allowing their currencies to appreciate or depreciate. Mundell argues that in the case of flexible exchange rate regimes, "if demand shifts from the products of country B to the products of country A, a depreciation by country B or an appreciation by country A would correct the external imbalance and also relieve unemployment in country B and restrain inflation in country A" (Mundell, 1961: 659). In both countries either unemployment or inflation can be prevented but always at the cost of the other. Therefore where countries have their own national currencies, central banks can prevent unemployment by increasing the money supply, but that will create inflationary pressure.

Mundell concludes his argument about flexible exchange rate regimes in two different parts. The first part explains how effectively and efficiently the system of a flexible exchange rate can work in a modern world economy. His view is that for a flexible exchange rate to work the following conditions must apply:

> 1) making allowances for speculative demands, a currency must be stable to some extent; 2) small changes in the exchange rate may be necessary to eliminate normal disturbance to dynamic equilibrium; 3) exchange rate risk can be minimized by some cost in the forward market; 4) the central bank must refrain from monopolistic speculation; 5) monetary discipline will be maintained despite the unfavourable political consequences of continuing depreciation; 6) reasonable protection of debtors and creditors can be assured to maintain an increasing flow of long-term capital movements; 7) wages and profit are not tied to the price index in which import goods are heavily weighted. (Mundell,1961: 663)

The second part of the Mundell's argument concerns how the world can be divided into different currency areas. Flexible exchange rate system stabilization can be achieved only if there are different currency regions within each of which there is factor mobility and between which there is factor immobility. There should be different currencies for

each region, and exchange rate changes should be relative to all the different regions. But in a region where national sovereignty is being given up it is not feasible to require that currencies should be re-organized. Therefore the validity of the argument Mundell makes for a flexible exchange rate regime hinges on the closeness with which nations correspond to regions. He then argues that the system works best if a region has internal factor mobility and external factor immobility. If there is no capital and labour mobility within a region, the flexibility of the external price of the national currency cannot be expected to perform the stabilization function attributed to it, and different rates of unemployment and inflation can be expected.

Countries will have their own reasons for joining a monetary union, and have to assess the costs or benefits of joining or not joining. As we saw in the above discussion, having an exchange rate regime would have both advantages and disadvantages, depending on a country's macroeconomic distribution, and on its monetary tools and exchange rate system for maintaining economic stability and currency stability.

Ronald McKinnon (1963) adopted Mundell's theory of optimum currency areas and the importance of certain economic characteristics for determining such areas. But McKinnon introduced the idea of an optimality ratio of tradable goods and non-tradable goods as a means of reconciling price level stability. If a country's economy is open to other countries, a fixed exchange rate regime may be advantageous. McKinnon concludes that in a world without a stable trade pattern, there is always a problem in preserving an external balance, full employment, and sufficient resource use. He adds that factor immobility among industries is a painful fact of economic life, which must be overcome as efficiently as possible.

Kenen (1969) also makes a major contribution to the theory of optimum currency areas. He looks at factor mobility, and considers what it requires for interregional occupational mobility. The point Kenen makes is that factor mobility is necessary to restore the balance of payments. He also introduces 'product diversification' as a criterion for adopting a single currency. He does not believe that factor mobility can be achieved, and thinks that product diversity is more significant than factor mobility. Therefore he believes that a country should have well diversified products, because decline in demand for a single product will affect the currency. A country with a single product

will run a greater risk than one with many products that external factors will affect its economy. Therefore he concludes that a country with a diversity of products will have greater advantage in joining a single currency union than a country with a single product.

Mundell, McKinnon and Kenen are the authors who contribute most to the theory of optimum currency areas. Now we will review the literature on the topic of optimum currency areas.

The theory of optimum currency areas was introduced in the early sixties by Mundell, and followed by the tremendous work of McKinnon and Kenen in the later sixties. There was not much work in the field of optimum currency areas theory during the eighties. When, at the beginning of the nineties, the European Union economic and monetary integration took place, and work was done on this subject, the theory of optimum currency areas was reviewed and looked at for that purpose.

Herbert G. Grubel (1970) extends the theory of optimum currency areas, aims to clarify the nature of the institutional changes required for a currency area formation, and viewed the relationships between welfare and currency area formation. Further, he develops an analytical framework for this purpose, which can also be used in the choice of optimum free trade areas and common markets.

I. Maes (1992) analyses the work that had been carried by Mundell, McKinnon, and Kenen. In addition, he considers new developments in the processes of European monetary integration, giving particular attention to both the relevance and the limitation of the theory of optimum currency areas for understanding the actual process of monetary integration in Europe. The work focuses on the economic mechanism at play, the required transfer of sovereignty from the member countries to the central authority within the union. Countries entering a monetary integration lose their responsibilities in the field of monetary and exchange rate policy, which has an impact at the political level.

The worked done by Maes concludes that the theory of optimum currency areas, debated by Mundell, McKinnon, and Kenen, can be looked at on the basis of fixed-versus-flexible exchange rate policies in the postwar period. Mundell defines an

optimum currency area based on the factor of mobility, which may cause a problem for the European monetary union, since labour mobility in Europe is low. But after the creation of the European financial area and several measures which stimulate the free movement of people across countries and so help to increase production, Europe has become more suitable as an optimum currency area. At the same time McKinnon argues that in small open economies devaluation will do little to correct an imbalance of payments, and would damage price stability. Kenen, on the other hand, focuses on the nature of external shocks. He argues that a high level of product diversity diminishes the need for exchange rate flexibility, as product specific shocks would average out. Maes concludes that the theory of optimum currency areas should focus on the exchange rate policy in the framework of macroeconomic policy, and on the cost to each country of giving up control over its exchange rate policy.

A currency exchange rate is one of the monetary tools that central banks use to stabilize a country's economy, and therefore it is one of the disadvantages for a country joining a monetary integration. Countries within a monetary union may have different economic structures, and consequently, as we have seen from the literature already discussed, a common exchange rate policy will impact on their economies in different ways.

Jurgen von Hagen and Manfred J. Neuman (1994) raise the question of whether Europe was ready for a monetary union. Manfred compares the conditional variance and the persistence of real exchange rate shocks within the monetary union between Germany and eight European countries to evaluate the viability of a monetary union in Europe. The author mentions that, on the basis of the optimum currency areas theory which was introduced by Mundell (1961), McKinnon (1963) and Kenen (1969), it is possible to identify a set of criteria – such as factor mobility, trade integration and regional production patterns – to help the region decide if it is ready for monetary union. Vaunle (1976), however, suggests that a country could use the empirical variance of RER (real exchange rate) rather than the magnitude of potential sources of RER variance to assess a country's readiness to join a monetary union. The empirical results have shown that on real exchange rates a Europe of two speeds is in evidence, in which Germany, Austria, Belgium, France, Luxembourg and the Netherlands are ready for a monetary union, while other countries should join after having attained a comparable degree of exchange rate variability.

Barry Eichengreen and Tamim Bayoumi (1996) have developed a procedure for using the main implications of the theory of optimum currency areas for cross-country data. The empirical results show that there is a strong relationship between the characteristics of countries to which OCA theory points, and that the pragmatic behavior of exchange rates looks stable enough to support a simple forecast. The authors' main focus is to operationalize the theory of optimum currency areas by constructing an OCA index based on a specification that measures the degree of each country's readiness for EMU. They show that the European countries are divided into three groups: those exhibiting a high level of readiness, those with a tendency to converge, and those in which little or no convergence is evident. According to their estimates, a country like France does not show the structural characteristics and cyclical performance that are consistent with a high level of bilateral exchange rate stability vis-à-vis Germany based on the OCA index, or with an easy transition to monetary union. However, political reasons rather than economic ones may influence France's decision.

Luca A. Ricci (1997) uses the optimum currency areas theory to investigate the status under which a country can participate in a currency area. He proposes a two-country model to investigate the arrangements under which it is beneficial to join a currency union, and uses both the real and the monetary arguments used by the theory of optimum currency areas. The benefits a country can gain from joining a currency union depend on the level of international mobility, the degree of adjustment provided by fiscal tools, the difference between the inflationary bias of domestic authority and the inflationary bias of the authority of the currency union, the variability of domestic monetary stocks, and the extent of a net benefit decrease with the variability of real shocks. In addition, the study points out that the main effect of the degree of openness on the net benefits is ambiguous, but that the more open economies make better candidates for joining a monetary union.

Frankel and Rose (1998) examine the endogeneity of the optimum currency area criteria. They also assess the costs and benefits of joining the European Monetary Union and investigate the relationship between the two. Joining a monetary union can enhance international trade between member countries and reduce transaction costs. But there are also costs of joining a currency union. There is a possibility of dampening business cycle fluctuation through an independent counter-cyclical monetary policy.

Countries with a symmetrical cycle are more likely to be attracted to joining a monetary union. Frankel and Rose examined thirty years' worth of data from twenty industrialized countries. From a theoretical viewpoint, the effect of increased trade integration on business cycle activity between countries is not clear. On the other hand, reduced trade barriers between member states can result in increased industrial specialization in any one country, and consequently more asynchronous business cycles following shocks in demand and intra-industry trade. The authors' empirical results indicate that greater international trade linkage would result in more closely correlated business cycles, and make the establishment of the European Monetary Union more desirable. In addition, an optimum currency area would increase trade integration and hence the business cycle symmetry.

Robert Lafrance and Pierre St-Amant (1999) have reviewed recent literature on optimum currency areas. They look at theoretical developments in the context of general equilibrium models and the endogeneity of OCA criteria, the role of exchange rate flexibility in promoting greater macroeconomic stability, and the links between productivity. They also add new ideas to the basic concept of the traditional OCA literature. Both flexible exchange rates and monetary unions are considered, but not the intermediate regimes. As a result of developments in the 1990s, including a financial crisis in some emerging markets, it appears that fixed and quasi-fixed exchange rates are unlikely to be sustainable in a world of large volatile capital flows. In conclusion, the authors have summarized the ways in which several recent authors have extended the literature on optimum currency areas. Erkel-Rousse and Mélitz (1995), for example, develop Mundell's (1961) understanding of the role of shock in asymmetries in the presence of nominal rigidities, which he formalizes in a general equilibrium model. Other recent studies have focused on the role of financial markets' completeness in determining optimal currency areas. In addition, other studies look at the asymmetry of shocks and business cycles between various regions or countries, and the mechanisms compensating for the absence of nominal exchange rates adjustments in a monetary union. Some studies have identified labour mobility as an essential adjustment mechanism in a monetary union.

IMF staff Paul Masson and Catherine Pattilo (2001) discuss whether a West African monetary union (consisting either of non-CFA members, or all ECOWS countries)

would be a valuable "agency of restraint". Their study shows how monetary union would affect members' fiscal discipline, and, using literature about the European Monetary Union, considers whether the CFA would have the same experience. The authors conclude that the literature on the EMU experience suggests that a CFA monetary union may generate inducements for fiscal profligacy because of the bailout prospect, with costs spread among member countries. In addition, the empirical results for CFA show that monetary union may create fiscal discipline only if the fiscal authority of the union imposes a strong set of rules for fiscal restraint.

Anssi Rantala (2001) considers the question of whether monetary union can reduce unemployment. The author uses a two-country model of a monetary union with an open economy to investigate the macroeconomic consequences of establishing such a union. His conclusion is that monetary union influences the trade-off between real consumer wages and employment. As a result, employment equilibrium is linked to the union monetary regime. The author also points out that choosing an exchange rate regime would, assuming the central bank to be conservative, also enhance employment, since the union would impose a fixed exchange rate regime on member countries.

Alberto Alesina, Robert J. Barro and Silvana Tenreyro (2002) discuss the recent developments in currency unions and explore the costs and benefits for the different regions of adopting either the dollar, the euro or the yen as an anchor. They also focus on how trade and co-movements of outputs and prices would respond to the formation of currency areas. Their work analyses the work already done by Mundell (1961), and extends the work of Alesina, Barro and Tenreyro (2002). The main focus of their papers is to assess whether natural currency areas emerge from an empirical investigation, and develop a framework for examining the trade-off between costs and benefits of currency unions. The authors conclude that there are reasonably well-defined dollar and euro areas but not a yen area. Moreover, a country's decision to join a monetary union should not be based on ex-ante, but should consider post-ante under a monetary autonomy, allowing, however, for the economic effects of currency union. The study also shows that currency unions tend to increase the co-movement of prices but are not systematically related to the co-movement of outputs. Historical data on inflation, trade and co-movements of prices and outputs suggest that the test of trade patterns and co-

movements that existed before the adoption of a common currency would underestimate the potential benefits of joining a currency union.

Andrew K. Rose and Charles Engel (2002) use the criteria Mundell introduced to characterize the integration patterns of international currency unions (such as the CFA Franc Zone) to empirically explore the different features of currency unions, and compare them to countries with sovereign monies. Their approach is to ask whether currency unions exhibit the type of economic integration that Mundell (1961) viewed as optimum currency areas. Rose and Engel measure a number of economic characteristics for international monetary unions, international political unions, and other countries. Their empirical results show that countries who are member of currency unions tend to have more trade, less volatility on exchange rates, and more synchronized business cycles than countries with their own national currencies. Some countries are well integrated, and may transform themselves into a currency union. Finally, the authors find that most of the existing currency unions consist of small and poor countries, and most convert to dollarization.

Philippe de Lombaerde (2002) analyses the process of monetary integration achieved on a gradual basis, and the idea of monetary union between a number of countries, and considers Kenen's thesis about inter-industry labour mobility for a given structural industry. He also considers whether Mundell's and Kenen's OCA theory is fully applicable in a case where a number countries are characterized by divergent industrial development patterns. He considers that an important criterion for testing the advisability of forming currency unions is the ranking of countries according to their readiness to enter a monetary union. De Lombaerde finds that the idea of a monetary union based on an incremental number of countries participating is not a logical outcome of the theory of OCA. As Kenen explains, the gradual process of monetary integration among economies with particular industrial structures might not be optimal owing to the fact that a minimum scale may be required in order to guarantee inter-industry labour mobility. Another finding is that for countries characterized by divergent industrial development patterns, OCA theory does not yield time-consistent recommendations about the suitability of monetary integration. Finally his empirical results on the optimality of currency areas seem to be very sensitive to the choice of criteria.

Naphil M. Maskay (2003) raises the question of whether the South Asian Association for Regional Cooperation will reach its goal of achieving an economic union in 2020. He finds that the South Asian economic union will only be achieved if there is more cooperation in monetary policies. His data analysis also shows that there is only a small trade relationship among the member states. Consequently there is a need to restructure the union and make a clear plan for their monetary cooperation.

David-Pascal Dion (2004) adds to the empirical literature on the effect on regional trade in the EU of a spillover in productivity. The author provides a quantitative means of measuring the influence of regional trade integration on productivity. The author's findings are that economic integration within a union will have a positive impact on growth owing to the free regional trade activities and the spillover of knowledge and information among member countries.

A paper issued by the European Central Bank (2005) reviews the different literature on the endogenous effects of monetary integration. The paper focuses on the literature that considers the euro as a model to discuss the endogeneities that occur if a country enters an optimum currency area. Four main concerns are looked at in this paper, namely, the endogeneity of financial integration or the equivalent of insurance schemes on the capital market, asymmetric shocks, and the endogeneity of product and labour market freedom. The conclusion is that the EMU has achieved a great effect on price changes in the product market, which are more homogeneous within the Euro zone, and that trade has been enhanced among the member countries. Financial markets are also found to have been affected by economic integration, and the size of liquidity has increased, but there are still some areas which are yet to be affected. Regarding the symmetry shocks for the euro area, there is still uncertainty how the effect of spillover shocks could affect the member countries, and to what degree symmetry shocks would affect other countries. Finally, the literature shows that labour market mobility is likely to be enhanced within the union.

On the same issue of monetary union and economic integration, some literature discusses the costs and benefits of entering a monetary union. Herbert Grubel (2005) investigates the costs and benefits to a small country of joining a monetary union with a larger country. It may benefit small countries to drop monetary independence and join a

large block in an economic monetary union because they will incur lower costs in foreign exchange and in risk premium interest rates. In addition, the author concludes that a large central bank within a union will produce a better monetary policy than a small central bank, because large central banks are less subject to pressure at the political level, and more efficient at dealing with statistical data. Finally, larger central banks can spot mistakes and errors made by monetary policy, since they dominate intra-union trade and capital flows.

The creation of monetary unions has led some researchers to investigate the possibility of a successful monetary union within the globe. Ying Huang and Feng Guo (2005) review empirically the feasibility of creating a monetary union in East Asia in view of the similarity in past years of the monetary policies of East Asian countries. Using a four-variable structure VAR model, they found that it could be an advantageous to Honk Kong, Indonesia, Korea, Malaysia, Singapore and Thailand to take the initiative to establish a common currency area. At the same time, they found that creating a currency area in East Asia would be difficult to achieve owing to differences in the countries' wealth.

Another important issue in the creation of a currency union is the convergence criteria. Anna Lipinska (2006) looks at the Maastricht Treaty convergence criteria and the optimality for the EMU accession countries. Her paper discusses what the optimal monetary policy would be for satisfying the Maastricht criteria. To find the answer she uses a DSGE model of a two-sector small open economy. Her findings are that the inflation target should not refer only to the domestic level, but also to the international level. Also, exchanging the local policy for the union policy will add certain constraints to satisfy the union criteria. These criteria will bring the benefits of union targets in inflation rates, interest rates and exchange rates. She also shows that constraints on monetary policy to satisfy the Maastricht criteria can result in more fluctuation in the CPI inflation rate and the nominal interest rate.

The European monetary union did not stop where it started, and until recently other countries have continued applying to join the union. But each country that wishes to join still has to adopt the rules and criteria that were set at the establishment of the EMU. Amy Verdun (2008) looks at the adoption of the euro by Cyprus, and the challenges that

could face the island. The decision by Cyprus to adopt the euro was made quickly, and because the small island depends heavily on foreign trade and investment, the problems it might face in the future may not have been clear at the time. But it will gain from being part of the European Union, even if the island loses it monetary independence.

We have started the literature review by considering the work done on the European Monetary Union, before going on to look at what the literature says about the GCC monetary union. The GCC countries have considered the EMU as a model for their own monetary union, making allowance for the fact that the EU countries are of a different character to the GCC countries.

Belkacem Laabas and Imed Limam (2002) have considered whether the GCC countries are an optimum currency area according to OCA theory, and are ready for a currency union. Their study found that the GCC countries have still to fulfill the necessary pre-conditions for a currency union, because of the structure of their oil-dependent economies and the low level of trade between them, and because there is no evidence of convergence in the GCC macroeconomic fundamental or synchronization of the countries' business cycles. In addition, the authors use another model, the Generalized Purchasing Power Parity, to show that the real exchange rates of the GCC countries were closely related and had the same stochastic trend, which suggested they were ready for union even though there might be some small differences between them. The authors argue that the GCC countries would benefit from a single exchange rate regime within a currency union, and had a strong political resolve to achieve economic integration. They also believe intra-GCC trade can and will increase. Synchronization of the business cycles will also increase once a convergence has been met to achieve the monetary union. Finally, the authors conclude that the only way for GCC countries to benefit from economic integration is by the rapid creation of supranational institutions to manage all the national interests of the member countries, and the willingness of the GCC countries to give up their independence to follow the GCC supranational agency.

George T. Abed, S. Nuri Erbas and Behrouz Guerami (2003) have written on the subject of the GCC's exchange rate regime. They study the choice between a dollar peg and a dollar-euro basket of currencies as the basis of an exchange rate regime. They have found that US dollar peg would not improve external stability for the union. But since

the GCC's exports and financial assets will become more diverse, the need for competition and stability is of considerable concern. Therefore being pegged to a basket of currencies would provide the region with a more conservative transitional strategy that would lead to a more flexible exchange rate regime.

Robert E. Looney (2003) wonders if the future holds more promise than the past in looking at the subject of GCC economic integration. He considers that one of the main reasons the GCC countries contemplated a union was the threat to regional security of the Iran–Iraq war. He comments on the slow progress of GCC integration, and believes that the time is now ripe for it.

Bessma Momani (2005) observes that the creation of the GCC was for security reasons. But by the end of the 1990s the GCC had taken further steps to enter into a closer economic and political integration as a result of the "New Regionalism Approach" created by the current global situation.

IMF papers issued by Abdulrahman, Al-Mansouri and Dziobek (2006) look at the possibility of creating the "Gulf States System of Statistics", and what lessons could be learned from statistical organizations in Africa (Afristat) and the European Union (Eurostat). The author believes that both agencies could provide a model and a framework for the GCC countries to create their own statistical agency, which would help to provide comparable data for the member countries.

Saif S. Alsowaidi (2007) writes about the GCC single currency and the steps the GCC has taken to achieve the single currency before 2010. The author used the SWOT analysis to bring a list of activities that should have been taken into consideration before the due date of 2010. His findings were that GCC countries should consider seriously the issue of establishing a supranational institution and creating a healthy investment environment.

Bassem Kamar and Damyana Bakardzhieva (2006) examine monetary policy cooperation among GCC countries in order to suggest how a common currency might be achieved. The authors use the results of the main variable on the real exchange rate behavior in four GCC countries (Qatar, Kuwait, Saudi and Bahrain), and also the Engle-Granger "two steps single equation co-integration" method. They found that the

exchange rate determinants in each of the four countries were different, which explains why each examined country would adopt a different macroeconomics mix. They also found that there were minor misalignments between the examined countries, but the Central Bank reserve could be used to neutralize the volatility in the countries' income from oil and other source of capital inflows.

Michael Thorpe (2008) is interested in the potential costs and benefits that monetary union could bring to the member countries. He uses the theoretical and empirical literature to identify these. He believes that there is a potential benefit to be had from establishing the union, and that the union will increase integration of the financial and capital market flow among members, and will gain a much stronger trading position with the region's trading partners. He also mentions that the success of the union will depend on how it will react to the economic shocks that might occur after its establishment.

Emilie Rutledge (2008) argues that the GCC leaders looked at the economic benefits of forming a union but did not consider its political consequences. She concludes that the decision to establish a monetary union will create a super-national institution that will look at the region as a whole, and will require more budgetary transparency on fiscal policy than the leaders would be prepared to provide.

Mohsin S. Khan (2009) investigates the choice of exchange rate regimes for the GCC common currency. He concludes that for the GCC common currency a US dollar peg would be suitable in the short run. Nevertheless GCC courtiers would have to consider a more flexible exchange rate regime in the future to protect the region from inflation in case of dollar depreciation against world major currencies.

Ahmed Al-Kholifey and Ali Alreshan (2009) study the variability of the creation of the GCC monetary union, and investigate the main difficulties of establishing a monetary union. They conclude that the creation of a GCC monetary union would increase intra-trade between GCC members, and that the adoption of single monetary and fiscal policies would be an important step towards the successful creation of the union.

Eisa A. Aleisa, Shawkat Hammoudeh and Yuan Yuan (2008) study the likely effects of external shocks on a GCC monetary union by considering the exchange rate regime.

They find that the amount produced in the GCC currency union as an economic bloc will be influenced by the domestic shocks in the short run and by the terms of trade in the long run. Economic shocks will arrive mainly from the US dollar but the euro will also have a minor impact. Furthermore, they suggest that the exchange rate regime should be pegged to a basket of currencies as a first step towards moving to a more flexible exchange rate regime in the future.

Magda Kandil and Mohamed Trabelsi (2009) investigate the desirability and feasibility of the GCC countries forming a monetary union. They use Multivariate VAR for the period 1980–2006 to estimate the feasibility of the monetary union. For the purpose of their study, the authors chose four shock variables to investigate the feasibility of the creation of the GCC monetary union. These are global supply, domestic supply, and domestic and monetary shocks. The methodology used is to investigate the correlation between the different shock variables. The main findings were as follows: according to the correlation coefficient calculated among the different shock variables, the GCC countries are still far from being an optimum currency area. The study also shows that some countries (namely, Saudi Arabia, the United Arab Emirates and Qatar) should be ready to adopt and be part of a monetary union, since their economies have a positive correlation with the shock variables. Their results show that according to the various shock variables Oman holds a position which is very different from that of other GCC countries. Finally they have found that a high level of factor labour mobility, economic openness, and inter-regional mobility should still be the main focus of efforts to speed up the GCC economic integration and to achieve the single monetary union.

Mohsin S. Khan (2009) discusses the costs and benefits of different exchange rate regimes. He looks at the GCC countries' past and present experience of the US dollar peg, and particularly at their increased levels of inflation during the time of the US dollar's depreciation against the other major currencies. He also considers the possibility of the US dollar peg bringing US economic and financial shocks to the GCC economies. On the other hand, he points out the benefits of administering the US dollar peg exchange rate regime. His conclusion is that, given their long experience of the US dollar peg, the GCC countries should adopt it at the outset of the new currency and then move to fully flexible exchange rate later, when, after the necessary institutional reform, they will be ready to manage the exchange rate complexities.

Russell Krueger, Bassem Kamar and Jean-Etienne Carlotti (2009) discuss the methods of establishing a conversion value of the new GCC currency. The authors propose an econometrics model to determine the conversion rate by estimating the level of misalignment in the real exchange rate and applying it to the GCC currency union. For each member of the GCC, the authors identify the year that the economy will be closest to its internal and external equilibrium, and then calculate the level of misalignment in the bilateral real exchange rate against the US dollar, based on the WEC projection until 2013. The empirical results of the study show that only a small nominal exchange rate adjustment is required for the GCC currencies to create the conversion at the closest level to the equilibrium, and adjustment seems to decline between 2010 and 2013. Finally they suggest that the GCC countries apply their proposed methodology to study these results to help produce a conversion rate for the proposed union.

From the above-discussed literature we can appreciate that there is still much to do before the GCC countries establish their currency union. Researchers have looked at the union from different perspectives, but mainly treat the GCC countries as a single bloc. For this reason we believe that the investigation of Kuwait's own national interests in entering monetary union will be a valuable addition to the above literature, and could fill in some of the gaps I existing research.

Studying Kuwait's economic and trade data in Chapters 3, 4 and 5 will produce a clearer picture of Kuwait's readiness to join a single monetary union. We will also find out from the semi-structured interviews described in Chapter 7 whether it is likely to be in Kuwait's national interest to join the GCC single monetary union.

2.9 CONCLUSION

This chapter has traced the evolution of the International Monetary System, which performs the necessary function of regulating trade between different countries, facilitating transactions, and stabilizing currencies. It was initiated in the latter half of the nineteenth century, and since then has reflected the different economic situations and needs of the times it has passed through.

Various exchange rate regimes have been adopted. Initially the gold standard enabled countries and nationals to exchange currencies by valuing their currencies in terms of gold. However, because this system relied on the availability of gold, there was a lack of liquidity. The Bretton Woods agreement in 1945 addressed this problem by giving nations some flexibility to adjust their exchange rate value against other currencies.

After the Bretton Woods agreement collapsed, the Fixed Dollar Standard (1950–1970) allowed countries to fix their currencies against the US dollar. Ultimately this gave way to the floating exchange rate system in which currencies floating on the financial market found their equilibrium on the basis of supply and demand. Most currencies continued to be quoted against the US dollar, which made the dollar still the most valuable currency. The IMF introduced a new set of rules to organize the trade on the international market and to prevent advantage being taken of currency fluctuations.

Owing to the importance of currency stability, a new exchange rate system was introduced under the Monetary Union and Economic Integration system. This led to the development of Monetary and Economic Unions, which enabled groups of countries within specific regions to adopt a fixed exchange rate system between themselves at a set conversion rate as a means of increasing intra-trade. Of the many monetary unions that have been created, some successfully and some not, the most recent is the European Monetary Union. This union inspired the GCC countries to aim to create a GCC monetary union. The costs and benefits of such a union has been the subject of much discussion and study.

The main cost to the member countries will be the loss of independence with regard to monetary and fiscal policies, which will be in the control of a central authority. Kuwait may find it has to conform to a dollar pegged exchange rate and abandon its current exchange rate regime which pegs the dinar to a basket of currencies. Moreover, removal of all trade barriers may result in more competition between the union member countries. The likely benefits, however, include tighter fiscal and monetary discipline, the elimination of transaction costs, increased intra-trade, a large financial market, more job opportunities, greater credibility and international awareness of the union as a group, along with all the economic and political advantages of being part of an economic bloc which will be one of the world's largest oil and gas producers.

Currency union is more prevalent nowadays than previously, especially since the establishment of the European Union the introduction of the euro, when member countries gave up their own currencies. The GCC countries now need to consider whether joining a monetary union will involve more costs or benefits. Because the GCC countries have almost the same economic structure and generate revenues by the export of oil and gas, most researchers and economists believe that the benefits should significantly outweigh the costs.

Chapter 3 EXCHANGE RATE DEVELOPMENT

3.1 INTRODUCTION

After reviewing the literature on the development of the International Monetary System and on economic integration and monetary union in Chapter 2, we would like to continue in this chapter to focus on the exchange rate developments and the history of the Kuwaiti dinar (KD).

Maintaining the value of the KD against the US dollar and other major currencies has been a very challenging task for the Central Bank of Kuwait (CBK) in past decades, and the CBK has used its freedom to choose the most advantageous exchange rate regime. The exchange rate has been an important monetary tool that most central banks use to influence their economy and stabilize the purchasing power parity of their national currency.

The value of any given currency is determined by the country's economic situation, political stability and other sovereign risk issues. Currency value is not different from any traded or non-traded product and value can change in the financial markets according to the supply and demand.

In addition, the exchange of currencies is carried out in the financial markets, where currency values change. Economics literature explains that there are a number of factors that determine the value of the exchange rate between two different currencies. In this chapter we will review some of the principal determinants of exchange rates, such as PPP theory, Covered Interest Rate Parity, and Uncovered Interest Rate Parity.

The foreign exchange market and currency fluctuation have been a subject of contentious debate in the economics of international finance. Exchange rates on the financial market are very difficult to predict. The value of a currency can change for different reasons, one of which can be the activities of speculators,

though others can be more fundamental. Exchanging currencies on the financial market does not require a physical market or place to be traded, and buyers and sellers can exchange electronically.

The aim of this chapter is to answer the following questions. What is the exchange rate? How is the currency quoted? What is the foreign exchange market? What are the fundamental determinants of exchange rate movements? What causes currency value to change on the foreign exchange market? What have been the trends for the KD? And what have been the exchange rate tools used by the Central Bank of Kuwait (CBK) to control and stabilize the KD? What is the history of KD rates of exchange against the US dollar and other world major currencies? How have exchange rate measures been used, and how successfully, to control inflation in Kuwait?

3.2 WHAT IS THE EXCHANGE RATE?

An exchange rate is the value of one currency expressed in terms of another currency, which means the rate at which a particular currency is exchanged for another one. Table 3.1 below shows the FX prices for the different currencies. On the foreign exchange market the price of a currency is always quoted in terms of a base currency. Most currencies are quoted on a US dollar base, and the price of the quoted currency will be equal to one US dollar. This is known as a 'direct' quote. The base currency appears on the left, and the counter currency on the right.

For example, in Table 3.1 below the price quote of USD/KD means that a bank would sell USD at the bid price of 0.2749 KD and buy USD at the ask price of 0.2754 KD. As we can see, the difference between the bid and ask prices is where the bank makes a margin of profit, and the spread between them is usually very small.

Some currencies are quoted, not on a US dollar base, but on other currencies, such as the British pound sterling (GBP), the New Zealand dollar (NZD), the euro (EUR) or the Australian dollar (AUD). These are known as 'indirect'

quotes. They are read from left to right. GBP/USD (Bid) $1.4820 (Ask) $1.4824, means that a bank would sell GBP at the bid price of $1.4820 and buy GBP at an ask price of $1.4824. Usually banks or dealers quote a currency at both bid and ask prices. The other way of quoting a currency is called a 'cross' quote. In this case the base currency can be any other currency than the USD, or than the GBP, EUR, AUD and NZD in the case of indirect quotes. Thus there are three ways of quoting a currency: by a direct quote when the USD is the base currency, by an indirect quote when the USD is not the base currency, and by a cross quote where the value of the USD is not reflected.

Each currency has its own prices on the FX market and the exchange rates of currencies are different. Prices on the foreign exchange market are based on a currency's supply and demand. A currency with a floating exchange rate regime can float freely on the market and its price is determined by market traders and how willing they are to buy or sell it. On the other hand, a currency within a fixed exchange rate regime, where the price is fixed by the government or central bank, is less volatile and less subject to currency fluctuation.

Table 3.1 Foreign Exchange Quotes

Quote	Bid	Ask
USD/KD	0.2749	0.2754
KD/USD	3.6376	3.6310
GBP/USD	1.4820	1.4824
EUR/USD	0.4075	0.4083
GBP/KD	0.4075	0.4083
GBP/JPY	137.450	137.530
EUR/KD	0.3557	0.3564

Source: Reuters FX and Cross Spot.

3.3 FOREIGN EXCHANGE MARKETS

The foreign exchange market is the place where the price of a currency is quoted, and both buyer and seller can meet their required needs of a specific currency. Buyers and sellers can be countries, banks, investors or individuals, and they all meet to exchange one currency for another according to their needs. The exchange rates of a currency are determined largely by supply and demand, but other factors such as major economic events, political stability, central bank interventions and the effects of speculation can also play a role.

Currency supply and demand vary according to market needs, and similarly the value of any specific currency can appreciate or depreciate. The question that always arises is what moves the exchange rate. There are many fundamental economic indicators, as well as non-fundamental factors, that can affect the currency movements in either direction and influence supply and demand. We will list some of the major factors that have been mentioned in the literature on exchange rates.

1. Industrial countries usually export many products to other countries, and buyers have to pay in the currency of the seller. If exports increase, foreign buyers will have to buy more of the local currency to pay for their goods. There will therefore be an increase in demand for the exporter's currency, and conversely, the supply for the importer's currency or USD will increase on the market.

2. Investors most of the time look for investment opportunities abroad. In doing so, they buy the currency of the country where they invest and sell other currencies on the market.

3. Tourists and travelers sell their own currencies and buy the currencies of the countries to which they travel.

4. Foreign exchange speculators, who try to arbitrage any opportunity on the FX market, buy currencies at one price and sell at a higher price to make a profit.

5. Countries undergo political and sovereign risks, and the market will read these as signs whether to buy or sell their currencies.

The fundamental determinants of exchange rates may not apply as a result of the above mentioned factors, and exchange rates theories sometimes may need to be stretched to take account of them. For the purpose of this research I will discuss some theories that have been discussed in the literature on exchange rate behaviour.

Government officials and central bankers focus on explaining how the national currency moves and try to protect it from both appreciation or depreciation. Central bankers and monetarists always set an exchange rate target for the national currency. In case the currency moves below or above the exchange rate target they use all the monetary tools at their disposal to stabilize the currency and keep the rates within their targets. There are some important theories on the behaviour of exchange rate movements. We will visit some of these theories, but before we do so let us explain how the currency is quoted in the financial market.

The foreign exchange market is different from other markets in that there is no physical trade. Most of the trade on the foreign exchange is carried out electronically. Buyer and seller usually do not need to meet and an intermediary can carry out the transactions.

There have been major developments in the foreign exchange markets over recent years, and the subject of exchange rates has received a lot of consideration by countries' central bank officials.

3.4 EXCHANGE RATE BEHAVIOUR

Economists and monetarists look at the Purchasing Power Parity (PPP), and the Law of one Price (LOOP) to estimate and value exchange rate movement and value. The PPP determines the exchange rate between two different currencies on the basis that they share the same price level for identical units in the respective countries. PPP theory is usually based on the absolute exchange rate.

However, a relative PPP exchange rate is used when the rate of depreciation varies between two different currencies.

Since the real exchange rate between two currencies is referred to as the price of one currency against the other currency, the nominal exchange rate is adjusted in terms of the relative price differential. The PPP measures the deviation on the exchange rates between different countries, the exchange rate level of appreciation and depreciation, and also the level of the national income. Lucio Sarno and Mark P. Taylor review the literature of PPP and LOOP in their (2002) book *The Economics of Exchange Rates*, which we will use as a reference in discussing exchange rates.

3.4.1 PPP and the Law of One Price

The PPP index is known worldwide as the means allowing any given product to be sold in different countries. The main concept behind the theory of PPP is that the price of goods in two different countries should be the same when the currencies are converted. Before we start developing the PPP theory we have to consider where the theory comes from. The PPP was derived from the Law of One Price, and then a distinction was made between absolute Purchasing Power Parity, and relative Purchasing Power Parity.

We saw earlier that the PPP was derived from the Law of One Price (LOOP), which takes no account of the costs involved in the sale of a product, such as tariffs, transportation costs and taxes, and assumes that the same product should be sold at the same price in different countries. The LOOP can be written in terms of absolute value as follows:

$$Pi,t = StP*i,ti = 1.2.3 \dots \dots N$$

In the above equation $\mathbf{Pi,t}$ represents the price of product i at time t in the local currency, and $P*i,t$ represents the price of the identical product in another foreign currency at the same time. St represents the nominal exchange rate between the two currencies at the same time. On the basis of this equation,

the Law of One Price would require that the price between the two countries for the identical product at one time should be the same.

The theory of the Law of One Price would hold if there is no arbitrage. In its relative value it can be written as follows:

$$\frac{P*i,t+1St+1}{Pi,t+1} = \frac{P*i,tSt}{Pi,t} i = 1,2,\ldots,N$$

The Law of One Price holds in a case where the product in two countries is tradable and identical, where no arbitrage occurs, and where no other tax, fee or any sort of transaction cost exists between the countries.

The Purchasing Power Parity theory (also known as the Law of One Price) means that the price of identical products (tradable goods) would cost the same in two different countries even though there is a currency exchange rate between them. If countries share a common currency the comparison can of course be made more easily.

By assuming that all products are tradable between different countries, the absolute version of the theory of PPP would require the following:

$$\sum_{i=1}^{N} \alpha iPi,t = St \sum_{i-t}^{N} \alpha iP*i,t'$$

And the weight in the summation represents $\sum_{i=1}^{N} \alpha i = 1$, and when a geometric index is used to build a price index, we take the logarithms' weights as follows:

$$\sum_{i=1}^{N} \gamma iPi,t = St + \sum_{i=1}^{N} \gamma iPi*t'$$

And the geometric weight represents $\sum_{i=1}^{N} \gamma i = 1$ and the letter below represents the logarithm. The price index will include weights αi and γi based on the country price level. Cassel (1918) derives the absolute PPP value by using the following equation:

$$St = Pt - P * t$$

From the above equation we can write the logarithm real exchange rate as follows:

$$qt = St - Pt + P * t$$

This will show the deviation from the PPP.

A number of problems arise by deriving the PPP from the LOOP, because each country will use a different weight for the national price index. Real life researchers assume that when each country's price index is used the PPP should hold. The geometric index would result in the following equation:

$$\sum_{i=1}^{N} \gamma i \; Pi, t = St + \sum_{i=1}^{N} \gamma i * \; Pi * t + ut,$$

γi * represents the weights in the foreign price index, and the gap increases each time the gap in the national price index increases. The gap will be clearly represented by ut according to the PPP theory, even if the LOOP holds for individual goods. The overall price index increases in proportion as the price increases, but we assume that the prices are constant; otherwise a currency appreciation would be needed to ensure equilibrium. The same applies to non-traded goods and services. But if we assume that the Law of One Price can be used only for traded goods, all things being equal, an increase on the percentage for traded goods would require currency appreciation. On the other hand, if there were an increase in all foreign non-traded goods prices, the theory of PPP on individual national price indices would cause the exchange rate to move some points. And in real life the arithmetical price index is used rather than the geometric index, though the deviation between them is not large and derives from the differentials in price inflation on traded and non-traded goods and services.

The PPP theory uses a long-term equilibrium of the exchange rate between two countries to stabilize the purchasing power for each country. Inflation and other related costs should be taken into consideration between two different countries. Deviation results from movements on the foreign exchange market, and the

difference in exchange rate is set by each country's price level changes. The Law of One Price assumes a zero tariff on traded goods and services to allow identical products to sell at the same price in two different countries.

Exchange markets are dealt in both spot markets and forward markets. A spot market occurs where a deal requires delivery within two working days using spot market rates. The rates are set at the time of transaction by both buyer and seller. A forward market occurs where both buyer and seller meet to agree on a specific price, date and delivery.

3.4.2 Covered Interest Rate Parity and Uncovered Interest Rate Parity

The theory of CIP states that interest rate differentials will be offset by the differential of the forward versus spot exchange rate. And the spot rate is the rate of the cash delivery within two working days, while the forward is the exchange rate which two parties agree on for a future date of delivery.

Covered Interest Rate Parity (CIP) assumes that there are no barriers or restrictions to arbitrage on the foreign exchange market. The arbitrage between currencies should cover the interest rate differential between two separate assets that are identical apart from the currency of domination. The currencies' fluctuation will be covered at the delivery date to cover the interest rate parity. The interest rate parity is written as follows:

$$\frac{Ft(k)}{St} = \frac{1 + it}{1 + i * t}$$

St represents the domestic spot market exchange rate, and $Ft(k)$ represents the k period on the forward market exchange rate.

If the domestic interest rate is low at the time of the transaction then the CIP theory will not hold and it will result in the following:

$$It < \frac{Ft(k)}{St}(1 + i *) - 1$$

The CIP in this case will not hold owing to the low interest rate on the domestic currency. By the end of the period the arbitrageur will have to repay $(1 + it)$ for each unit of the domestic currency which was borrowed, but will receive $\frac{Ft(k)}{St}(1 + i*)$ units of domestic currency for every unit of domestic currency used in the arbitrage. Therefore the arbitrageur will make a net profit of $[\frac{Ft(k)}{St}(1 + i*)$ -$(1 + it)$, and this will last until the arbitrage disappear when the CIP theory hold. (Note: the above example is taken from Sarno and Taylor, 2002: 6.)

3.4.3 Uncovered Interest Rate Parity

The UIP can be used to forecast a future spot rate by looking at the current spot rate and the interest rate differential. The theory of UIP assumes that an interest rate differential between two currencies will be equalized by the expected depreciation of the currency, where investors assume the risk premium is zero. The expected return is a concern from the two invested currencies. The equation is written as follows:

$$\frac{s^e_{t+1}}{s_t} = {1 + r_t}/{1 + r^*_t}$$

Or

$$s^e_{t+1} - s_t = r_t - r^*_t$$

s^e_{t+1} represents the $\ln s^e_{t+1}$.

The UIP equation ignores the exchange rate risk, and investors make their investments on the basis of their asset allocation, since the future exchange rate is unknown and uncertain.

By ignoring the risk of future exchange rates, and being neutral on their investments, investors will relax the assumption by introducing the CAPM model for an expected return. The CAPM model is written as follows:

$$E_t R_{it+1} - r_t = \beta_i [E_t\ R^m_{t+1} - r_t$$

β_i is the risk on a foreign investment which relies on the covariant between the market return and the investment return, and $E_t\ R_{t+1}^m$ is the expected market return from an investment. Therefore, if UIP does not hold, then investors can easily move to invest in different countries. Risk is always neutral when using UIP theory and the speculation effect is not active in the market place.

From the above discussion of Purchasing Power Parity, Covered Interest Rate Parity, and Uncovered Interest Rate Parity, we can see that exchange rate behaviour varies from one currency to another currency according to the macroeconomic structure and stability of the different countries. The theory of CIP will only hold good in the event that there are no costs involved. On the other hand, UIP does not easily forecast the future exchange rate. Therefore the prediction of a future exchange rate is very difficult for any given currency.

In the next section we will introduce the development of the KD, and the history of the KD exchange rate against the USD and other major world currencies.

3.5 DEVELOPMENT OF THE KUWAITI DINAR AND EXCHANGE RATE REGIMES

The State of Kuwait established the national currency in 1961. Before that the monetary system was dependent on foreign currencies, especially the Indian rupee, which was circulated widely in Kuwait from the 1930s to the 1960s, and the Gulf Indian rupee, which was introduced in 1959. The country got its national currency soon after gaining its independence.

In 1960 the Kuwaiti Currency Law established the Kuwaiti dinar, which was issued by the Kuwaiti Currency Board. The value of the dinar at that time was set at a par with the British pound (1 Kuwaiti dinar = 1 British pound). Kuwaiti dinar coins were introduced in 1961. The Kuwaiti currency includes the following coins and banknotes: 1 fils, 5 fils, 10 fils, 20 fils, 50fils, 100fils, ¼ KD, ½ KD, 1 KD (which equals 1000 fils), 5 KD, 10 KD and 20 KD.

The Currency Board issued the Kuwaiti dinar until 1968. There were five separate issues of currency notes. The first issue appeared on 1 April 1961 and

remained in circulation until 1 February 1982. The second issue, including the ¼, ½, and 10 dinar notes, entered circulation on 17 November 1970, while 1 and 5 dinar notes appeared on 20 April 1971. On 1 February 1982 the second issue was withdrawn. The third issue, including 10, 5, 1, ½ and ¼ dinar notes, was put into circulation on 20 February 1980, and was withdrawn on 24 March 1991 owing to the Iraqi invasion of Kuwait. 30 September 1991 was the last day for exchanging these notes at the Central Bank of Kuwait. The fourth issue was put into circulation just after Kuwait's liberation on 24 March 1991 and stayed in circulation until 16 February 1995. The fifth and last issue was put into circulation on 3 April 1994 and is in circulation at the current time.

The State of Kuwait did not have its own Currency Board until the country gained its independence in 1961, when the Currency Board and the Central Bank of Kuwait assumed responsibility for the currency issuances of both coins and notes.

The exchange rate is an important monetary policy tool that a country's central bank can implement to stabilize and secure the national currency and to ensure positive economic outcomes. Since the establishment of the KD, the State of Kuwait has adopted different types of exchange rate regimes, including both fixed regimes and regimes floating within prescribed margins.

From 1975 to the end of 2002 the Central Bank of Kuwait adopted a fixed exchange rate regime against a basket of major currencies determined according to the country's various trade relationships.

The exchange rate was fixed by the Central Bank of Kuwait on the basis of currency fluctuations on the foreign exchange market and the effect of these currencies on the country's economy. The bank followed a free capital market system, which does not impose any kind of restriction on currency convertibility or capital control on transfers. It has always been one of the bank's main objectives to ensure the currency stability of the KD against the US dollar and other major currencies that have strong trade links with Kuwait. The bank has worked hard through the years to maintain the KD's purchasing power, and to protect the economy from imported inflation and the currency from speculators.

During the 1980s the Gulf Cooperation Council was established, and set certain objectives for its participant countries, with the aim of achieving economic and monetary integration by the year 2010. This has meant that countries have had to adopt similar monetary and fiscal policies. Kuwait became a member of the GCC at its establishment in the 1980s, and since most of the GCC central banks used an exchange rate regime fixed against the US dollar the Central Bank of Kuwait had to follow suit and drop its previous regime of an exchange rate fixed to a basket of currencies.

The new exchange rate for the KD was set at 299.63 fils against the US dollar. However, the Central Bank of Kuwait did not follow a fully fixed exchange rate against the US dollar. The rate was set with the option of letting the KD change within certain boundaries to protect the country's economy from imported inflation and to give the monetarists the opportunity to change the exchange rate as the US dollar appreciated or depreciated. Therefore, the Central Bank set a margin of ±3.5% (max. 310.11 fils per $, and min. 289.14 fils per $), which allowed the bank some flexibility to protect the value of the national currency from depreciating or appreciating beyond the bank target rates. And the bank did not allow the KD to fluctuate much against other major currencies either.

The Central Bank of Kuwait did not keep the fixed exchange rate against the US dollar for more than few years. Following economic changes that caused the US dollar to decline against the major world currencies, the KD and other world currencies that had adopted a similar fixed exchange rate against the US dollar were put under a lot of pressure. The Central Bank of Kuwait therefore re-valued the KD and dropped the fixed exchange rate regime against the US dollar, and went back to a fixed exchange rate regime against an unspecified basket of currencies, to prevent the decline of the KD and protect the country from imported inflation which had reached record levels. A fixed exchange rate regime against a basket of the world major currencies gave the CBK the flexibility to adjust the KD's value according to daily currency market fluctuations, but the bank continues to work with other GCC central banks to achieve monetary union and a single currency.

3.6 HISTORY OF KD RATES AGAINST THE USD

The CBK has worked towards stabilizing the value of the KD against the US dollar. Data available from 1994 to 2009 reveal the average rate of the KD against the USD, based on the average selling rate declared by the CBK. These figures include exchange rate regimes in which the KD is pegged to a basket of currencies and to the US dollar alone.

3.6.1 USD/KD Exchange Rate 1994–2009

The average monthly value of the US dollar against the KD during the studied period changed every month. The descriptive statistics in Table 3.2 show that the average USD/KD rate was 0.2963 fils per dollar. The US dollar reached its highest value against the KD with a rate of 0.3081 fils to the dollar (at the average monthly exchange rate), and its lowest value of 0.2652 fils.

The standard deviation was 0.0099 because the CBK uses a fixed exchange rate regime, and does not allow the KD to fluctuate on the financial market. As discussed in Chapter 2, the CBK used its monetary tools to peg the KD against other currencies, and adjusted the exchange rate according to the movements of these currencies on the financial market.

Figure 3.1 The Mean USD/KD Monthly Exchange Rate, 1994–2009

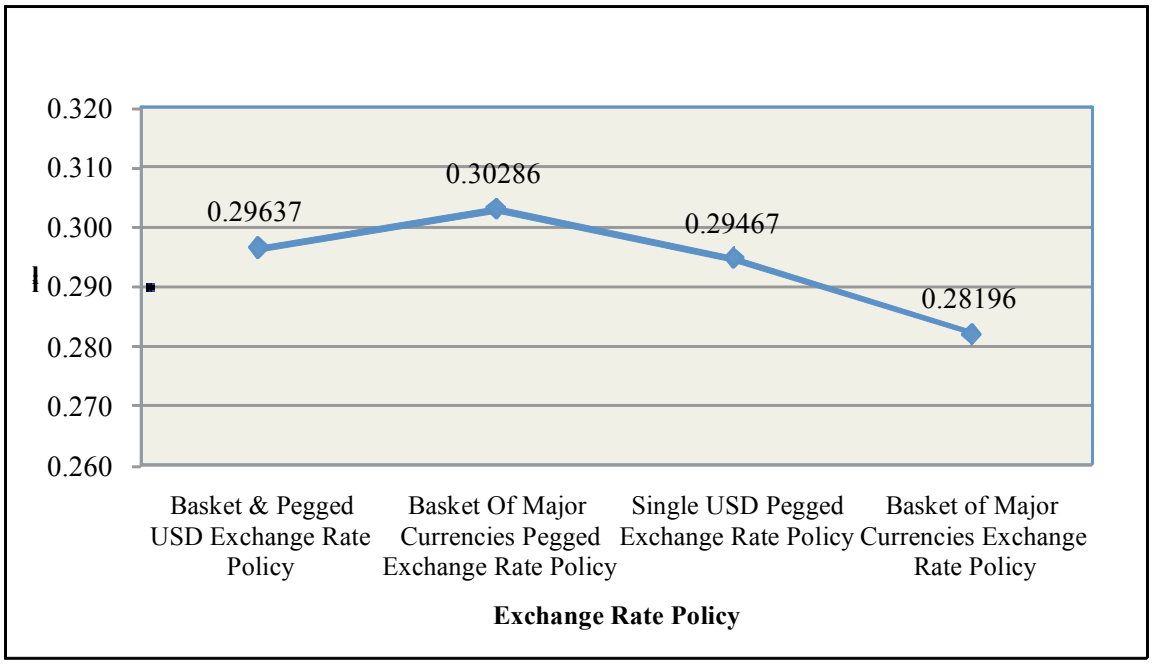


Table 3.2 Descriptive Statistics for USD/KD Rates in KD, 1992–2008

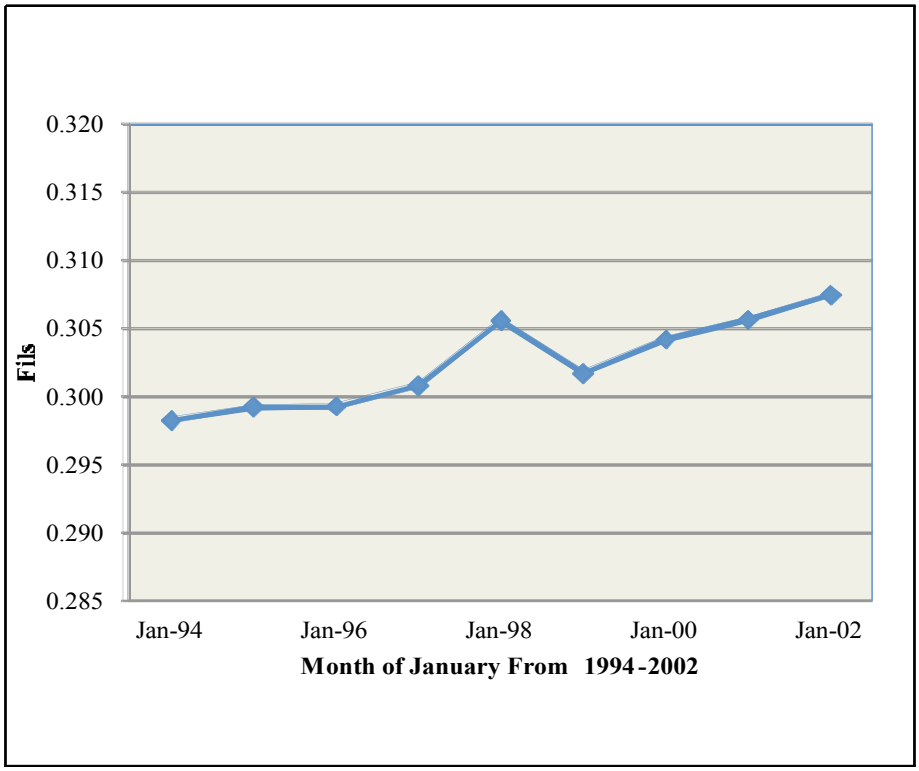
Exchange Rate Regimes	Period	Mean	Median	Std.Deviation	Minimum	Maximum	Count
Both Basket of Currencies & USD Peg	1994–2009	0.2963	0.2990	0.0099	0.2652	0.3081	192
Basket of Currencies	1994–2002	0.3028	0.3033	0.0036	0.2919	0.3081	108
USD Pegged	2003–Apr 2006	0.2946	0.2947	0.0028	0.2920	0.3000	40
Basket of Currencies	May 2006–Dec 2008	0.2819	0.2867	0.0090	0.2652	0.2918	44

3.6.2 USD/KD Exchange Rate for the Period 1994–2002

The CBK pegged the exchange rate regime to a basket of major currencies for the period 1994–2002. Figure 3.1 below shows the average monthly USD/KD exchange rate for the month of January during this period. The CBK allowed the KD to trade within 0.3057 fils and 0.2983 fils per dollar, which means the exchange rate for USD/KD trade remained within a 3% margin. The highest appreciation of the US dollar was in January 2002, and the lowest depreciation was in January 1994.

Figure 3.2 Average Monthly USD/KD Exchange Rates for the Month of January, 1994–2002

Month	USD/KD Exchange Rate
Jan 94	0.2983
Jan 95	0.2992
Jan 96	0.2993
Jan 97	0.3008
Jan 98	0.3056
Jan 99	0.3017
Jan 00	0.3042
Jan 01	0.3057
Jan 02	0.3075



Source: CBK, *Monthly Monetary Statistics* (several issues, 1994–2002).

3.6.3 USD/KD Exchange Rate for the Period January 2003 – April 2006

Until the end of year 2002, the CBK remained firmly committed to pegging the KD to a basket of unknown currencies. The GCC has set its goal of achieving a single monetary and currency union, and because Kuwait is part of the Council it

had to adopt a similar monetary policy to that of other member countries. Therefore, starting in January 2003, the State of Kuwait dropped its basket of currencies exchange rate policy to adopt an exchange rate policy of pegging the KD to the US dollar alone.

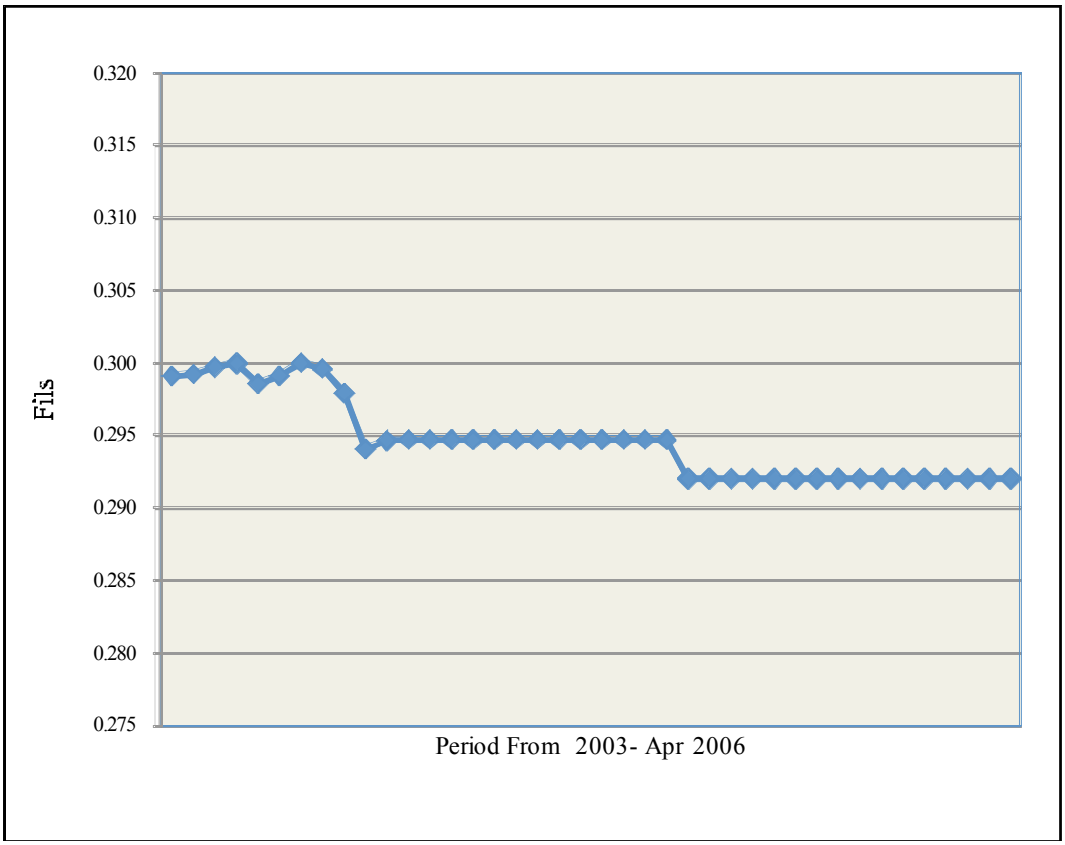
On Sunday 5 January 2003 the CBK valued the USD/KD exchange rate under the new exchange rate regime as 299.63 fils per dollar, with a margin of ± 3.5%, which would allow the CBK to re-value the KD against the US dollar value on the foreign exchange market. But the CBK did not use a fully US dollar pegged KD, but allowed the USD/KD rate to float between the boundaries of 310.11 fils and 289.14 fils per dollar.

Nevertheless, after the Central Bank of Kuwait adopted the new exchange rate policy of the US dollar peg, the value of the US dollar declined against world major currencies, and against the KD, but the KD was not allowed by the new exchange rate policy adopted by the CBK to fluctuate above or below 3.5%.

During the single US dollar pegged exchange rate policy, the CBK was able to control the value of the USD/KD exchange rate, but did not have the freedom to adjust the rate according to the fluctuations of the major currencies, as had been the case during the basket of major currencies pegged exchange rate regime.

CBK did not want to lose the advantage of the depreciation of the US dollar, but the exchange rate regime did not allow the CBK to adjust the USD/KD value below or above the margin of ± 3.5%. At the same time CBK did not fully fix the USD/KD rate as other GCC countries had done.

Figure 3.3 Average Monthly USD/KD Exchange Rates, 2003 – Apr 2006



As is shown in Table 3.2, during the US dollar pegged exchange rate, the USD/KD rate had a mean of 0.2946 fils per dollar, with a highest value of 0.3000 fils, and a lowest value was 0.2920 fils per dollar. As a result of the exchange rate policy followed by the CBK, the standard deviation during this period was no more than 0.0028, which was the lowest standard deviation compared to other periods.

Figure 3.3 indicates the trend of USD/KD exchange rate. We can see from the figure that the exchange rate was not allowed to trade above or below the parity rate of the margin set by the CBK. The KD was under pressure to stay within these levels, and its value against the major world currencies depreciated because of the depreciation of the US dollar. The CBK could not meet its objective to protect and stabilize the national currency, and therefore the US dollar pegged exchange rate regime was dropped and the CBK re-adopted the old exchange rate regime of pegging the KD to a basket of major currencies.

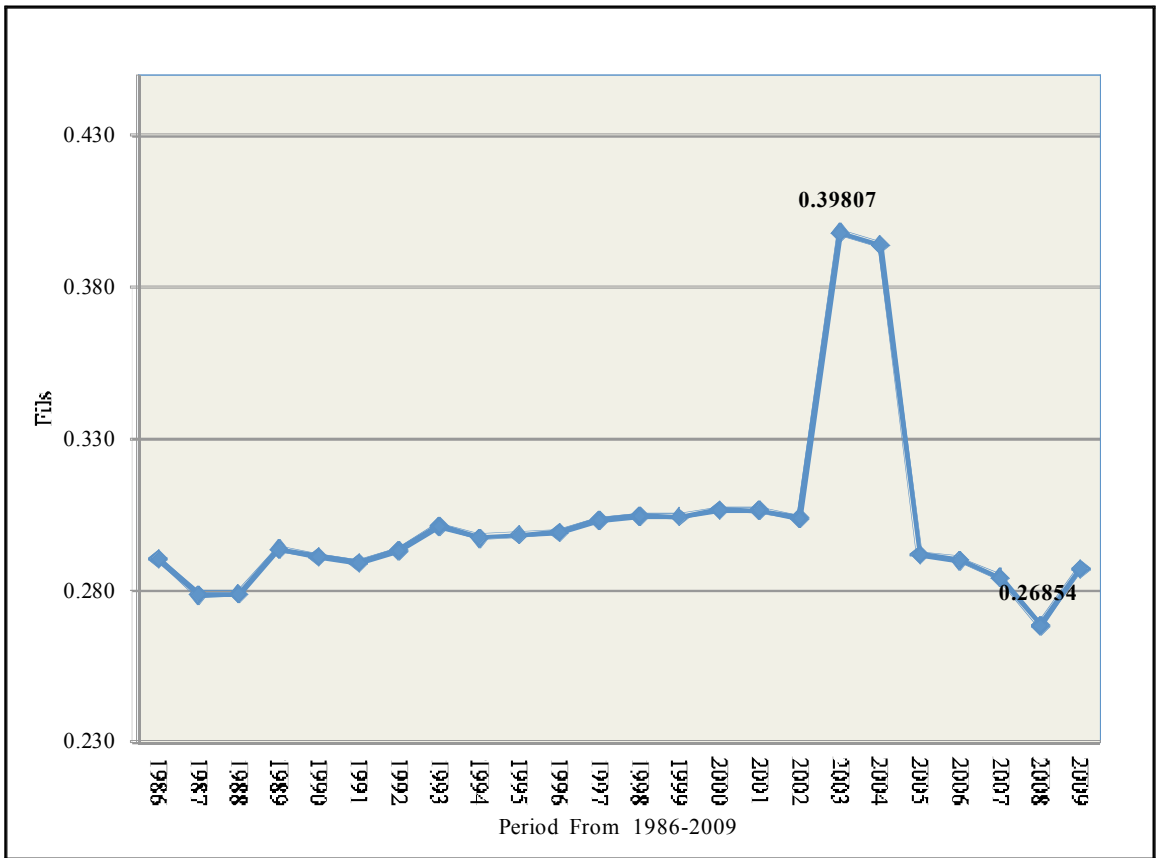
3.6.4 USD/KD Exchange Rate, May 2006 – End of 2009

In May 2006 the Central Bank of Kuwait re-valued its USD/KD exchange rate at 289.14 fils per 1 US dollar. The CBK then dropped the single US dollar pegged exchange rate regime and reverted to its old policy of pegging to a basket of currencies, arguing that changing the policy would reduce the inflationary pressure of being pegged to a depreciating US dollar. Historically the CBK has worked towards controlling inflation, especially because Kuwait imports all its needs from abroad.

Kuwait has been known for decades as a country with a very low inflation rate, and the value of the KD has been an important means of controlling imported inflation. When the CBK adopted the old exchange rate regime of pegging the dinar to a basket of undisclosed major currencies the average USD/KD rate was 281.9 fils, and the KD then appreciated against the US dollar to reach 265.2 fils per dollar. The standard deviation was 0.0090, which was higher than it had been during the previous period.

From the foregoing discussion, we can appreciate that the CBK has proved its efficiency in using the exchange rate as a monetary tool to control the value of the KD against the US dollar. Having an appropriate exchange rate regime also helped the country towards economic growth, and enhanced its income. Because most of Kuwait's revenue comes from oil priced in US dollars, the value of the KD against the dollar is especially important to the country's balance of payments.

Figure 3.4 Average Monthly USD/KD Exchange Rates, 1986–2009



The movements in the USD/KD exchange rate over the years during both exchange rate regimes is summarized in Figure 3.4, which shows the average USD/KD exchange form 1986 to 2009 based on monthly rates (only till June in 1990, because of the invasion).

The KD depreciated most during 2003 to record its highest level at 398.07 fils per dollar, and appreciated most in 2008 to reach an average of 268.54 fils per dollar, thus revealing the effect of the basket of major currencies exchange rate regime. We can see that the Central Bank of Kuwait enjoyed more flexibility to change the USD/KD exchange rate during the regime in which the dinar was pegged to a basket of currencies, whereas when it was pegged to the US dollar alone the rates did not change and maintained a mean of 294.53 fils per dollar.

Thus pegging to a single currency was not favoured by the Central Bank of Kuwait. The KD had gained no advantage from the depreciation of the US

dollar, rather the opposite. Moreover, the CBK had more control over the KD during the basket of currencies regime. The new policy proved its effectiveness for the State of Kuwait and its economy.

3.7 KD EXCHANGE RATES AGAINST MAJOR CURRENCIES

The exchange rate of the KD against the major currencies is another concern that the CBK watches very closely because Kuwait imports a very large proportion of the country's merchandise to meet local demand. In Chapter 5 we will discuss in more detail the country's merchandise balance.

The Kuwaiti dinar over the years has fluctuated against the major currencies, and its value against them is less controlled by the CBK than it had been against the US dollar. However, the adjustment of the value of the KD was then based on the daily market prices, whereas the exchange rates of the GBP/USD, EUR/USD, USD/CHF, and USD/JPY are changing constantly on the financial market. Previously the fluctuation of the US dollar rate against the major currencies had a direct impact on the value of the KD.

The available data of the average monthly exchange rates for the above-mentioned currencies against the US dollar and the Kuwaiti dinar are shown in the following sections.

3.7.1 The GBP Exchange Rate against the USD and the KD

The exchange rate of the GBP against the USD for the entire period 2002–2009 had a mean of $1.756 to the pound sterling. It had a maximum value of $2.071, and a minimum value of $1.419. The range between the maximum and the minimum was 0.652 US dollars, which represents an appreciation of 45.9% from the minimum to the maximum value.

In addition, we are interested to find out what the fluctuation for the GBP/KD exchange rate was for the same period 2002–2009. The mean was 0.508 KD to the pound sterling. The pound had a minimum value of 0.405 KD, and a

maximum of 0.579 KD. The range between the maximum and the minimum was 0.174 KD, which represents an appreciation of 42.9% from the minimum to the maximum value.

The GBP used a floating exchange rate regime, which differed from the exchange rate policy used for the KD against both a basket of major currencies and for some time against the US dollar alone.

From 2003 to April 2006 when the CBK used a fixed exchange rate regime against the dollar, the GBP/USD exchange rate had a mean of $1.761 to the pound, and the range between the maximum and the minimum was $0.358, which represents an appreciation of 22.28% from the minimum to the maximum value.

For the same period the GBP/KD exchange rate had a mean of 0.519 fils to the pound, and a range of 97 fils which is an appreciation of 20.59% for the pound against the KD. We can also see that the GBP appreciated against the KD if we compare the mean of 508 fils for every sterling pound with 519 fils to the pound. This increase in the relative value of the pound reflects the change in the exchange rate policy by the Central Bank of Kuwait, which dropped the basket of major currencies exchange rate regime and adopted instead the US dollar peg.

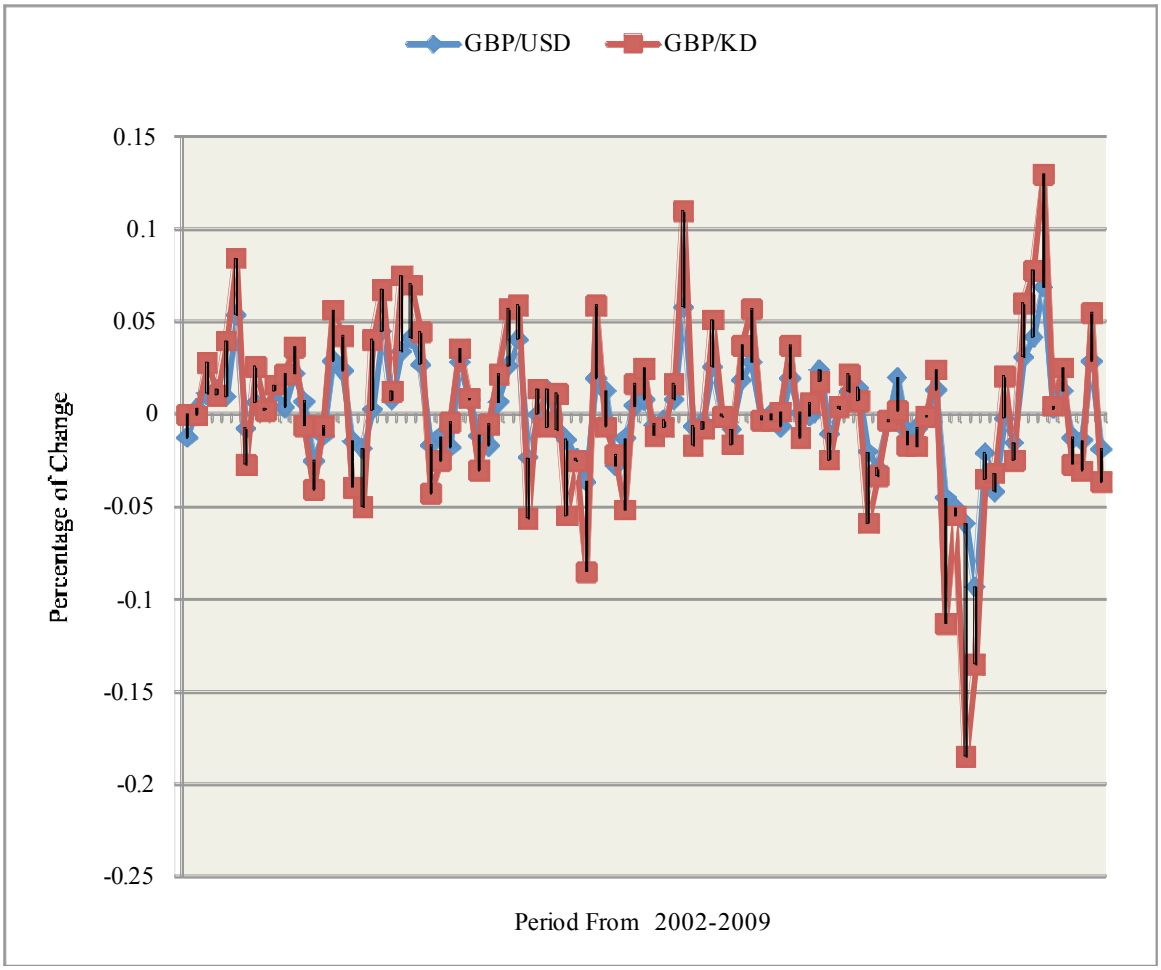
The Central Bank of Kuwait then dropped the single US dollar exchange rate regime, and reverted to its old exchange rate regime which pegged the KD against a basket of major currencies. The effect of this change could be seen from May 2006 when the CBK re-valued the KD. The GBP/USD exchange rate for this period had a mean of 1.822 USD to the pound. The range also increased to reach a difference of 0.650 USD, showing a GBP appreciation of 45.8% between the minimum and maximum values. In addition the GBP/KD exchange rate during this period had a mean of 0.512 KD to the pound, with a range of 0.174 KD between the maximum and the minimum.

Table 3.3 Descriptive Statistics for the GBP against the USD and the KD, 2002–2009

Period	Exchange Rates	Mean	Minimum	Maximum	Std. Deviation
2002–2009	GBP/USD	1.756	1.419	2.071	0.181
	GBP/KD	0.508	0.405	0.579	0.046
2003–Apr 2006	GBP/USD	1.761	1.569	1.927	0.099
	GBP/KD	0.519	0.471	0.568	0.026
May 2006–2009	GBP/USD	1.822	1.421	2.071	0.200
	GBP/KD	0.512	0.405	0.579	0.056

The GBP/KD exchange rate is reflected by the volatility of the GBP/USD rate on the foreign exchange market. The standard deviation on the GBP/USD exchange rate for the entire period of 2002–2009 was 0.181USD, compared to the standard deviation of 0.046 KD for the GBP/KD exchange rate. Thus we can see that the volatility of the GBP/USD rates are higher than the GBP/KD rates. Also Figure 3.5 below shows that the movements of the GBP/USD and GBP/KD are in the same direction, suggesting that the GBK/KD reflected the changes of the GBP/USD.

Figure 3.5 The Percentage of Change in the Exchange Rate of the GBP/USD and GBP/KD 2002–2009



3.7.2 The Euro Exchange Rate against the USD and the KD

The euro is another major currency that the State of Kuwait watches very closely, for a number of reasons, such as the foreign assets that the State of Kuwait owns, and the trade relationships that European countries have with Kuwait. We will see in Chapter 5 that European countries are in the top five trading countries with the State of Kuwait, and this reflect both exports of oil and imports of goods from European countries to Kuwait.

The average EUR/USD exchange rate during 2002–2009 had a mean of $1.256 to the euro, and the range between the maximum and the minimum was 0.699 cents. For the period from 2003 to April 2006 the mean of the EUR/USD was

1.206 USD to the euro, and the range dropped to 0.278 cents against the euro owing to the depreciation of the euro against the USD.

From May 2006 to 2009 the euro appreciated against the USD, and the mean was $1.387 to the euro. The USD was depreciating against the euro on account of the economic crisis and the instability of the dollar in the financial market. For the same period we can see that the volatility of EUR/USD increased in the trading data, and the EUR held its value against the USD.

Table 3.4 Descriptive Statistics for the EUR against the USD and the KD, 2002–2009

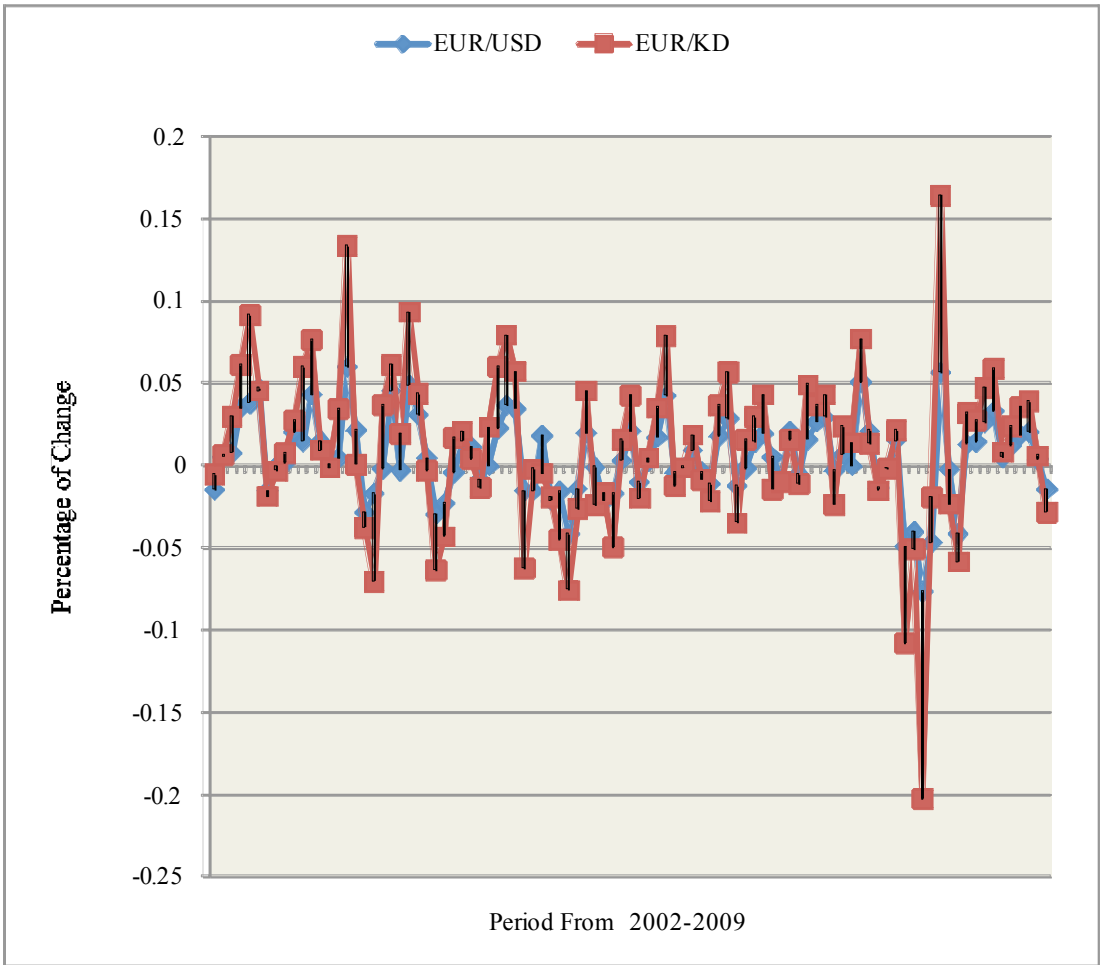
Period	Exchange Rates	Mean	Minimum	Maximum	Std. Deviation
2002–2009	EUR/USD	1.256	0.871	1.57	0.166
	EUR/KD	0.363	0.267	0.425	0.038
2003 – Apr 2006	EUR/USD	1.206	1.060	1.338	0.068
	EUR/KD	0.356	0.321	0.401	0.018
May 2006–2009	EUR/USD	1.387	1.261	1.579	0.0.96
	EUR/KD	0.391	0.340	0.425	0.020

The EUR/KD exchange rate during the same period has also been variable. The average exchange rate for the years 2002–2009 was 363 fils to the euro, with a range of 158 fils between the maximum and the minimum. And the mean for the EUR/KD for the period 2003 to April 2006 was 356 fils to the euro, and the range dropped to 80 fils. After May 2006 until 2009 the euro appreciated against the KD to a value of 391 fils, and the range also increased to 84 fils.

Figure 3.6 below shows the movement of the EUR/USD and EUR/KD exchange rates for the period 2002–2009. We can see from the graph that the volatility of the EUR/USD is higher than that of the EUR/KD, with a standard deviation of 0.166 for the EUR/USD, and a standard deviation of 0.038 for the EUR/KD.

The EUR/KD exchange rate was more controlled than the EUR/USD due to the fact that the CBK follow a fixed exchange rate regime against a basket of currencies for most of the period except for the period from 2003 to April 2006, when the CBK adopted a fixed exchange rate regime against the US dollar.

Figure 3.6 The Percentage of Change in the Exchange Rate of the EUR/USD, 2002–2009



3.7.3 The USD Exchange Rate against the CHF, and the CHF Exchange Rate against the KD

The USD/CHF exchange rate went through different levels according to the trading data of 2002–2009. The mean of the USD/CHF rate was 1.253 CHF to the USD. The difference between the maximum and the minimum was 0.683 CHF to the USD. During the same period the volatility had a standard deviation of 0.152.

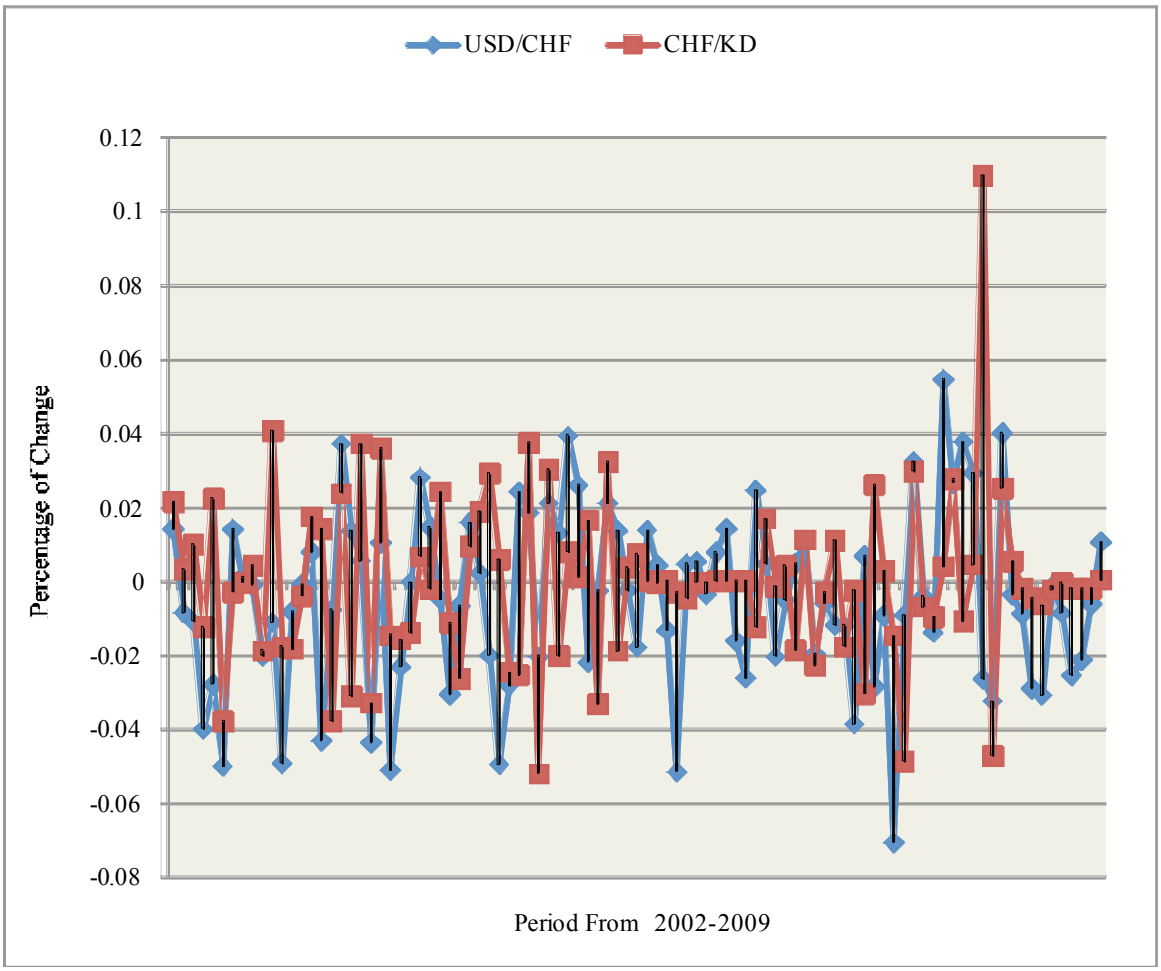
The next studied period was from 2003 to April 2006, during which the USD/CHF exchange rate had a mean of 1.280 CHF to the USD, which represents an appreciation of the USD against the CHF. But the range dropped from the previous period which had a difference of 0.238 CHF, followed by a decrease of volatility to a standard deviation of 0.062.

Table 3.5 Descriptive Statistics for the USD against the CHF and the CHF against the KD 2002–2009

Period	Exchange Rates	Mean	Minimum	Maximum	Std. Deviation
2002–2009	USD/CHF	1.253	1.009	1.692	0.152
	CHF/KD	0.234	0.181	0.281	0.021
2003–Apr 2006	USD/CHF	1.280	1.146	1..384	0.062
	CHF/KD	0.231	0.212	0.260	0.011
May 2006–2009	USD/CHF	1.144	1.009	1.260	0.079
	CHF/KD	0.248	0.227	0.281	0.015

From May 2006 to 2009 the USD depreciated against the CHF to reach a mean of 1.144 CHF to the USD, with an increase in the range to 0.079 CHF. Over the entire studied period 2002–2009 the highest appreciation value for the CHF was 1.009 CHF to the USD. Figure 3.7 below shows the difference between the USD/CHF and CHF/KD exchange rates.

Figure 3.7 The Percentage of Change in the Exchange Rate of the USD/CHF and CHF/KD 2002–2009



The CHF/KD exchange rate had a mean of 234 fils to the CHF for the period 2002–2009, and a range of 100 fils between the maximum and the minimum. For the period of 2003 to April 2006 the value of the CHF dropped to a mean of 231 fils, and the range between maximum and minimum also dropped to 47 fils. In the period after that from May 2006 to 2009 the CHF appreciated against the KD to a value of 248 fils. In addition, the range was 54 fils for this period, which is somewhat higher than in the previous period. From Table 3.5 we can see that the volatility of the CHF/KD exchange rate during the years from May 2006 to 2009 was 0.015. Figure 3.7 shows the percentage of change for the USD/CHF and CHF/KD exchange rates for the entire period.

3.7.4 The USD Exchange Rate against the JPY, and the JPY Exchange Rate against the KD

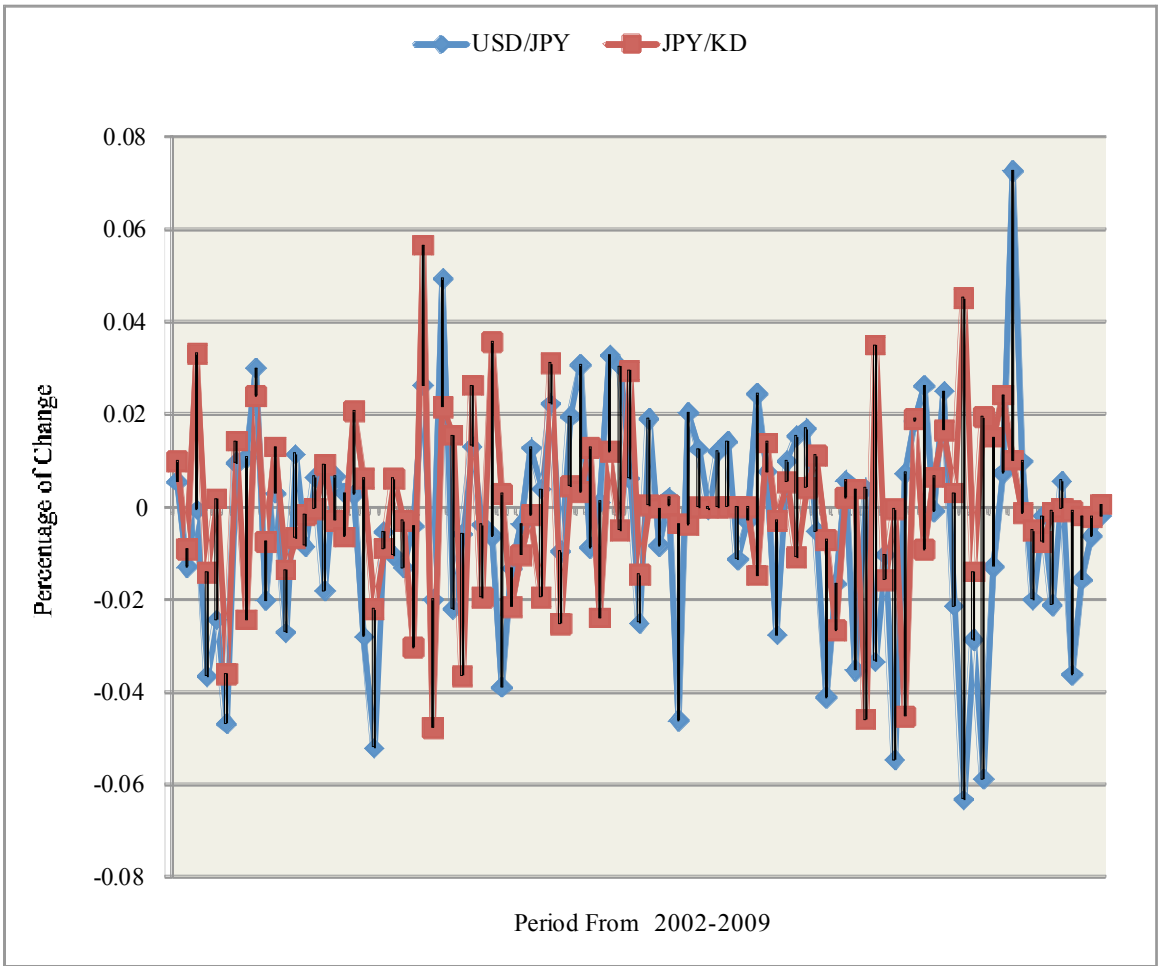
The USD/JPY exchange rate had a mean of 111.350 JPY to the USD during the period 2002–2009, and the range between the maximum and minimum values was 43.917 JPY. The USD appreciated to have a mean value of 112.005 JPY in the period from 2003 to April 2006, and a range of 16.65 JPY, which is much lower than the range for the entire period. From May 2006 to 2009 the volatility of the USD/JPY rate increased and the USD depreciated against the JPY to a mean of 106.919 JPY, but during this time the USD appreciated against the JPY when it reached its minimum value of 89.507 JPY.

Table 3.6 Descriptive Statistics for the USD against the JPY and the JPY against the KD, 2002–2009

Period	Exchange Rates	Mean	Minimum	Maximum	Std. Deviation
2002–2009	USD/JPY	111.3	89.507	133.42	10.09
	JPY/KD	0.003	0.002	0.003	0.000
2003–Apr 2006	USD/JPY	112.0	103.316	119.96	5.343
	JPY/KD	0.003	0.002	0.003	0.002
May 2006–2009	USD/JPY	106.9	89.507	122.52	10.735
	JPY/KD	0.003	0.001	0.003	0.002

At the same time the JPY/KD exchange rate for the period 2002–2009 had a mean of 0.002 fils, and a range of 0.001 fils. The maximum value of the JPY was 0.003 fils to the JPY, but the KD depreciated against the JPY during the period from May 2006 to 2009. Figure 3.8 shows the volatility of the USD/JPY and the JPY/KD exchange rates and we can see that the former recorded more fluctuation than the latter.

Figure 3.8 The Percentage of Change in the Exchange Rate of the USD/JPY, 2002–2009



Exchange rates fluctuate on the foreign exchange according to specific currencies' supply and demand, and other related factors, such as political risks, balance of payments, external debts, and speculation. Most of the major currencies included in Table 3.7 are floating currencies, but the KD is an exception in using a fixed exchange rate regime with adjustments made according to market conditions.

We have calculated the correlation coefficient of the relationship between the exchange rate movements of the USD/KD and the GBP/USD. The result was ρ -0.5453, i.e. a negative correlation. This means the exchange rate of the GBP/USD tended to move in the opposite direction to that of the USD/KD. Table 3.7 shows that the GBP had a minimum value of $1.419 in February 2002.

On the other hand, the GBP recorded its minimum value against the KD in December 2008 and its maximum value in April 2007.

The EUR had a minimum value against the US dollar of 87.1 cents in February 2002, and a maximum rate of $1.579 in April 2008. The correlation between the EUR/USD and the USD/KD exchange rates is negative, with a correlation coefficient of ρ –0.87123. In addition there is positive correlation between the KD/USD and the EUR/KD exchange rates, with a correlation coefficient of ρ 0.72626. Thus the EUR/KD exchange rate tends to move in the same direction as the KD/USD exchange rate.

Table 3.7 The Minimum and Maximum Exchange Rates for the GBP/USD, GBP/KD, EUR/USD, EUR/KD, USD/CHF, CHF/KD, USD/JPY and JPY/KD

ITEMS	Currency	PERIOD	RATE	ITEMS	PERIOD	RATE
MIN.	GBP/USD	FEB. 2002	1.419	MAX.	NOV. 2007	2.041
	GBP/KD	DEC. 2008	0.405		APR. 2007	0.579
MIN.	EUR/USD	FEB. 2002	0.871	MAX.	APR. 2008	1.579
	EUR/KD	FEB. 2002	0.267		NOV. 2009	0.425
MIN.	USD/CHF	APR. 2008	1.009	MAX.	FEB. 2002	1.692
	CHF/KD	JAN. 2002	0.181		NOV. 2009	0.281
MIN.	USD/JPY	DEC. 2009	89.507	MAX.	FEB. 2002	133.424
	JPY/KD	JAN. 2002	0.00229		FEB. 2009	0.00319

The USD/KD exchange rate showed a very small correlation coefficient of ρ 0.152 with the USD/CHF exchange rate. The minimum value of the USD against the CHF was 1.009 CHF in April 2008, compared with a maximum value of 1.692 CHF. The KD/USD exchange rate had a higher correlation (ρ 0.626) with the CHF/KD exchange rate, showing that they tend to move in the same direction.

Finally, the minimum value of the USD against the JPY was 89.507 JPY in January 2002, compared with a maximum value of JPY 133.24 to the dollar.

Moreover, the relation between the USD/KD and USD/JPY showed a positive correlation of ρ 0.5229. In comparison, the JPY against the KD had a minimum value of 2.29 fils, and a maximum of 3.19 fils. Furthermore, the correlation coefficient between the KD/USD and JPY/KD exchange rates was ρ 0.118, which represents a very small positive correlation.

When the Kuwaiti dinar was fixed to an undisclosed basket of currencies, the USD was assumed to have a weight of more than 70%, with other major currencies such as the GBP, EUR, CHF, and JPY making up the remainder of the basket. The USD/KD exchange rate has been stable since May 2006, with a mean value for the USD of 282 fils. The abandonment of the single USD exchange rate regime in May 2007 helped the CBK to protect and stabilize the value of the KD against the USD.

The pegging of the KD to a basket of major currencies was used by the CBK for a decade. The bank was allowed to modify the basket of currencies and had some scope to re-value and devalue the KD within certain margins. The CBK argued that one of the main reasons for reverting to its old exchange rate regime was the record level of inflation in which began to hit Kuwait and the GCC region. In the next section we will investigate the historical data relating to the Kuwaiti Consumer Price Index (CPI).

3.8 THE CONSUMER PRICE INDEX

A consumer price index (CPI) measures changes in the price level of goods and services over time. If the CPI shows an increase in price level, the price for all goods, services and other traded goods tends to be pushed upwards. The Central Bank of Kuwait's main objective is to protect the national economy from domestic and imported inflation. The State of Kuwait has mostly experienced very low inflation since independence. Inflation has not been a threat to the country's economy, and the CBK has successfully protected the country from inflation by using different monetary tools.

Inflation can be caused by various factors, such as the country's economic growth, government expenditure, depreciation of the national currency against other major currencies, and an increase in commodity prices.

The State of Kuwait, like other GCC countries, has not had any experience of inflation until recently. Average yearly inflation gradually increased in Kuwait over the years. It rose to 4.11 % in 2005 and dropped to 3.3% in 2006, but in 2007 it increased again to 5.5%. The following year, 2008, it increased to 10%, and in 2009 dropped again to 3% to record a CPI index of 136, compared to an index of CPI 130.8 in 2008.

Figure 3.9 The Consumer Price Index, 1994–2009

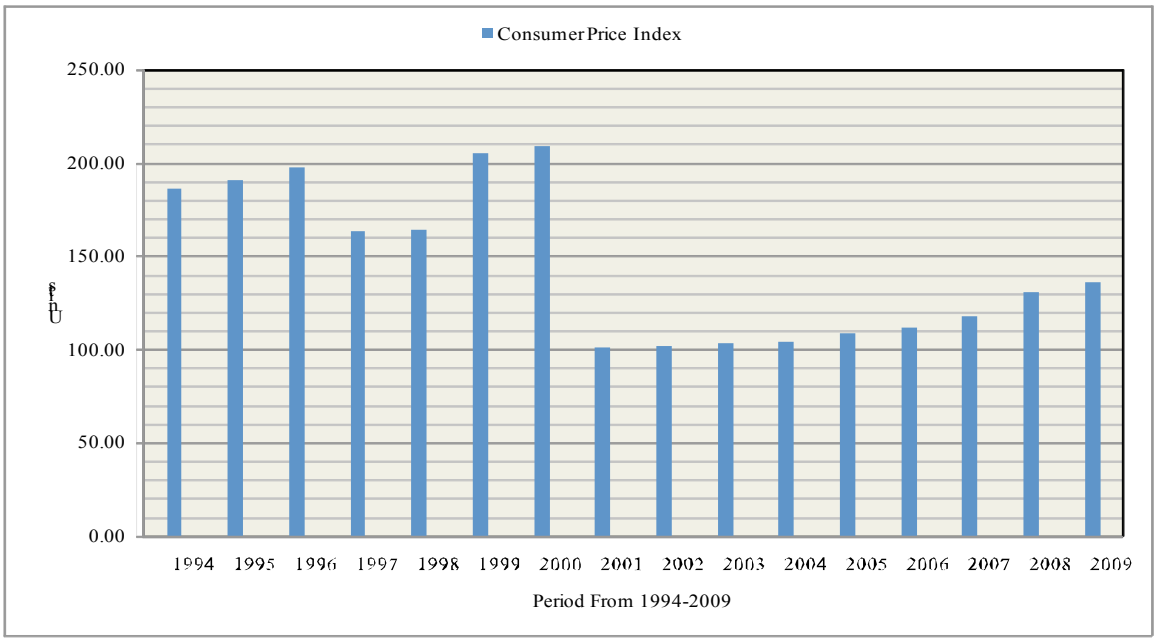


Figure 3.10 The Consumer Price Index, 1994–2009

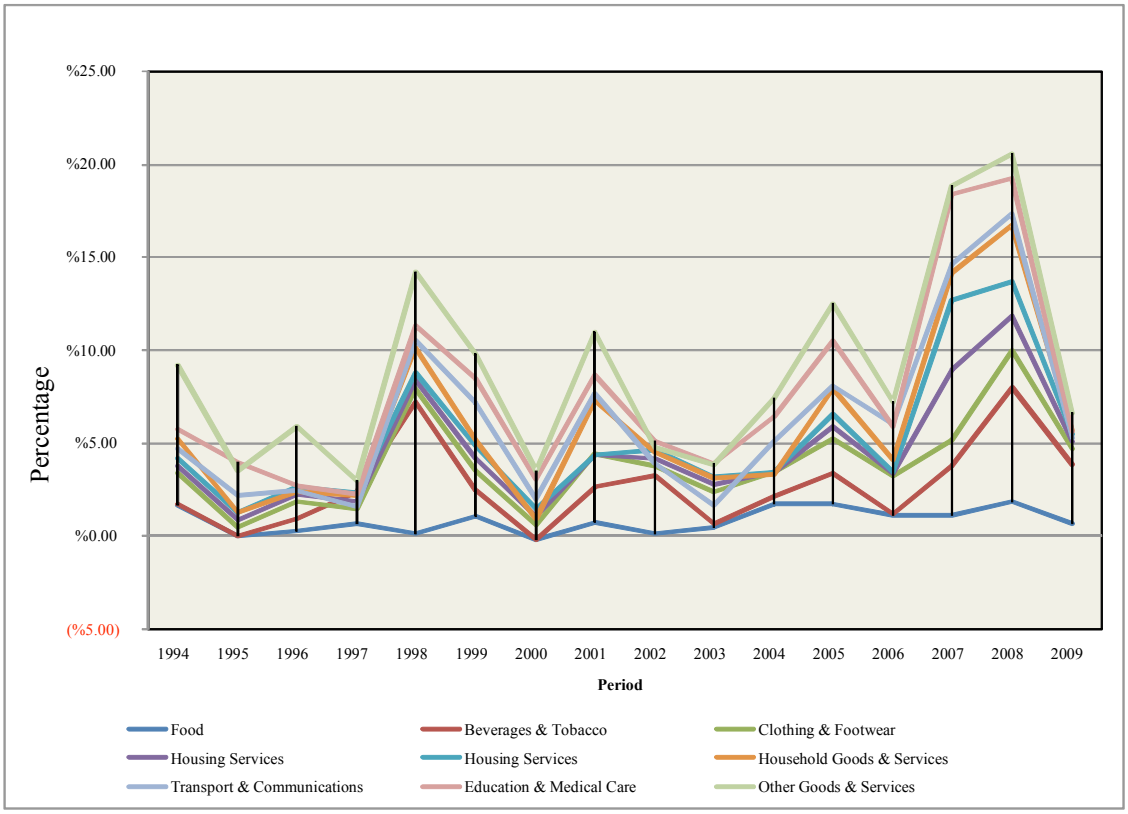


Figure 3.10 shows the percentage change of the CPI by expenditure. We can see from the figure that the CPI index increased from the year 2003 onwards. The highest increase was in the educational and medical care sectors in 2007, and the minimum increase was in other goods and services. In 2008 inflation increased as a result of a price increase of 6.15% in the beverages and tobacco sector. The minimum increase (0.46%) was in the transportation and communication sector. The main CPI index increased by only 3%, which was lower than the previous year when there had been an increase to 10.57%. The 2008 increase was mainly due to the increase of 3.11% in the beverages and tobacco sector. The transport and communication sector, however, saw a decrease to 0.37%.

Thus the data has shown that the CPI index has gone through different changes over the past few years. These have been mainly due to recent economic events such as the hike in commodity prices worldwide and the change of the exchange rate policy used by the Central Bank of Kuwait in the period 2003 to April 2006.

Figure 3.11 Average Exchange Rates For the USD/KD, 2003–2009

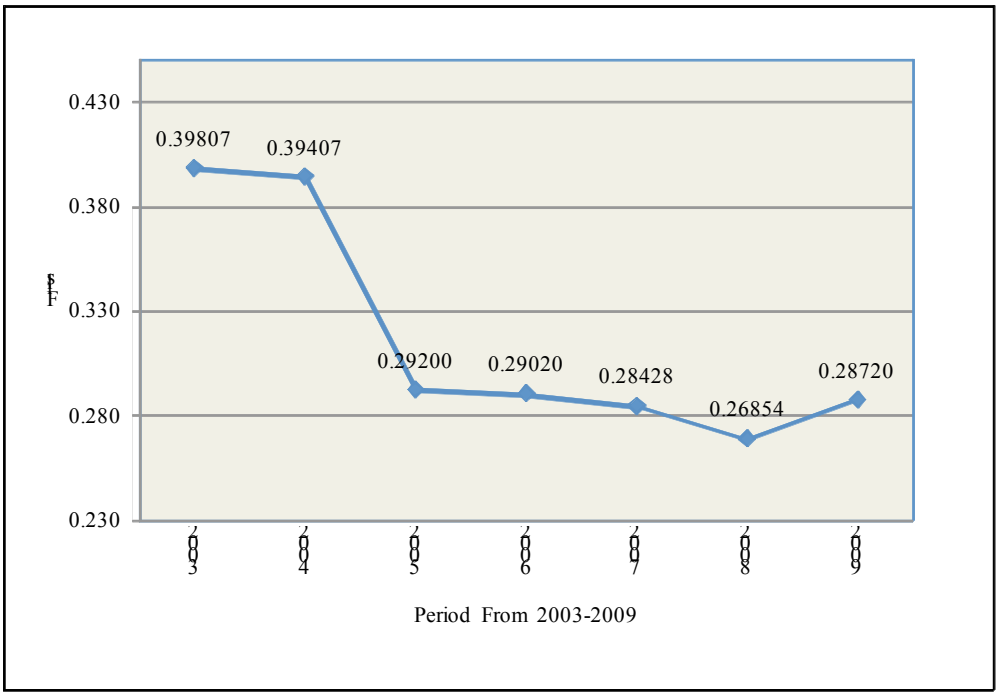


Figure 3.11 shows that the average exchange rate for the USD against the KD was 398.07 fils in 2001, compared to the average exchange rate for the entire period 2002–2009 of 296 fils, which represents an appreciation of the US dollar of 0.256%. In 2004 the USD/KD exchange rate still did not change much and the value of the dollar stayed within 394.07 fils. An appreciation of the KD was noticed on the average exchange rate for the year 2005 when the USD had a mean value of 292 fils, which represented a depreciation of the US dollar of –0.259%. In the first quarter of 2006 the CBK decided to re-value the KD value against the USD, which brought the exchange rate value of the USD to 290.20 fils in 2006 and 284.28 fils in 2007.

The CBK saw inflation pressure as a threat to the national economy, and it set itself the objective of stabilizing the national currency and the purchasing power of the KD. Until the beginning of 2003, the CBK adopted an exchange rate policy of pegging the KD to a basket of currencies, and, as we can see from the above graph, inflation over that period was almost stable. Then the CBK changed its exchange rate policy to fix the KD to the USD alone, and inflation began to appear in Kuwait. The appreciation of the real-estate sector over the

past few years and the increased price of food have also had the effect of pushing up the inflation rate. The increase in cost of raw materials, food, commodities, liquidity, and other factors may also have contributed.

Exchange rate policy is one of the tools that the CBK has used to fight inflation. However, in the case of Kuwait, the change rate policy and the depreciation of the KD against the major currencies was probably the main factor causing increased inflation. The KD depreciated against the currencies of those countries with which Kuwait enjoys important trade relationships, such as European countries and Japan.

The US dollar pegged exchange rate regime was set by the CBK to allow the KD to fluctuate against the USD within a margin of ±3.5%. The CBK had the flexibility to regulate the KD against other major currencies, and the dollar exchange rate was controlled within set margins.

In the period 2003–2009 the average value of the KD declined against other major currencies. It fell in value against the EUR by 7%, 11%, and 7% for the years 2003, 2004, and 2007 respectively. It also depreciated against the JPY by 6% for the years 2003, 2004 and 2008. However, when the CBK dropped the US dollar pegged rate, the KD started to retrieve its value against the euro. It can be understood from the previous discussion in this chapter that, although it was not by any means the only cause, the fall in value of the KD against major currencies such as the GBP, EUR and JPY during the US dollar pegged regime was one of the main drivers of inflation hikes.

3.9 CONCLUSION

The exchange rate is the value of one currency expressed in terms of another, and can be quoted in three different ways. A direct quote uses the US dollar as the base currency and is the one most used. It puts the base currency on the left side and the counter currency on the right side. The second type of quote is the indirect quote, which uses not the US dollar but another currency such as the GBP, AUD or NZD as the base currency, and again it is read from left to right. The third way of quoting a currency is by the cross rate, in which any other

currency than the currencies used in direct and indirect quotes can be the base currency, and the USD is not reflected.

Currencies are quoted in the foreign exchange market, and the price of a particular currency is given an FX market value. The foreign exchange market is place where both buyer and seller can meet their specific needs, whether they are countries, banks, investors or individuals, and they all meet to exchange one currency for another.

The price of a currency is determined by the supply and demand for that particular currency. But the exchange rate can be influenced by other factors too, such as economic events, political stability, central banks' interventions and speculation.

Currency movements and fluctuations have been considered by economists and monetarists. The fundamental determinants of exchange rate movements have been studied in this chapter are the PPP, CIP, and UIP. The PPP theory rests on the basic idea, derived from the Law of One Price (LOOP), that in a competitive market free of transportation costs and other barriers to trade, identical products should sell in different countries at the same price. However, the PPP theory takes into account that inflation influence prices, and that a country with high inflation will have a higher price for any given product than a country with lower inflation. The exchange rate between them will therefore vary according to the relative purchasing power of the two currencies. CIP and UIP assume that in the case of free movement of capital among countries, the exchange rate will stabilize at a points where equality of interest is established, and that the nominal interest rate in a country is determined by the real interest rate and inflation. Currencies will therefore fluctuate accordingly. However, there is much debate about whether these theories hold water in the real market and one has to exercise caution in applying them.

The State of Kuwait established the national currency in 1961, and before that the monetary system was dependent on foreign currencies, especially the Indian rupee which was circulated widely in Kuwait from the 1930s to the 1960s. The KD was established in 1960 by Kuwaiti law just after the country got its

independence. The value of KD at that time was set at par value of KD 1 = 1 sterling pound. Kuwaiti coins were introduced in 1961. The currency board was responsible for issuing the KD until 1968. There were five different issues of currency notes.

The KD exchange rate regime is one of the most important monetary tools that the Central Bank of Kuwait uses to stabilize the currency. From 1975 to the end of 2002 the CBK adopted fixed exchange rate regimes against a basket of foreign currencies which were selected according to Kuwait's various trade relationships. But in January 2003 the CBK took a step foreword and fixed the KD rate against the US dollar alone. It did so in accord with the GCC economic agreement which states that all GCC countries should adopt a similar exchange rate policy as a step towards GCC single currency and union.

In summary, the CBK has over the years been very successful in keeping the USD/KD exchange rate at a consistent level. As we saw at the beginning of our discussion, when the CBK took the decision to drop the basket of currency exchange rate regime and adopt a USD single currency regime instead, the CBK set the exchange rate parity to within a ±3.5 margin, and this remained the level of the historical USD/KD exchange rate. The CBK then found it advantageous to return to a basket of currencies pegged exchange rate regime in order to gain the flexibility to adjust the value of the KD according to daily fluctuations on the foreign exchange market. This was especially important when the USD was depreciating against other currencies.

The basket of currencies regime was set by the Central Bank of Kuwait because the basket would contain currencies of countries with which Kuwait enjoyed good trade relationships. Although the currencies in the basket remained undisclosed, most people assumed that the US dollar constituted the largest portion, while other portions were made up by the GBP, EUR, CHF and JPY. The bank monitors the changes in value of these currencies in order to protect the value of the KD and to protect the national economy from imported inflation.

The US dollar exchange rate regime enabled the CBK for many years to control the value of the KD against the USD. In fact, the bank had even succeeded in

doing this during the earlier basket of currencies exchange rate regime. However, the value of the KD was less controlled against the other major world currencies during the US dollar exchange rate regime. The rise in price of raw materials, commodities and oil was another cause of increased inflation. Since Kuwait is not an industrial country and imports most of its goods from abroad there was a need for a more flexible exchange rate regime that would successfully protect the country from imported inflation.

The choice of exchange rate regime has been an important tool in the fight against inflation. By its decision at a time when the USD was falling in value to drop the regime in which the KD was pegged to the dollar and to adopt a basket of currencies in its place, the CBK has been able to maintain the value of the KD against other world currencies and protect the Kuwaiti economy from inflationary pressure. This exchange rate regime remains in place at the time of writing this thesis.

Chapter 4 THE DEVELOPMENT OF KUWAIT'S MONETARY POLICY

4.1 INTRODUCTION

The development of Kuwait's monetary policy is an outcome of the country's economic performance. It has been principally influenced by the great expansion in government expenditure and economic investment following the country's significantly increased oil revenues in recent decades. During these years the Kuwaiti economy has witnessed a remarkable growth in all its sectors, which has in turn created a growing demand for banking activities and monetary services.

Theoretically, monetary policy is an aspect of overall macroeconomic policy, a form of the government's intervention in the country's economic processes with particular objectives. The main objective of monetary policy is to look at the relationship between the interest rate in an economy, which is the cost at which money can be borrowed, and the supply of money. Monetarists use different monetary tools to control the both of these.

Monetary policy influences economic growth, inflation and unemployment. Only the monetary authority or central banks have control of the money supply and thus are able to influence interest rates according to policy objectives. Monetary policy follows one of two courses. The monetary authority pursues either a policy of contraction, by which it reduces the money supply or increases the interest rate, or an expansionary policy, by which it increases the money supply or reduces the interest rate. An expansionary policy can be pursued by, for example, the allocation of credit in accordance with developed priorities rather than permitting commercial banks and other financial institutions to carry out this task without supervision.

One of the problems facing policy makers when they consider stabilization polices in small open economies with a high degree of export specialization is

the limited size of the impact multiplier of monetary injections. This is due to the limited size of sectors producing non-traded goods and services (the bulk of non-oil GDP in the case of Kuwait). In such an economy, production (total GDP) and real income are mainly influenced by the costs of domestic supply and by world, rather than domestic, demand.

Other problems include information and response lags, together with uncertainty about the link between policy instruments and domestic output. These problems may indeed have been responsible for the extremely volatile monetary growth in Kuwait. They may also explain why monetary policy is aimed at the regulation of interest rates, the control of inflation, exchange rate stability, credit availability and its allocation, rather than at short-term monetary control. But there can be conflicts between these aims.

The objective of this chapter is to review the development of the Central Bank of Kuwait (CBK) and its aims. We will also analyse the development of the monetary system in Kuwait, and show how the CBK uses monetary tools to achieve its objectives of controlling inflation and enhancing economic growth. In addition, since one of the CBK's main responsibilities is to supervise and manage the country's financial system, it will be interesting to review the financial market in Kuwait and how the CBK controls and influences the level of borrowing by financial enterprises.

4.2 THE CENTRAL BANK OF KUWAIT

In 1960 the Kuwaiti Currency Board was established by Emiri Decree No. 41 and the Kuwaiti dinar was put into circulation in April 1961. On 30 June 1968 the Central Bank of Kuwait was established under Law No. 32, which was also concerned with currency and the organization of banking business. The chief role of the central bank in any country is twofold: to ensure the soundness of the financial sector, and to ensure a rate of monetary expansion that is appropriate for short-term stability and long-term economic growth. Accordingly, Article (15) of Law No. 32 of the year 1968 stated that the objectives of the Central Bank of Kuwait should be:

1. To exercise the privilege of the currency issuance on behalf of the state;

2. To secure the stability of the Kuwaiti currency and its free convertibility into foreign currencies;

3. To direct credit policy in a manner that assists social and economic progress and the growth of national income;

4. To control the banking system in the state of the government;

5. To serve as banker to the government;

6. To render financial advice to the government.

Institutions subject to the supervision of the CBK are commercial banks, Islamic banks, specialized banks, exchange companies and investment companies. Article No. (72) of Law No. 32 of 1968 states that "the Board of Directors of the CBK may – whenever necessary – draw up rules and regulations to which all banks shall adhere in order to ensure their liquidity and solvency, particularly with regard to the ratios which must be maintained between the following items:

a. The bank's own funds on the one hand and the amount of its liabilities on the other;

b. The bank's liquid funds on the one hand and the aggregate of its term and demand liabilities on the other;

c. The amount of the bank's own funds on the one hand, and the amount of its liabilities in the form of acceptance and guarantees on the other." (CBK *Bulletin*, 1968, p. 38).

The Central Bank of Kuwait is the main government authority responsible for deciding and implementing monetary policy. One of the CBK's most important monetary tools is control of exchange rate policy, which has a bearing on a number of the bank's goals. The major objective of the exchange rate policy in Kuwait is to achieve relative stability in the exchange rate of the KD against foreign currencies and particularly the major intervention currency, the US dollar. But there are other goals which are of particular importance to the

Kuwaiti economy. These include openness to the outside world, free movement of capital and trade, and availability of foreign investment to both private and public sectors. Such investments have an increasing role as a source of income besides exports of oil.

4.3 THE CENTRAL BANK OF KUWAIT'S ASSETS

Table 4.1 shows the major items on the CBK's balance sheet. This table also illustrates the bank's assets. In October 2009 the total assets of the CBK reached 5191 million KD. Foreign assets represent more than 95 per cent of total assets. The same table shows that the total assets of the CBK peaked in 2009 and were at their lowest level in 2003.

Table 4.1 The Central Bank of Kuwait's Balance Sheet, 2000–2009

Items Values (KD) Million	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Gold	31.7	31.7	31.7	31.7	31.7	31.7	31.7	31.7	31.7	31.7
Deposits & Cash Balances	1,976.9	2,821.8	2,501.1	1,955.9	2,164.0	2,445.9	3,519.4	4,443.3	4,581.4	5,098.2
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total	2,008.6	2,853.5	2,532.8	1,987.6	2,195.7	2,477.6	3,551.1	4,475.0	4,613.1	5,129.9
Foreign Assets										
Rediscount Commercial Papers	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Accounts with Local Banks	14.0	0.0	0.0	0.0	1.0	0.0	0.0	0.0	311.0	0.0
Claims on Government	0.0	0.0	0.0	0.0	0.0	14.5	0.0	0.0	0.0	0.0
Other	46.7	66.1	52.5	31.4	24.9	119.5	42.5	179.3	251.9	61.1
Total	2,069.3	2,919.6	2,585.3	2,019.0	2,221.6	2,611.6	3,593.6	4,654.3	5,176.0	5,191.0

Source: Central Bank of Kuwait, *Monthly Monetary Statistics* (several issues).

4.4 MONETARY POLICY DEVELOPMENTS

The CBK's Law has been amended under Decree Law No. 130, issued on 25 October 1977. This law gave the CBK more powers and tools. A number of these tools were changed during the 1980s to give them greater flexibility. The most important instruments were reserve requirements, interest rates and liquidity ratios. The CBK has employed reserve requirements since 1980. Commercial banks and specialized banks are required to maintain 3 per cent of their deposits in cash. Since this tool was introduced, reserve requirements have not changed. As noted earlier regarding interest rates, Kuwait has an open economy, and therefore the CBK has traditionally tried to meet its objectives by controlling interest rates. However, during the 1980s and 1990s the CBK showed a gradual move towards more flexible use of this instrument. To free interest rates from its control, the CBK moved away from direct controls by taking the steps outlined as follows.

During the late 1970s the interest rate became fully controlled by the CBK. Before then the CBK could not change the interest rate by itself but had to obtain permission from the Ministry of Finance. For loans over a year in maturity their maximum effective rate was 10 per cent.During the mid-1980s the CBK fixed the minimum rates for bank savings deposits.

In March 1987 the CBK introduced a new structure for interest rates. Limits were adjusted, and rates on loans over one year were linked to the interbank market.

In December 1988 the CBK took a step forward to free interest rates. This was done by linking the whole interest rate structure to the discount rate. The new structure, which has been applicable since 11 December 1988, is highly flexible and links interest rates on both loans and deposits with a reference or discount rate within certain margins, and the level of interest rates can be amended automatically to this discount rate.

Therefore, there is no need for the CBK to seek permission from the Ministry of Finance. According to this structure, the upper limit on interest rates shall not be

more than the discount rate determined and declared by the CBK's board of directors as follows: a 2 per cent margin for loans less than one year, a 2.5 per cent margin for those greater than a year in maturity, no margin for time deposits of less than three months, and a 1 per cent margin for time deposits of more than six months. It may be argued that the discount rate became the basis for the Kuwaiti interest rate structure after the December 1988 changes. In response to higher interest rates in the world market at that time, the CBK raised the discount rate from 5 to 7.5 per cent, which shifted the prevailing level of domestic rates noticeably upward. However, the CBK did not change the discount rate again until April 1993. Moreover, during the post-1988 period the interest rate regime combined a fixed spread with a ceiling on loan rates.

During 1993 and 1994, the CBK adjusted the interest rate more frequently. The advantages of wider financial liberalization became more attractive to the CBK. However, between November 1993 and August 1994, the CBK changed the minimum rates on savings accounts several times, and in 1994 it increased the discount rate on three occasions in the interests of KD exchange rate stability and in response to international rate movements. In 1995 the CBK deregulated interest rates on all deposit accounts and removed limits on banks' fees and charges.

In view of developments in interest rates policy, we can argue that rates payable on the liabilities of financial institutions in Kuwait are more closely linked to market forces. In consequence, domestic financial market conditions are more openly linked to international developments than they have ever been in the past. In fact, the only controls remaining are those on certain lending rates, which continue to be linked to the discount rate.

The CBK took seven decisions in 2001 concerning the discount rate, which resulted in the reduction of this rate by three percentage points (from 7.25% to 4.25%). These decisions were within the framework of the CBK's constant monitoring of the developments and trends in domestic interest rates, the levels and trends of domestic liquidity, and interest rates in the world market.

From another perspective, the domestic interest rate structure was unchanged, and the maximum interest rates of KD-denominated loans extended by local banks to their clients continued to be linked to the discount rate, within specific margins. It is worth noting is that the floor of interest rates on KD deposits and savings accounts was abrogated on 30 January 1995.

The CBK carried out two consecutive cuts to the discount rate during 2002, totalling one percentage point from 4.25% to 3.25%.

During 2003 the CBK maintained the discount rate at its recorded level of 3.25% at the end of 2002 without introducing any significant changes. The CBK's decisions for discount rate adjustment were made on the basis of the needs of domestic economic sectors. Such changes were intended to boost their activity without substantially affecting the country's price indices.

During the second half of 2004 the CBK issued five decisions raising the discount rate by a total of 1.5 percentage points from 3.25% to 4.75%.

During 2005 the CBK issued five decisions raising the rate of discount and rediscount on commercial papers presented to it local banks by a total of 1.25 basis points from 4.75% to 6%. The CBK continued during 2005 to use the instruments of monetary policy available to it for the purpose of influencing the level of domestic liquidity. Particularly notable among these instruments was the system which the CBK endorsed in late 1995 for accepting deposits from local banks to absorb the domestic liquidity surplus.

Furthermore, within the efforts aimed at developing the domestic money market, in August 2005 the CBK resumed the application of the CBK bonds system, after introducing certain amendments to it, so as to enhance the role of that instrument in absorbing excess domestic liquidity. The most significant of these amendments was the extension of the maturity period of bonds to a period not exceeding one year instead of 91 days.

The CBK in 2005 continued its efforts to boost competition among the banking and financial sector units by allowing foreign banks to open branches in Kuwait. Consequently, branches of the BNP bank, the HSBC bank and the Abu Dhabi

National Bank were entered in CBK's register of commercial banks between August and November 2005.

The CBK continued during 2006 to use the system of accepting deposits from local banks as a main mechanism for the absorption of excess domestic liquidity, in addition to issuing its own bonds. The CBK also continued its efforts in the issuance of public debt instruments on behalf of the Ministry of Finance, though the role of these instruments in regulating the levels of domestic liquidity contracted substantially.

The CBK intensified its efforts to absorb excess domestic liquidity whereby amounts withdrawn by the CBK reached levels. In May 2007 Decree No. 147 was issued by virtue of which the peg existing since beginning of 2003 between the KD exchange rate and US dollar was decoupled and the KD exchange rate was thereby pegged to a special weighted basket of currencies of the main trade and financial partners of the State of Kuwait.

Table 4.2 shows the developments in the KD interest rate structure during 2000–2009. This table indicates that in 2009 the discount rate was 3 per cent compared with 7.25 per cent in 2000, and at its lowest level since then. It is worth mentioning that the CBK is keen to keep domestic interest rates on the KD consonant with the developments in interest rates of major currencies (mainly the USA dollars). During the period 2000–2007 the CBK always kept a margin (two points) between the KD interest rate and US interest rate.

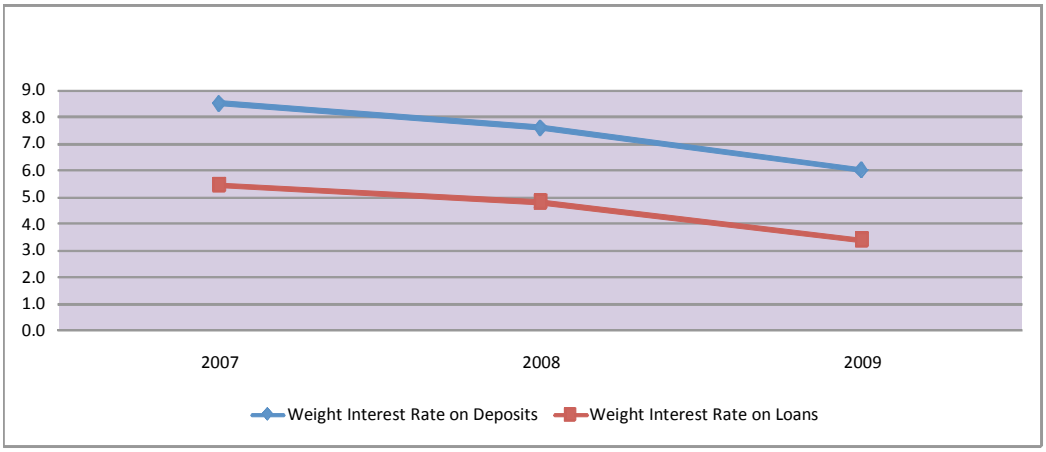
The main purpose behind this margin is to curb capital outflow and stabilize the KD deposit base of local banks. However, due to world financial crisis, the CBK reduced the discount rate to 3.75% in 2008, and in 2009 to 3% only.

Table 4.2 Developments in Kuwaiti Dinar Interest Rate Structure, 2000–2009

Items	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Discount Rate	7.25	4.25	3.25	3.25	4.75	6.00	6.25	6.25	3.75	3.00
Change (percentage points)	0.50	-3.00	-1.00	-1.00	1.50	1.25	0.25	0.00	-2.50	-0.75
Maximum Contractual Interest Rate s on KD Lending Transactions:	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
Less than one year	9.70	6.75	5.75	5.75	7.25	8.50	8.75	8.75	6.25	6.00
In case of overdraft	10.25	7.25	6.25	6.25	7.75	9.00	9.25	9.25	6.75	5.50
Over one year	11.25	8.25	7.25	7.25	8.75	10.00	10.25	10.25	7.75	6.00
In case of overdraft	11.25	8.25	7.25	7.25	8.75	10.00	10.25	10.25	7.75	6.00
Consumer loans	7.25	4.25	3.25	3.25	4.75	6.00	6.25	6.25	3.75	3.00

Source: Central Bank of Kuwait Economic Reports, CBK Quarterly Bulletin Several Issues.

Figure 4.1 Developments in Kuwaiti Dinar Weighted Interest Rate, 2000–2009



Since the mid-1970s the CBK has used minimum liquidity ratios. By this ratio the CBK determines certain components of assets which must be in liquid form. In fact, there are two objectives behind the minimum liquidity ratios in Kuwait: to affect individual banks and to affect the market. Banks in Kuwait are required to hold liquid assets. Liquid assets include cash balances with the CBK, and holdings of bills and other liquid assets.

During the 1980s the minimum liquidity ratios were 25 per cent of total deposits and other liabilities. During the 1990s liquidity ratios varied. For instance, it was 5 per cent on time deposits of more than a year in maturity, 20 per cent on time deposits of 3–6 months maturity, and 35 per cent on demand deposits.

As with reserves, it is clear that the CBK has not aggressively used liquidity requirements as a principal tool of its monetary objectives in recent years. However, liquidity management as an indirect tool has been used effectively by the CBK during the 1990s and 2000–2009.

The main purpose of using this tool is to keep the exchange rate stable and to influence interest rate policy. Liquidity management in Kuwait has been defined by types and modalities of CBK purchases and sales including swaps of market instruments with the banking system.

4.5 MONEY SUPPLY

Table 4.3 shows the changes in the various money measures over the years from 2000 to 2009. During 2000–2009 Money (M1) (money supply in its narrow definition) increased by an average annual rate of 23 per cent more than Money (M2) (money supply in its broad definition), and Money (M3) (money supply in its broadest definition), both of which grew at an annual rate equivalent to 20 per cent for both of them.

Quasi–Money (QM) grew at an average annual rate of 19 per cent during the same period. The broad money growth during the same period was driven principally by an expansion of net domestic assets, and most of this rose from claims on non-government sectors. It is worth mentioning that the M2 growth in 2009 was lower than in previous years and this could be explained by the world financial crisis and its impact on the local economy.

Table 4.3 Developments in Money Supply and its Components, 2000–2009

Items (KD) Million	M1	%	QM	%	M2	%	M3	%
2000	1467.7	0%	6695.6	0%	8163.2	0%	8175.2	
2001	1641.4	12%	7567.1	13%	9208.5	13%	9220.4	13%
2002	2066.7	26%	7579.6	0%	9646.3	5%	9655.5	5%
2003	2611.5	26%	7789.7	3%	10401.2	8%	10410.2	8%
2004	3174.2	22%	8481	9%	11655.2	12%	11678.4	12%
2005	3727.4	17%	9358.8	10%	13086	12%	13100.4	12%
2006	3550.3	-5%	12370.3	32%	15920.6	22%	15946.7	22%
2007	4146.7	17%	14813.2	20%	18959.9	19%	18986	19%
2008	4370.3	5%	17579.9	19%	21950.2	16%	22007	16%
2009	4890.7	12%	19835.4	13%	24726.2	13%	24750.8	12%

Source: Central Bank of Kuwait, *Economic Reports*; CBK, *Quarterly Bulletin* (several issues).

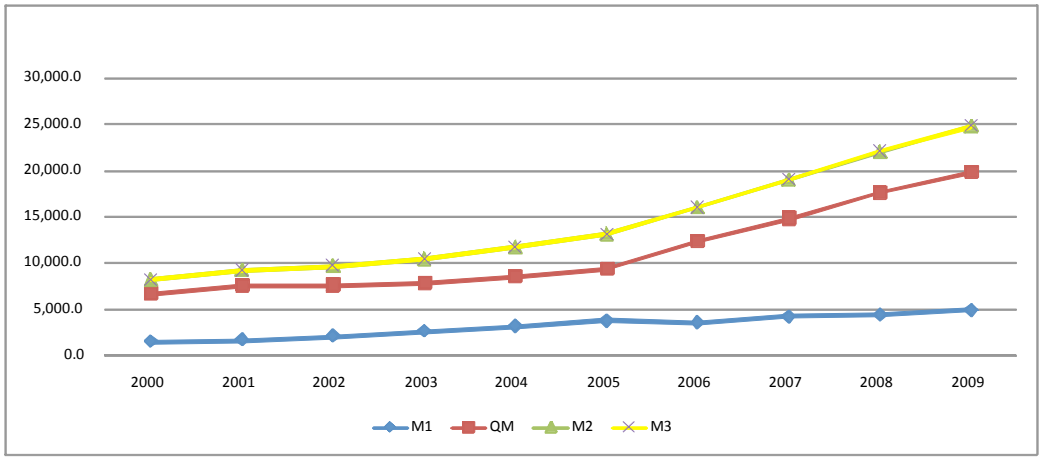
Monetary growth in Kuwait remained within reasonable bounds throughout the 2000–2009 period, and the liquidity policies and the heightened supervision exercised by the CBK contributed to this favourable result. This stability in the Kuwaiti money demand was supported by several important factors, including the following:

(i) The relatively slow and steady course of domestic non-oil prices and activity.

(ii) Openness. As mentioned earlier, Kuwait has an open economy, i.e., capital flows smoothly into and out of Kuwait.

(iii) The ability of the CBK to maintain a stable exchange regime.

Figure 4.2 Developments in the Kuwaiti Dinar Money Supply, 2000–2009



Monetary growth in Kuwait is influenced mainly by government domestic expenditure and the domestic credit growth of banks. The balance of payment transactions of the private sector through payments for imports, remittances by expatriates and capital flows usually act to reduce the potential expansionary effect of these factors. The current account of the private sector is more stable and depends on more or less stable variables, while the capital account is subject to periodic fluctuations. And the effect of the government's expenditure was based on the country's oil revenues, as discussed in Chapter 3.

4.6 MONETARY POLICY AND INFLATION

In Kuwait there are two indices measuring changes in prices. The first index is the Consumer Price Index (CPI) which is a single measure of the changes in the prices of goods and services bought by consumers. It is also referred to as the cost of living index. The second index is the Wholesale Price Index (WPI) which measures the price of all goods entering the retail trade.

Table 4.4 shows that inflation in consumer prices (CPI) has generally been low at an average rate of 1.3 per cent during 2000–2004, while during the period of 2005–2008 the CPI rose to 10.6%. Wholesale prices saw a lower average rate of inflation of 3.9% in 2007.

However, Table 4.4 shows that the average annual growth of the CPI and WPI during 2000–2009 was 3.4 and 2.4 percent only. Figure 4.3 shows the difference between the CPI and WPI in Kuwait during the period 2000–2007.

Figure 4.3 Developments in the Kuwaiti Consumer Price Index & Wholesale Price Index, 2000–2009

Although the CBK has been successful in preventing inflation during the last two decades, it failed to control inflation during 2005–2008. Reports from the CBK argued that the high inflation rate in Kuwait was imported from outside Kuwait. It may be explained by the weaknesses of the US dollar against the major currencies during the pegged period. As we mentioned in Chapter 3 and earlier in this chapter, the KD was pegged to the US dollar in 2003.

Table 4.4 Developments in Kuwait's Consumer Price Index & Wholesale Price Index, 2000–2009

Items	Consumer Price Index (2000=100)	Percentage of Growth	Wholesale Price Index (1980=100)	Percentage of Growth
2000	100	--	163.1	--
2001	101.3	1.30%	166.3	2.0%
2002	102.2	0.89%	171.8	3.3%
2003	103.2	0.98%	175.1	1.9%
2004	104.5	1.26%	175.8	0.4%
2005	108.8	4.11%	183.6	4.4%
2006	112.1	3.03%	187.5	2.1%
2007	118.3	5.53%	194.8	3.9%
2008	130.8	10.57%	--	--
2009	134.6	2.91%	--	--
Average	111.58	3.40%	177.25	--

Source: Central Bank of Kuwait, *Economic Reports*; CBK, *Quarterly Bulletin* (several issues).

4.7 THE FINANCIAL SECTOR

The financial sector in Kuwait will now be considered as it has carried all deposit and loan transactions. This sector includes the Central Bank of Kuwait (CBK), six domestic commercial banks, three Islamic banks, seven branches of foreign banks, one specialized bank (the Industrial Bank), 100 investment companies (54 Islamic Investment Companies and 46 conventional Investment Companies), and 30 insurance and reinsurance companies, 39 exchange companies, 111 investment funds, and the Kuwait Stock Exchange.

4.8 LOCAL BANKING IN KUWAIT

At the end of 2009 there were eleven local banks with a total of 308 branches, one specialized bank and three Islamic banks. Except the Bank of Bahrain and Kuwait, which is jointly owned by the states of Kuwait and Bahrain, all other banks are purely Kuwaiti institutions and share holding companies listed on the Kuwait Stock Exchange.

Table 4.5 shows local banks in Kuwait. It shows that the National Bank of Kuwait was the first established bank in Kuwait. The same table indicates that the total share capital of local banks in 2009 was KD 1540.5 million.

Table 4.5 Kuwaiti Local Banks as of 2009

Banks	Year Found	Number of Branches	Share of Capital in (m KD)
National Bank of Kuwait	1952	67.0	297.3
Commercial Bank of Kuwait	1960	53.0	127.2
Gulf Bank	1960	48.0	250.8
Al-Ahli Bank	1967	23.0	115.3
The Bank of Kuwait and Middle East	1971	24.0	97.6
Burgan Bank	1975	21.0	104.1
Bank of Bahrain and Kuwait	1978	1.0	77.4
Kuwait International Bank	1973	9.0	103.7
Bobyan Bank	2004	14.0	116.5
Industrial bank	1974	1.0	20.0
Kuwait Finance House	1977	47.0	230.5
Total		308.0	1,540.5

Source: Institute of Banking Studies (2004); CBK, *Quarterly* Bulletin (several issues).

However, Table 4.6 includes several financial ratios which measure the capability of local banks to conduct their operations. Total assets of these banks amounted to KD 39379.2 million in 2009, compared to KD 13806.2 million in 2000, i.e. an increase of 185 per cent. The ratio measures bank efficiency in using available resources to achieve continued growth in the bank and profitable returns on shareholders' funds. Local banks in Kuwait continued to realize good profit levels during 2000–2009.

Figure 4.4 Kuwaiti Local Bank Branches in 2009

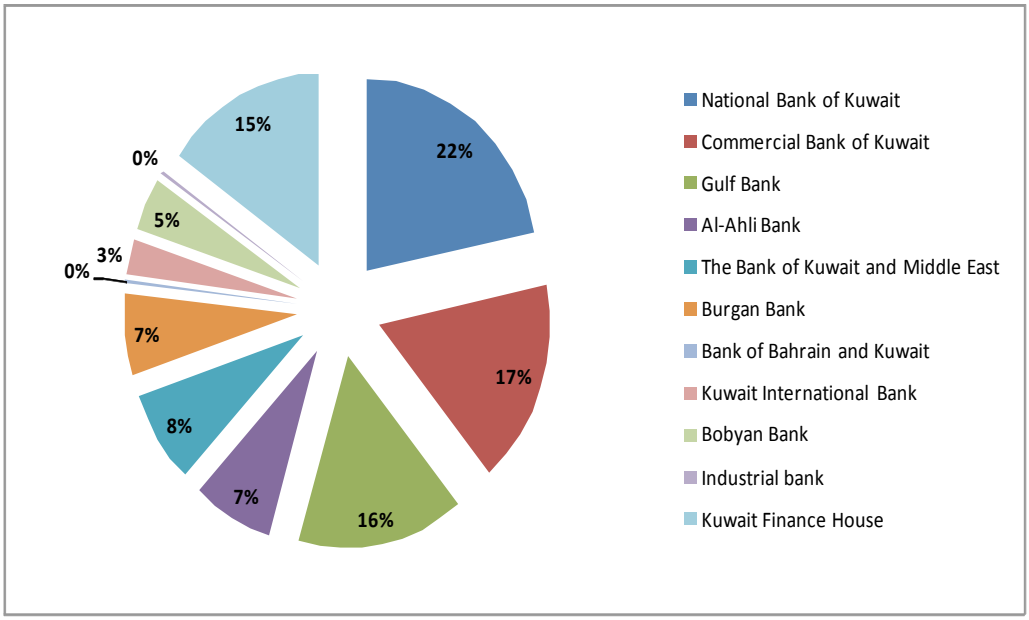


Table 4.6 Kuwait Local Commercial Banks Indicators, 2000-2009

Items in (KD) Million	Total assets	Total liabilities	Total Equity	Loans	Deposits	Liabilities to Assets %	Deposits to Assets %	Loan to Deposits %
2000	13806.2	13806.2	1582.7	5251.7	7931.7	100%	38.04%	66.21%
2001	15064.2	15064.2	1681.9	6125.3	9038.2	100%	40.66%	67.77%
2002	17063.7	17063.7	1770.3	6853.5	9863.6	100%	40.16%	69.48%
2003	18813.9	18813.9	2008.7	8419.4	10541.4	100%	44.75%	79.87%
2004	19144.2	19144.2	2311.3	9867	11966.3	100%	51.54%	82.46%
2005	21611.6	21611.6	2800.1	11827.3	13503.4	100%	54.73%	87.59%
2006	26990	26990	3170	14933.7	16698.6	100%	55.33%	89.43%
2007	35555	35555	4495.8	20138.7	20322.7	100%	56.64%	99.09%
2008	39242.1	39242.1	4599.9	23660	24777.5	100%	60.29%	95.49%
2009 Q1	39517.3	39517.3	4790.9	24178.4	27290.6	100%	61.18%	88.60%
Q2	39049.5	39049.5	4841.7	24313.1	27646.4	100%	62.26%	87.94%
Q3	39379.2	39379.2	4894	24778.3	27430.8	100%	62.92%	90.33%

Source: Central Bank of Kuwait, *Economic Reports*; CBK, *Quarterly Bulletin* (several issues).

Table 4.7 illustrates the types of the deposits in commercial banks. This table shows that private KD deposits in 2009 reached KD 23813.7 million compared to KD 7746.6 million in 2000. In fact, the ratio of KD deposits to total deposits increased from 88% in 2000 to 89% in 2009. Deposits in foreign currencies

represent 11% of the total deposits in 2009. Table 4.8 shows more details of all deposits types in the commercial banks.

Table 4.7 The Amount of Kuwaiti Local Bank Deposits from Both the Private Sector and the Government

	Items	2000	2009*	Average
Private Deposits	Amount in KD	6852	21147.8	13999.9
	Amount in Foreign Currency	894.6	2665.9	1780.25
	Total	7746.6	23813.7	15780.2
Government Deposits	Government Deposits	426	3617.1	2021.55
	Grand Total	8172.6	27430.8	17801.7

Source: F.C., *Deposits in Foreign Currency*; CBK, *Economic Report*, Sept. 2009.

Table 4.8 The Development of Local Bank Deposits by Type, 2000–2009

Items	Sight	Saving	Time	Cds	Total	Foreign currency	Total	Government	Gr.Total
2000	1,051	1,257	4,449	95	6,852	895	7,747	10	175
2001	1,240	1,394	5,217	64	7,915	892	8,807	14	217
2002	1,625	1,536	5,139	0	8,301	904	9,204	22	638
2003	2,117	1,573	5,175	52	8,917	991	9,907	15	619
2004	2,643	1,732	5,535	45	9,955	1,169	11,124	26	816
2005	3,149	1,779	6,010	22	10,960	1,548	12,508	40	956
2006	2,894	1,982	8,144	-	13,020	2,245	15,264	44	1,390
2007	3,505	2,370	10,760	-	16,636	1,683	18,318	48	1,957
2008	3,663	2,489	13,192	-	19,343	1,899	21,242	42	3,493
2009	4,142	2,809	14,198	-	21,148	2,666	23,814	62	3,555

Source: Central Bank of Kuwait, *Economic Reports*; CBK, *Quarterly Bulletin* (several issues).

Table 4.9 The Development of Local Bank Balances of Cash Portion Utilised from Domestic Credit Facilities by Sector, 2000–2009

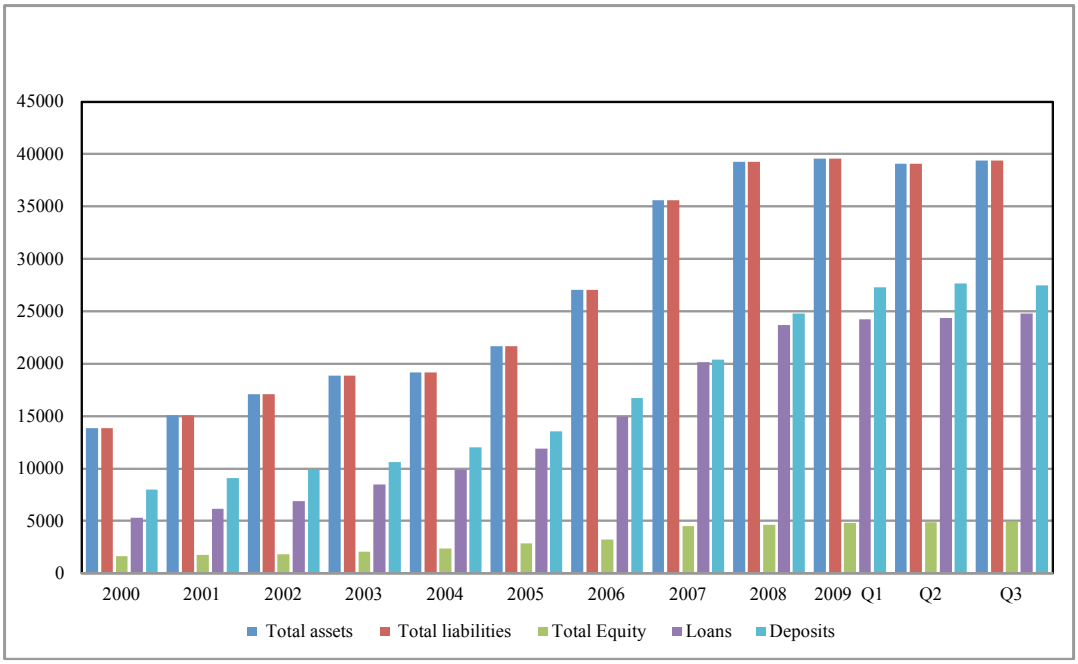
Items	Trade	Industry	Construction	Agriculture and Fisheries	Financial Institutions	Personal Facilities	Real Estate	Other	Total
2000	968.2	396.7	441.7	10.6	329.6	1683.8	853.8	567.5	5251.9
2001	1076.3	439.6	376.6	13.9	711.9	2022.6	1165.3	319.8	6126
2002	1021.9	465.5	454.1	20.1	538.1	2627.9	1298.4	360.5	6786.5
2003	1072.2	441.7	632.6	48.7	650.2	3442.6	1434.3	622.9	8345.2
2004	1276.2	447.1	591.5	22.8	781	4169.1	2029.5	494.9	9812.1
2005	1371.2	467.9	769.8	19.1	932.8	5137.5	2538.5	534.3	11771.1
2006	1702	608.9	1069.6	36	1427	6052.4	3288	694	14877.9
2007	1899.8	1071	1366.8	14.6	2408.7	7092.6	5001.9	1221.6	20077
2008	2284.9	1465.2	1674.4	12.4	2754.6	7865.9	5965.5	1524.9	23547.8
2009	2212.1	1460.8	1620.4	14.4	2918.6	8194	6565.5	1598.5	24584.3

Source: Central Bank of Kuwait, *Economic Reports*; CBK, *Quarterly Bulletin* (several issues, Sept. 2009 until the 3Q).

Table 4.9 shows the development of bank credit over the period 2000–2009. This table shows that the utilized domestic cash credit facilities extended by the local banks to economic sectors witnessed a marked annual growth of 37 per cent during the 2000–2009 period.

Consumer loans within the utilized cash credit facilities represent more than 33 per cent of the total domestic facilities, and their annual growth during the 2000–2009 period was 38 per cent. However, the sector distribution of balances of the utilized cash credit facilities extended by local banks to economic sectors at the end of 2009 show that all domestic economic sectors witnessed a high rate of growth. It may be argued that the high growth in balances of cash portion utilized from domestic facilities during the 2000–2009 period which are shown in Table 4.9 can be explained by the following two factors: confidence had returned after the Iraqi regime had been changed by US troops, and oil prices had shown good growth.

Figure 4.5 Kuwait's Local Bank Indicators in KD Million, 2000 to the 3rd Quarter of 2009



In fact, the oil price boom of 2003–2008 placed the Kuwaiti economy in a relatively strong position to confront the global crisis which appeared in 2008. This boom resulted in rapid growth in credit to the private sector (see Table 4.9).

A large portion of the credit growth was allocated to real estate, financial institutions and trade. The CBK's responses to the crisis have been timely and substantial, helping the local economy to weather the global crisis without major scars. The CBK has adopted extraordinary measures to ensure the normal functioning of financial markets. These have included deposit guarantees, liquidity support to ensure orderly money markets, capital injections, equity purchases and monetary easing. These policy actions are aimed at restoring confidence, stabilizing the banking system, and supporting demand to avoid an adverse downward spiral.

A key issue has been the interaction of policies, for the effectiveness of monetary and fiscal policies depends on a restoration of normal functioning to financial markets. Tightening of the lending standard persists. Credit to the

private sector in Kuwait has stopped since November 2008. Monetary policy has helped financial institutions through a lowering of funding costs.

4.9 OTHER FINANCIAL INSTITUTIONS

At the end of 2007, there were 79 investments companies registered with the CBK and subject to its supervision. The aggregate balance sheet of these companies stood at KD 16040.5 million at the end of 2007. The net financial resources available to these companies came from their domestic operations.

The total capital and reserves of these companies reached KD 5362.3 million or 33.4% of total liabilities. On the assets side, the domestic investments reached KD 5683.6 million (35.4% of total assets). These companies play a big role in the economy. Most of their activities are in the stock market, creating funds and new investments tools.

4.10 LOCAL EXCHANGE COMPANIES

At the end of 2007, there were 38 local exchange companies subject to CBK supervision. The aggregate balance of these companies reached KD 104.7 million at the end of 2007. The financial data of these companies for the period 2005–2007 indicate a qualitative improvement in the financial and operational positions. (CBK, *Economic Report*, 2007, p. 148).

4.11 KUWAIT STOCK EXCHANGE

The Kuwait Stock Exchange (KSE), set up in 1977, was the first of the Arab Gulf stock exchanges to be established. The KSE was closed for the period from 2 August 1990 (date of the invasion) to 28 September 1992. At the end of 2009 there were 204 listed companies in KSE with market capitalization of KD 16.5 billion. The KSE was established by Emiri Decree as a legally independent

entity and, according to this decree, the KSE is managed by an Exchange Committee which is chaired by the Minister of Commerce and Industry.

According to Ministerial Resolution No. 35/1983, the Kuwaiti Stock Exchange membership pays registration fees and annual fees. The membership fee is KD 10,000, and the registration fee is 0.1 % of the membership capital. However, the commission to be paid by the traders upon the transactions is calculated as follows:

1. For transactions of less than KD 50,000, the commission is 1.25 KD for each KD 1000.

2. For transactions of less than KD 50,000, the commission is 0.001%. For example; the commission on 100,000 KD transactions is paid as follows:

   KD 62.5 for the first KD 50,000

   KD 50 for the second KD 50,000

Brokerage firms pay 30% of their total transaction net profit to KSE and retain the remaining 70%. In fact, some of the brokers believe that their commissions are low and do not cover their costs. In fact, their commissions are insufficient to cover the cost of any of the various services normally provided by brokers in other markets.

On the other hand, the stock market committee sets a price unit system, providing that the price increment during the trading session should not exceed five points (up and down). These points represent a percentage ranging from 1% to 2% of the market price. This system does not permit an increment exceeding 20 fils per day over share prices of shareholding companies whose share prices are between 255 and 500 fils, and aims at softening the severity of speculation. Table 4.10 explains the trading units and share price in the KSE.

Table 4.10 The Development of Trading and Share Units on the Kuwait Stock Exchange

Category Number	Category in Fils	Changing Price Units in Fils	Trading Units in Shares
1	1 – 50	0.50	80,000.00
2	51 – 100	1.00	40,000.00
3	102 – 250	2.00	20,000.00
4	255 – 500	5.00	10,000.00
5	510 –1000	10.00	5,000.00
6	1020 – 2500	20.00	2,500.00
7	2550-5000	50.00	1,000.00
8	5100 - 9,900	100.00	500.00

Source: Kuwait Stock Exchange (1984, 1985, 1993).

As mentioned earlier, the commission on transactions paid by investors is KD 1.250 per 1,000 KD transactional value for each transaction up to KD 50,000 in value and 0.1% for any value in excess of KD 50,000. These commission levels are fairly low in comparison to international levels. Trading in the KSE is done in cash settlements only.

Table 4.11 The Developments of the Kuwait Stock Exchange Trading Activities

Items	Value of Shares Traded in (thousand KD)	Number of Shares Traded in (thousand)	No. of Transaction	KSEI
2000	1,290,424.00	6757992.00	156521	1142.5
2001	3,581,100.00	16299655.00	354321	1398.8
2002	6,680,028.00	27837038.00	520946	2375.8
2003	16,250,266.00	49562592.00	1081689	4790.2
2004	15,274,158.00	33535732.00	1056869	6409.5
2005	28,420,842.00	52245080.00	1955395	11445.1
2006	17,283,878.00	37657896.00	1486231	10067.4
2007	37,012,376.00	70441776.00	2101756	12558.9
2008	35,747,693.00	80850768.00	1997660	7782.6
2009	21,828,882.00	106331721.00	1938987	7005.3

Source: Kuwait Stock Exchange (1984, 1985, 1993).

Figure 4.6 Kuwait Stock Exchange Value of Shares Traded in KD Million, 2000–2009

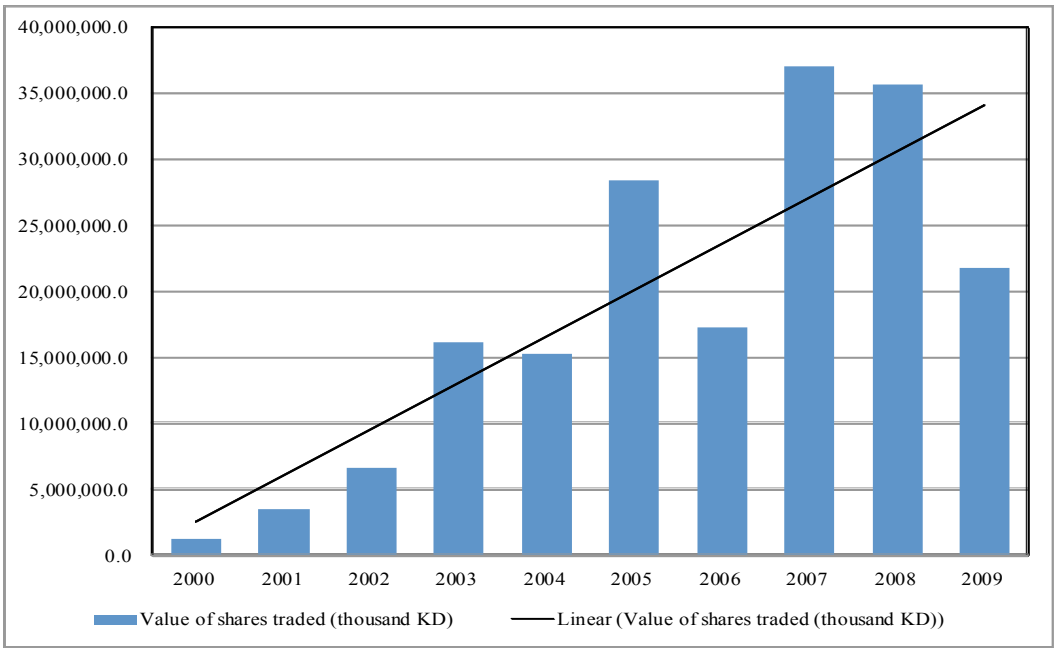


Table 4.11 shows that in 2007 the KSE witnessed the highest value of shares traded, KD 37 million. The total value of transactions amounted to KD 2.1 million. However, from 2002 to 2008, the KSE made good progress in its activity (see Table 4.11). The main factors and events behind this progress can be summarized as follows:

1. KSE witnessed positive regulatory changes during 2001–2007. These regulations aimed to enhance the performance of the KSE.

2. The market was expanded and deepened as a result of economic events such as the introduction of more mutual funds into the stock exchange. The market became less dependent on a few prominent traders, and attracted more foreign investors, who participated in local investments jointly with the private sector.

3. Oil prices recorded high levels during 2001–2007.

4. United Nations compensation to the Kuwaiti governments, and Kuwaiti nationals and enterprises, increased the money supply, which was invested in the stock market.

Figure 4.7 Kuwait Stock Exchange Number of Shares Traded in Thousands, 2000–2009

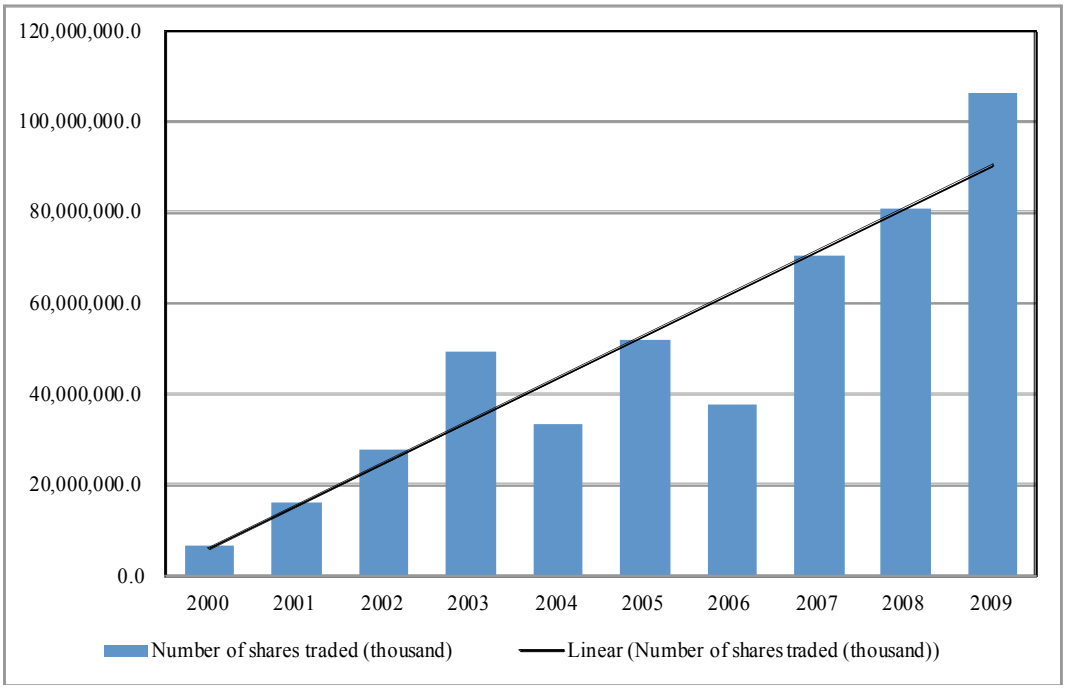
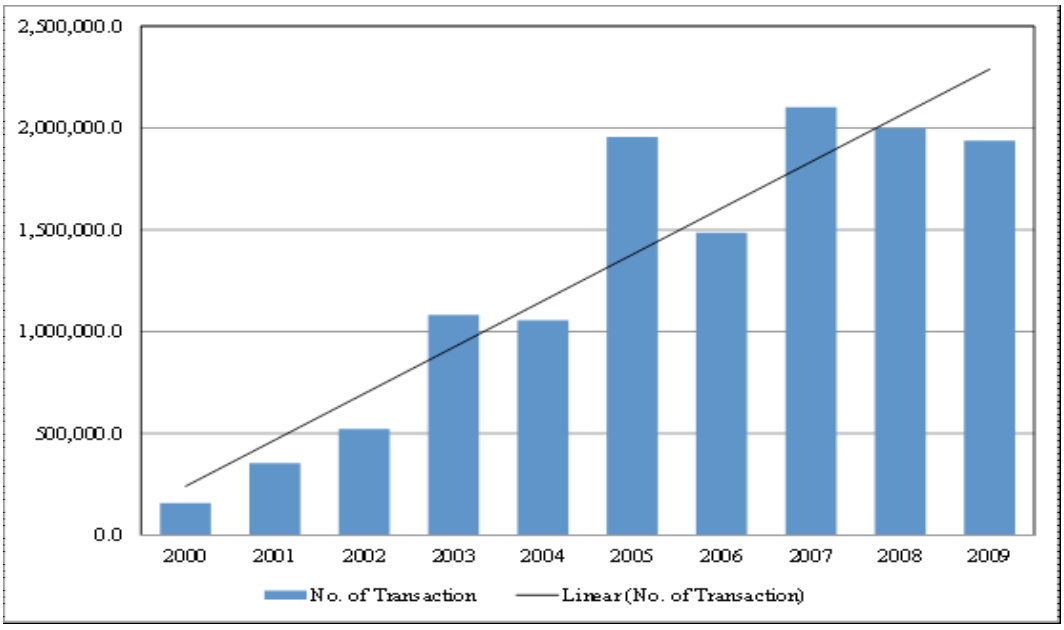


Figure 4.8 Kuwait Stock Exchange Number of Share Traded in Thousands, 2000–2009



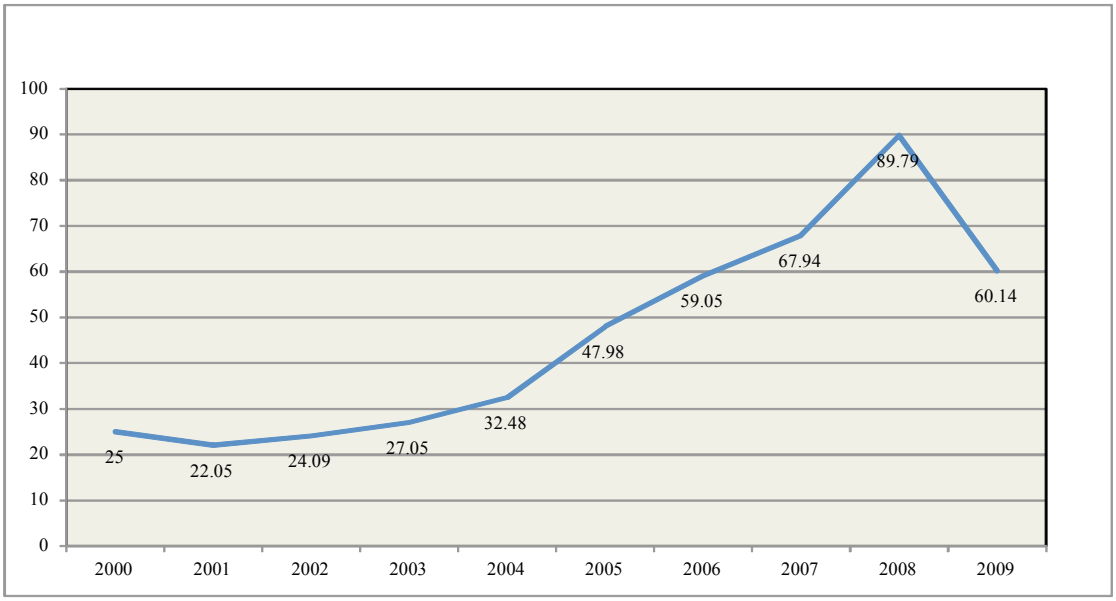
4.12 OIL PRICES AND GOVERNMENT EXPENDITURE

Oil prices are very important to the State of Kuwait, since the country's main source of income derives from oil. The external transactions of the State of Kuwait will be discussed in more detail in Chapter 5. Kuwait's oil prices have increased considerably over recent years, as is shown by the average KWT oil price at the end of each month.

Figure 4.9 shows that the average price rate for KWT oil has increased from $25 per barrel in 2000 to $89.79 per barrel in 2008. Commodity is another factor that affected inflation and during 2003–2004, when the price of oil started to increase. The hike in oil prices has made a major contribution to increased inflation in Kuwait, and, along with the growing costs of raw materials, has increased the cost of imported good and traded products.

With the increase of Kuwait oil prices, government spending also began to increase. Kuwait's main source of income is the sale of oil, which accounts for more than 90% of the state revenues, while foreign assets investments accounts for the rest.

Figure 4.9 Kuwaiti Oil Price Developments, 2000–2009



Government expenditure in the year 2004 was 5,522.8 million which was an increase of 38% from the base year 2000. The highest increase was in the year 2006, when the amount of government spending was 6,862.0 billion an increase of 71% on the year 2004. It then dropped to an increase of 27%, or 5,109.2 million in 2007.

The State of Kuwait increased its capital expenditure on infrastructure, housing, health care and other economic sectors as a result of the rise in oil revenues.

4.13 EMPIRICAL ANALYSIS

In this part of the chapter some hypotheses are examined with the aim of answering the following two questions: what is the relationship between the inflation index (CPI) and some of the main economic factors; and what is the relationship between the and foreign exchange rates?

The data employed were collected from the Central Bank of Kuwait. The data are monthly and cover the period 2005–2009.

4.14 METHODOLOGY

Most researchers nowadays use regression analysis. In fact regression is a useful and powerful tool that can be used to examine the relationship between a dependent variable and an independent one. Multiple regression is used in this research in order to examine three equations: firstly, the variable (CPI) and independent variables (macro-economic variables); secondly, the exchange rate and other foreign exchange rates; and finally, the USD exchange rate and other exchange rates.

Koustsoyiannis (1977) points out that in any econometric research we may distinguish four stages. The first stage is the specification of the model with which one will attempt to measure the phenomenon being analysed. The second stage is known as the stage of the maintained hypothesis; that is, after the

formulation of the model, one should obtain estimates of its parameters. The third stage occurs after the model has been estimated, when one should proceed with the evaluation of the estimates – that is, decide on the basis of certain criteria whether the estimates are satisfactory and reliable. The final stage of any econometric research is concerned with the evaluation of the forecasting viability of the model.

4.14.1 Hypotheses

The null hypothesis to be tested is:

$$H_0 : b_1 = b_2 = ...b_k = 0$$

against this the alternative hypothesis is:

$$H_1 : not\ all\ b_i' = 0$$

If the result shows that $H_0 : .....b_k = 0$, it means that the independent variables do not qualify to affect the dependent variable, or, in other words, there is no linear relationship between the dependent and independent variables. Therefore, another independent variable should be chosen. On the other hand, if the result shows that: $H_1 : not\ all\ b_s' = 0$ the null hypothesis will be rejected and the relationship between the dependent and independent variables will be accepted. The following regression equations have been applied by using the Ordinary Least-Square method (OLS). In the equations R2 stands for the coefficient of determination, MR denotes the multiple R, and DW is the Durbin-Watson test.

4.14.2 The equations

It may be useful for the purpose of this study to examine three equations as follows:

1. CPI = f(GEX, M1, M2, OILP, USD/KD), where CPI is the price index in Kuwait, GEX is government expenditure, M1 is money supply in its narrow

definition, M2 is M1 plus quasi-money, and USD/KD is the USD exchange rate against the KD.

2. USD/KD = f(GBP/USD, EUR/USD, USD/CHF, USD/JPY), where USD/KD is the USD exchange rate against the KD, GBP/USD is the British pound against the USD, EUR/USD is the euro against the USD, USD/CHF is the USD against the Swiss franc, and USD/JPY is the USD against the Japanese yen.

3. KD/USD = f(GBP/KD, EUR/KD, CHF/KD, JPY/KD) where KD/USD is the KD against the USD, GBP/KD is the British pound against the KD, EUR/KD is the euro against the KD, and CHF/KD is the Swiss franc against the KD, and JPY/KD is the Japanese yen against the KD.

A simple multiple regression using rates of monthly change over the period 2005–2009 the results shown in Table 4.12.

Table 4.12 Results of the Regression of USD/KD against the Other Major Currencies

Dependent Variable: LUSDKD
Method: Least Squares
Sample (adjusted): 1 60
Included observations: 60 after adjustments

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	–1.107121	0.438361	–2.525591	0.0145
LGBPUSD	0.05784	0.064287	0.899726	0.3722
LEURUSD	–0.615754	0.212482	–2.897919	0.0054
LUSCHF	–0.335003	0.273075	–1.226781	0.2251
LUSDJPY	0.010719	0.111666	0.095989	0.9239

R-squared	0.603	Mean dependent var	–1.256924
Adjusted R-squared	0.574127	S.D. dependent var	0.032051
S.E. of regression	0.020916	Akaike info criterion	–4.816960
Sum squared resid	0.024061	Schwarz criterion	–4.642431
Log likelihood	149.5088	F-statistic	20.88472
Durbin-Watson stat	0.212114	Prob(F-statistic)	0

Source: Author's calculation.

Table 4.12 shows that there is a negative relationship between the USD/KD and EUR/USD exchange rates. This is the only significant relationship since its *t*

statistic is above –2, and other variables have insignificant *t* statistics. The USD/KD exchange rate tends to move in relation to other currencies movements, especially when the exchange rate fluctuates between the USD/CHF and GBP/USD. Therefore, one can predict that the value of the USD/KD will change according to fluctuations of the GBP/USD and USD/CHF.

As discussed in Chapter 3, the Central Bank of Kuwait in past decades used an exchange rate regime pegged to a basket of currencies, which allowed the CBK to value the KD on a daily basis against the currencies in the basket. Consequently the USD/KD rate was influenced by the movements of other major currencies, which we assume were a part of the basket of currencies.

Table 4.13 The Results of the Regression of KD/USD against the Cross Rate

Dependent Variable: LKDUSD
Method: Least Squares
Sample (adjusted): 1 60
Included observations: 60 after adjustments

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	–0.979930	0.465532	–2.104966	0.0399
LGBPKD	–0.314039	0.048031	–6.538244	0.0000
LEURKD	0.285768	0.209126	1.366486	0.1773
LCHFKD	0.186818	0.271053	0.689233	0.4936
LJPKD	–0.432193	0.103365	–4.181233	0.0001
R-squared	0.602487	Mean dependent var		1.256989
Adjusted R-squared	0.573577	S.D. dependent var		0.031998
S.E. of regression	0.020895	Akaike info criterion		–4.818943
Sum squared resid	0.024013	Schwarz criterion		–4.644415
Log likelihood	149.5683	F-statistic		20.84003
Durbin-Watson stat	0.649363	Prob (F–statistic)		0.000000

Source: Author's calculation.

The above Table 4.13 indicates that there is a significant relationship between KD/USD, GBP/KD and JPY/KD, which have –6.53 and –4.18 *t* statistics respectively. The EUR/USD and CHF/USD exchange rates have a closer relationship to the KD/USD than to other exchange rates, such as the GBP/KD and JPY/KD.

Most dealers and foreign currency traders assume that the basket of currencies contains such major currencies as the USD, GBP, EUR, JPY, and CHF, but that the USD dollar is the anchor currency. In which case it is to be expected that the exchange rate of the KD against the major currencies should follow the changes of these other currencies on the foreign exchange market.

Table 4.14 The Results of the Regression of CPI against Monetary Indicators and Oil Prices, and USD/KD Rates

Dependent Variable: LCPI
Method: Least Squares
Sample (adjusted): 4 60
Included observations: 57 after adjustments

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	–0.077576	0.033406	–2.322221	0.0243
LEX(–2)	–0.001905	0.001193	–1.596931	0.1165
LM1(–2)	–0.030166	0.020723	–1.455694	0.1516
LM2(–2)	0.053284	0.046517	1.145463	0.2574
LOILP(–2)	0.002849	0.007062	0.403486	0.6883
LUSDKD	–0.064790	0.026515	–2.443560	0.018
R-squared	0.158336	Mean dependent var		0.004427
Adjusted R-squared	0.07582	S.D. dependent var		0.006641
S.E. of regression	0.006384	Akaike info criterion		–7.170598
Sum squared resid	0.002079	Schwarz criterion		–6.955540
Log likelihood	210.3621	F-statistic		1.918854
Durbin-Watson stat	2.053651	Prob(F-statistic)		0.107358

Source: Author's calculation.

To investigate the relationship between the consumer price index (CPI) and other important factors which we believe may have an effect on the CPI, we performed several regressions to reach the results in Table 4.14. In fact, lag times of two months have been used because the impacts of these factors on the CPI can be more evident after that time.

The results in Table 4.14 show that there is a highly significant relationship between the CPI and the USD/KD exchange rate. What we find is that the CPI index tends to increase or decrease according to the value of the USD/ KD exchange rate. As we will find in Chapter 5, because Kuwait's external

transactions consist primarily in the export of oil, which is paid for in USD, and in the import of most of its goods and services from abroad, if the KD depreciates against the USD and other major currencies there is an increased likelihood that imported inflation will appear.

Moreover, Kuwait experienced inflation during the USD pegged exchange rate regime when the value of the USD depreciated against the world major currencies, which resulted in the value of the KD depreciating also against major currencies such as the EURO, JPY, CHF and GBP.

The results in Table 4.15 show a quite significant *t* statistic of –2.340. This result confirms our argument that inflation in Kuwait is an imported one. As we mentioned earlier, most of Kuwait's goods and commodities are imported from abroad, and for this reason a weak USD will affect Kuwait's CPI.

Table 4.15 The Results of the Regression of the CPI against the USD/KD Rates

Dependent Variable: LCPI
Method: Least Squares
Sample (adjusted): 2 60
Included observations: 59 after adjustments

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	–0.071310	0.032362	–2.203497	0.0316
LUSKD	–0.060216	0.02573	–2.340331	0.0228

R–squared	0.087666	Mean dependent var	0.004404
Adjusted R–squared	0.071661	S.D. dependent var	0.006536
S.E. of regression	0.006298	Akaike info criterion	–7.264008
Sum squared resid	0.002261	Schwarz criterion	–7.193583
Log likelihood	216.2882	F–statistic	5.477149
Durbin–Watson stat	2.121361	Prob(F–statistic)	0.02279

Source: Author's calculation.

4.15 CONCLUSION

The development of the State of Kuwait's monetary system goes back to the establishment of the Central Bank of Kuwait, when the country recognized the importance of having an authority to monitor and control the financial sector and

the money supply by influencing the interest rate. The Central Bank of Kuwait was established in 1969, and, since then, monetary policy in Kuwait has undergone several changes. As we mentioned earlier, one of the main objectives of the CBK or any monetary authority is to protect the economy from inflation and to stabilize prices.

The previously discussed data from 2000–2009 has shown that the CBK has over the years developed the use of its monetary tools and implementing strategy to prevent an increase in the cost of borrowing through its monetary channels and to protect the country from inflation. CBK has used different monetary tools such as the exchange rate, the discount rate and intervention to prevent an increase in interest rates and a hike in inflation.

The CBK's exchange rate regimes have had an impact on inflation, especially because the State of Kuwait is an importing country which exports only oil. In the event of a hike in oil prices, the result will be an increase in the cost of imported products. In this case the CBK has no control over oil prices in the international market. This was witnessed recently when oil prices started to rise in 2003.

Monetary policy is the CBK's main tool for maintaining price stability when other pressures are causing inflation to rise. In recent years Kuwait has witnessed hikes in inflation despite having no past history of inflationary pressure. In fact, it can be argued that inflation began to increase during the period when the CBK used a fixed exchange rate regimes pegged to the US dollar, with the result that the value of the KD declined against other major currencies.

In response to global inflation pressure and the decline of the US dollar against world major currencies, the CBK dropped the US dollar pegged regime and re-adopted a basket of currencies to protect the Kuwaiti economy from imported inflation.

Inflation in the State of Kuwait has been at an average of 1 per cent during the studied period 2000–2009. The previously discussed data shows that the inflation hike developed only in the last few years as a result of global economic

growth and fluctuations in the exchange rate with Kuwait's major trading partners. It is evident, therefore, that exchange rate regimes have been an important tool for the CBK to use when necessary.

It is worth mentioning at this point some of the literature reviews and empirical studies which have been conducted to examine the effect of the money supply on prices and inflation in Kuwait. Important contributions have been made by Al-Sabah (1978), El Mallakh and Atta (1981), Moosa (1986), Salih *et al.* (1989) and Al Mutairi (1995).

Al-Sabah (1978) examines the relationship between the money supply and inflation in Kuwait by obtaining monthly data over the period 1973–1977. His results show that the effect of the money supply on the price index tends to produce a medium lag period. The effect is usually generated between the fifth and seventh lagged month.

El-Mallakh and Atta (1981) use an equation involving money supply and import prices to explain inflation. Their findings are that imported inflation is the supply side determinant of local inflation, whereas the demand pull side is generated and fuelled by a monetary stimulus.

Moosa (1986), in his study of the effect of money on prices output, tests the relationship between the CPI and real government expenditure lagged three quarters, government expenditure lagged four quarters, and real and total deposits of private sector with commercial banks lagged two quarters. Moosa used the OLS model and 24 quarterly observations over the period 1977–1982. His finding is that import prices, followed by monetary stimulus and then fiscal stimulus, are the main determinants of local prices.

Salih *et al.* (1989) argue that Moosa's prices equation is theoretically correct and is superior to the previous equations estimated for Kuwait.

Al Mutari (1995) constructs a VAR model to test the impact of the money supply, government expenditure and imported prices on inflation in Kuwait, and finds that government expenditure plays a dominant role in explaining the

variation in price levels, and that imported prices and the money supply are factors influencing inflation in Kuwait.

We can conclude that the CBK has used its monetary tools, such as the exchange rate, the money supply, and the discount rate just to protect the country from inflation. Other factors, such as international inflation, an increase in borrowing costs abroad, and hikes in prices of raw material and commodities, may have the effect of bringing inflation to Kuwait. In addition, government expenditure and fiscal policy can also cause inflation.

In Kuwait there are two indices which measure changes in prices: the consumer price index (CPI) and the wholesale price index. The role of the monetary authority in Kuwait (i.e. the CBK) is to stabilize the performance of the financial sector, and ensure a rate of money expansion that is appropriate to achieving short-term stability and economic growth. The CBK's monetary policy over the years has proved the effectiveness of the monetary tools it has used to ensure currency stability and resist inflationary pressure.

However, inflationary pressure, the stability of the exchange rate, and the costs of money borrowed have undergone various changes. Part of the CBK's role is to supervise and control the financial institutions and banking instruments, which are subject to the CBK's rules and regulations. The CBK also monitors the money supply that can be introduced by the commercial banks when they provide credit facilities.

The foundation of Kuwait's financial system is the banking sector and financial institutions. The financial sector in Kuwait includes the Central Bank of Kuwait, six local conventional banks, three Islamic banks, seven recently opened foreign bank branches, one specialized bank (the Industrial Bank), 54 Islamic investment companies, 46 conventional investment companies, 30 insurance and reinsurance companies, 39 exchange companies, 111 investments funds, and the Kuwait Stock Exchange. The stock exchange is one of the largest sectors of the country's economy.

The financial sector in Kuwait has a large number of financial institutions, and the number of newly established investment companies has increased in recent

years as a result of the economic growth the country has witnessed. The CBK supervises the financial sector and monitors banks very closely. Banks and financial institutions in Kuwait have enjoyed a number of years of profit earning. But during the financial crisis in the middle of 2008 the CBK introduced a number of new policies to protect the country's financial systems. For example, it guaranteed customers' deposits with local banks, required more provisions on bad loans, and reduced the ratio of lending to consumer loans.

In summary, the CBK's role has been to provide the liquidity required by financial institutions. The data for the period 2000–2009 has shown how the CBK has introduced different lending and borrowing instruments to control the cash position in the financial sector.

Chapter 5 KUWAIT'S EXTERNAL TRANSACTIONS

5.1 INTRODUCTION

The Kuwaiti economy has been making great advances in recent years thanks to the continuing rise in oil prices and the increase in overseas investments returns. Furthermore, the government of Kuwait has taken steps to boost business confidence by means of structural reforms that have encouraged both public and private investment. The growing solidity of the macroeconomic structure of the State of Kuwait is also indebted to the successful monetary policy of the Central Bank of Kuwait to prevent inflation and stabilize the KD exchange rate value against the US dollar and other major currencies that the country has close ties with. Moreover, the steps taken to eliminate all barriers amongst GCC member states in an effort to launch monetary and economic integration have further contributed to Kuwait's economic prosperity.

Kuwait's economic progress will be considered later on in this chapter when we discuss the country's oil exports and earnings, which are its main source of revenue and capital. The overseas assets owned by the Kuwaiti Sovereign Wealth Fund also contribute significantly to the country's balance of payments surplus.

Since the country began its first exploitation and shipment of oil Kuwait has enjoyed a high level of economic development in all sectors. The state of Kuwait is an oil rich country and the country's economy performance is highly dependent on its oil activities. The growth of the economy is highly driven by oil prices, and has been especially rapid from the early nineties when oil prices started to increase.

By using available data on Kuwait's external transactions and exchange rates for the period 1997–2008, we will investigate the answers to the following questions. What drives the country's economic growth? What is the country's main export product? What is the trend of Kuwait's trade balance? What are the components of Kuwait's exports and imports? Has oil production had an impact on Kuwait's income? Who are

the country's major trading partners? How does the exchange rate value of the KD affect Kuwait's trading activities and income?

Kuwait began its development as a trading country, but its oil reserves added a new dimension to its trading relationship with the international market. The relative KD exchange rate value against world major currencies will also be analysed to see what effect it has had on the country's income, and to help identify the main drivers of the country's exports, imports and inflation.

5.2 SUMMARY OF KUWAIT'S MAJOR ECONOMIC HIGHLIGHTS

Kuwait's economy has witnessed a number of developments in the country's main economic sectors. Table 5.1 gives the descriptive statistics, based on calculations of the data available, of Kuwait's major economic highlights during 1997–2008. The country's economy is deeply dependent on oil, which, as a result of the increase in the international demand and price of oil, has had a major impact on the growth of the country's GDP. Kuwait's GDP at current prices was 31,841 million KD during 2007, an increase of 2,347 million KD since the previous year, which is 8% per cent growth.

The development of the country's oil exports and the increase in oil prices are the main cause of the growth in GDP. The increased oil prices have helped the GDP to grow considerably over the past few years, and the year 2004 achieved a growth rate of 40.8%, which is the highest growth rate since 1997. The oil sector's share of GDP rose to its maximum level of 56% in 2006 and 55% in 2007.

In addition, the non-oil sector as a percentage of GDP grew by 2.7% in the year 2007 to 45%, compared to 44% of the previous year 2006. The maximum level of the non-oil sector as a percentage of GDP was in 1998 when it reached 72% owing to the decline in the share of the oil sector, which in that year reached its minimum level of 31% of GDP during the period 1997–2008.

Table 5.1 Descriptive Statistics for Major Economic Indicators in Kuwait, 1997–2008

Items	Mean	Maximum	Minimum	Range
GDP at Purchaser's Value (kd)	15,753	31,841	7,671	24,170
Share of Oil As % of GDP	45%	56%	31%	25%
Share of Non-oil Sector As % GDP	54%	82%	44%	29%
Crude Oil Production (Million Barrel Per Day	2,209	2,676	1,746	930
Oil Revenues (KD m)	8,733	22,200	2,582	19,618
Kuwait Oil Prices (USD)	39	94	12	82
Oil Export As % of Total Exports	93%	95%	89%	6%
Oil Revenues As % of Total Revenues	92%	96%	84%	12%

Furthermore, crude oil production increased by 3.9% in 2008 to 2,676 m B/PD, an increase of 53% over the minimum level of production of 1,746 m B/PD in 2002. For the period 1997–2008 the mean oil production was 2,209 m B/PD, and the range between the maximum and the minimum oil production was 930,000 barrels per day.

Since Kuwait started exploiting its oil resources, oil revenues have become a major component of the country's GDP. Kuwait's oil revenues amounted to KD 8,733 million for the period 1997–2008, but the year 2008 witnessed the highest oil revenue ever of KD 22,200 million, an increase of 32.3% over the previous year, which had seen oil revenue of KD 16,780 million.

Oil prices are the major driver for the country's oil revenues, and an increase in the price of oil on the international market helped the hikes on Kuwaiti oil prices. In addition, the oil revenues as a percentage of the government's total revenues had a mean of 92%, a maximum of 96%, and a minimum of 89% over the years 1997–2008. Data

collected on Kuwaiti oil prices show that they increased tremendously during this period. Oil prices for the year 1998 fell to a minimum of US $12 per barrel, whereas the increase in oil prices in more recent years pushed prices to record price of US $94 per barrel in the year 2008.

The previously reviewed and discussed data have shown that the state of Kuwait is a single product and single export country, and that the economy is largely driven by and dependent on oil. Oil prices and oil production are the major two factors that influence the country's growth and expenditure. The oil sector will stay the country's leading sector, and the oil industry in Kuwait will continue to play a major role in the country's economic activities.

5.3 BALANCE OF PAYMENTS

Oil prices reached a record high of US$94 in the year 2008 and consequently had a major impact on the balance of payments. Kuwait's current account surplus soared to KD 4.096 billion, reaching a new record high, and boosting Kuwait's investment portfolio. Although the increase in oil prices in the international market had an impact on the country's current account, the drop in the financial market due to the recent economic crisis had a negative Impact on the country's foreign assets return. This will continue to decline if the economic situation does not recover.

Table 5.2 Summary of Kuwait's Balance of Payments, 1995–2008

Periods	Current Accounts	*KD change*	Oil Exports	*KD change*	Capital & Financial Account	*KD change*	Portfolio Investment	*KD change*	Overall Balance	*KD change*
1995	1,497	-	3,597	-	-11	-	-631	-	-17	-
1996	2,128	*631*	4,231	*634*	-2,346	-	-228	*(403)*	-26	*(9.00)*
1997	2,407	*279*	4,085	*(146)*	-1,913	*(433)*	-2,101	*1,873*	-17	*9.00*
1998	675	*(1,732)*	2,582	*(1,503)*	-866	*(1,047)*	-1,453	*(648)*	60	*43.00*
1999	1,541	*866*	3,357	*775*	-1,523	*657*	-779	*(674)*	282	*222.00*
2000	4,501	*2,960*	5,578	*2,221*	-3,545	*2,022*	-3,886	*3,107*	695	*413.00*
2001	2,553	*(1,948)*	4,591	*(987)*	-1,037	*(2,508)*	-2,283	*(1,603)*	881	*186.00*
2002	1,292	*(1,261)*	4,273	*(318)*	-1,061	*24*	-992	*(1,291)*	-291	*590.00*
2003	2,181	*889*	5,664	*1,391*	-2,951	*1,890*	-3,887	*2,895*	-524	*(233.00)*
2004	4,596	*2,415*	7,861	*2,197*	4,838	*(7,789)*	4,091	*(7,978)*	197	*721.00*
2005	8,805	*4,209*	12,392	*4,531*	9,359	*(4,521)*	3,835	*256*	165	*(32.00)*
2006	13,181	*4,376*	15,429	*3,037*	14,167	*(4,808)*	8,452	*(4,617)*	1,039	*874.00*
2007	13,308	*127*	16,779	*1,350*	10,457	*3,710*	9,789	*(1,337)*	916	*(123.00)*
2008	17,404	*4,096*	22,200	*5,421*	15,346	*(4,889)*	8,001	*1,788*	171	*(745.00)*

Source: Central Bank of Kuwait, Quarterly Bulletin, Several Issues (1995–2008).

The current account balance increased by 31% in 2008 to a value of KD 17,404 million compared to KD 13,308 million in 2007, which was an increased of 1% over the previous year 2006. The current account increases are highly dependent on increases in oil prices; fluctuation in oil prices in either direction will have a direct impact on the country's current account.

The merchandise balance in 2008 was KD 23,372 million, an increase of 32% since the previous year, which itself had seen an increase of 8%. The average growth rate for the entire period 1996–2008 was 18%, and the maximum was an increase of 60% in the year 2000, while the biggest fall was by 32% in 1998. The merchandise balance contributes a large part of the current account, but most trade comes from the export of oil.

Kuwaiti oil exports grew by 32% in 2008, when the country's oil exports reached KD 22,200. Oil exports in 2008 were almost 8.5 times what they were in 1998. The growth in oil prices and oil production made great changes to the country's economy, which has gone through a number of different stages since the beginning of oil exploitation. Furthermore, the proportion of oil export to the total export rose to an average of 93% for the period 1995–2008.

Kuwait's non-oil exports consisted mainly of ethylene products, manufactured fertilizers, and re-exports. Global economic growth helped Kuwaiti non-oil exports to soar, both regionally and globally. Non-oil exports rose from KD 834 billion in 2007 to KD 990 billion in 2008, an increase of 17%. Re-exports also increased during the years 2006–2008: they increased by 49% in 2006, by 28% in 2007, and by 17% in 2008 to a value of KD 401.9 million. This figure was more than double their 2005 value of KD 180 billion.

Kuwait's industrial production is minimal, and the country imports goods from the international market to meet local demand. Imports rose by 10% to a value of KD 6,688 million in 2008, compared to a 20% increase in 2007, when they were worth KD 6,061 million. As Kuwait's economy has expanded over recent years, its economic activities have been accompanied by an increase in transports costs, and prices of commodities and raw materials, which has been reflected in the increased value of imports.

Kuwait imports goods according to international trade agreements with different parts of the world, and at the same time has entered into the advanced stages of regional trade cooperation with GCC countries as it moves closer to economic integration.

Part of the country's current account is the net services balance, which witnessed a decline of 8% in 2008 from the previous year. The net services account in 2008 was KD –972 million, compared to KD –902 million in 2007. Furthermore, 2006 recorded the lowest net services account with a value of KD 637 billion, and 2003 had the highest net services account of KD –1,383 million.

In addition, travel and transport accounts for Kuwait was KD 635 billion in 1995, which increased to KD 1,966 million in 2008. The travel accounts increased by 22% in 2006, 17% in 2007, and 8% in 2008, owing to increasing travel for such purposes as education and medical treatment.

Table 5.3 Kuwait's Current Account Values (KD Million), 1995–2008

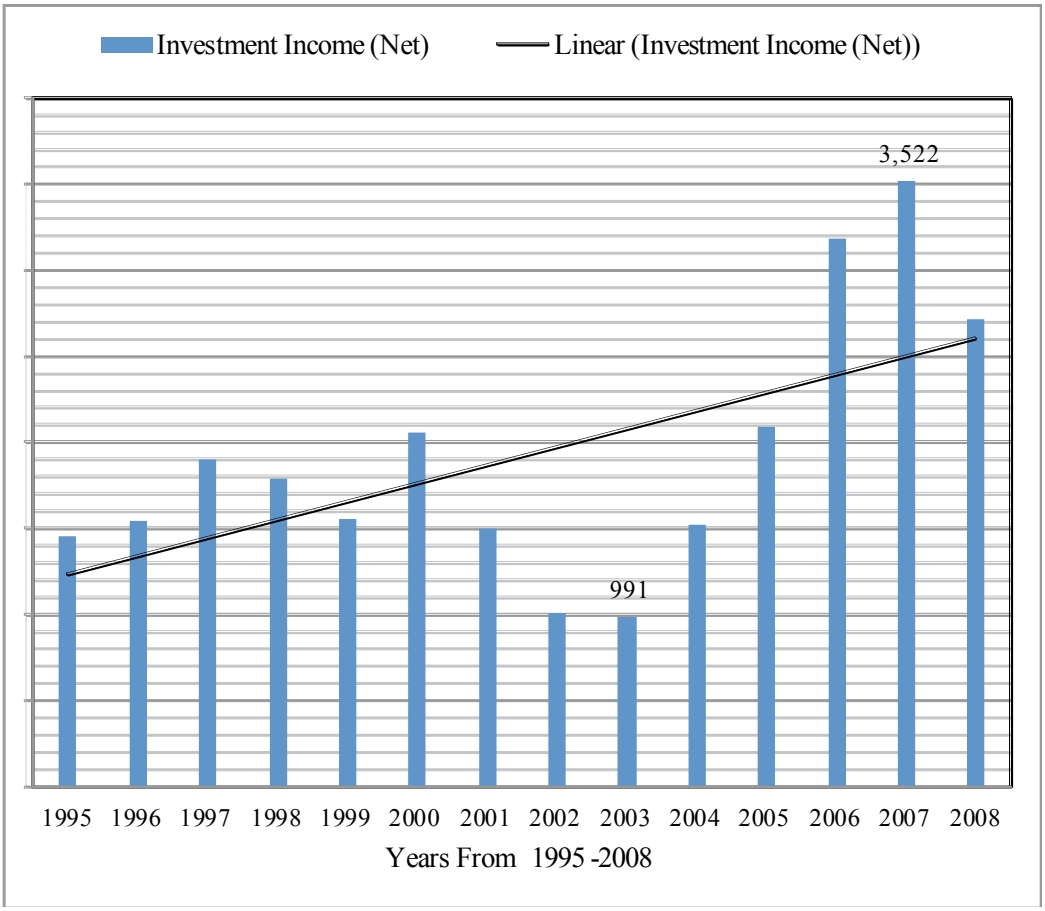
Periods	Balance of Goods	Merchandise Export	Oil Export	Merchandise Imports	Services (Net)	Travel (Net)	Investment Income (Net)	Central Bank	General Government	Current Transfers (Net)	Workers Remittances
1995	1,665	3,830	3,597	(2,165)	(1,188)	635	1,457	54	824	(437)	(404)
1996	2,095	4,475	4,231	(2,380)	(1,072)	691	1,551	45	974	(446)	(412)
1997	1,982	4,332	4,085	(2,350)	(1,022)	664	1,904	49	1,302	(457)	(417)
1998	580	2,931	2,582	(2,351)	(1,152)	704	1,788	51	1,422	(541)	(491)
1999	1,695	3,737	3,357	(2,042)	(1,099)	663	1,555	46	1,167	(610)	(527)
2000	3,996	5,975	5,578	(1,979)	(950)	735	2,055	79	1,438	(600)	(532)
2001	2,819	4,980	4,591	(2,161)	(1,132)	840	1,503	90	1,110	(637)	(547)
2002	2,201	4,670	4,273	(2,469)	(1,273)	882	1,016	68	841	(652)	(585)
2003	3,282	6,168	5,664	(2,886)	(1,383)	963	991	40	830	(709)	(639)
2004	4,891	8,546	7,861	(3,655)	(1,098)	1,039	1,528	45	1,306	(727)	(709)
2005	8,832	13,228	12,392	(4,396)	(1,151)	1,275	2,097	77	1,414	(974)	(773)
2006	11,668	16,381	15,429	(4,713)	(637)	1,558	3,182	137	2,048	(1,033)	(924)
2007	12,337	17,770	16,779	(5,433)	(902)	1,823	3,522	244	2,425	(1,649)	(1,489)
2008	17,206	23,372	22,200	(6,167)	(972)	1,966	2,720	156	2,347	(1,550)	(1,494)

Source: Central Bank of Kuwait, Quarterly Bulletin, Several Issues (1995–2008).

Kuwait's second greatest source of income is the returns it receives from its overseas assets. Investment income (net) has been on an upward trend and the income generated has been increasing over the life of the investments period. Average annual growth rate is 9% for the entire period 1995–2008. The greatest increase in returns on investments was 54% in 2004, and the greatest decline was by 32% in 2002.

Figure 5.1 shows that Kuwait's net income from investment in 2007 was KD 3,522 million, compared to KD 2,720 million in 2008, which represents a decline of 23% in 2008, compared to an increase of 11% in 2007. Kuwait's net income from investment has declined as a result of the financial crisis and the deterioration in the financial market during recent years.

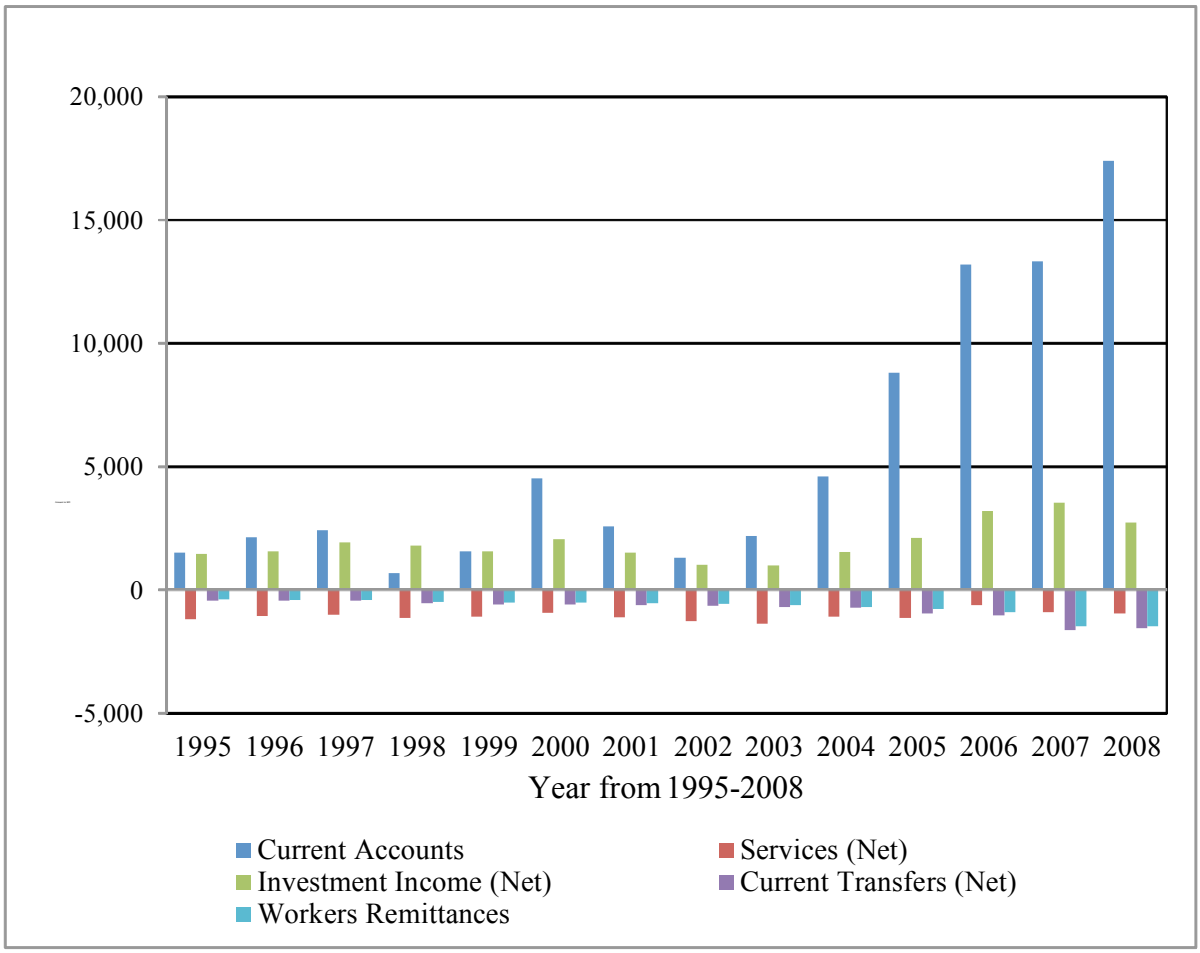
Figure 5.1 Kuwait's Investment Account, 1995–2008



Current account transfers and workers' remittances account for the deficit in the current account. Current transfers' average annual growth rate was 11% for the period 1996–2008, and the highest increase in current transfers was a 60% increase in 2007, with a minimum decline of –6% in 2008.

Current transfers in the year 2008 were KD 1,550 million, compared to KD 1,649 billion in 2007, which is a decline in current transfers of 6%. Current transfers by the government contribute to different overseas activities, such as foreign aid. Kuwait has a great number of international expatriate workers, who are paid their salaries in KD. Each month these workers transfer some of their savings and salaries abroad. Worker remittances were worth KD 1,494 million in 2008, which is almost the same value – KD 1,489 million– that they had in 2007. Figure 5.2 below shows that current accounts and investment net income are the largest two components of Kuwait's current account surpluses.

Figure 5.2 Kuwait's Current Account, 1995–2008



5.4 KUWAIT'S CAPITAL ACCOUNT

Capital and financial accounts (see Table 5.4 below) show that in the period 1995–2008 capital account inflows continued to drift upwards. The value of capital account inflows reached KD 464 million in 2008, compared to KD 422 million in 2007. The increase was due to the payments paid by the United Nations to the private sector as part of the compensation plan following the Iraq war. Capital outflows, on the other hand, reached KD 15,811 billion in 2008, an increase of 45%, which increased the country's investments abroad.

The values of financial accounts in 2007 were KD –10,897, compared to KD –14,382 million in 2006, representing a decrease of 24%. Kuwait's net portfolio investments outflows in 2006 were KD –8,452 million and increased to KD –9,789 million in 2007, an increase of 16%. However, the 2008 net portfolio investments dropped by 18% from

the previous year. Net portfolio investments in 2007 were KD –9,789 million, which declined by KD –1,788 million to reach KD –8,001 million as a result of the recent economic crises.

Table 5.4 Kuwait's Current Account Values (KD Million), 1995–2008

Periods	Capital Account	Financial Account	FDI (Net)	Portfolio Investment (Net)	Other Investments (Net)
1995	(58)	69	307	(631)	371
1996	(61)	(2,285)	(417)	(228)	(1,640)
1997	(29)	(1,884)	300	(2,102)	(83)
1998	24	(890)	587	(1,453)	(24)
1999	214	(1,737)	15	(779)	(973)
2000	680	(4,225)	98	(3,886)	(437)
2001	899	(1,963)	(157)	(2,283)	(504)
2002	508	(1,569)	(49)	(992)	626
2003	426	(3,377)	1,467	(3,887)	957
2004	102	(4,941)	(754)	(4,091)	(96)
2005	207	(9,567)	(1,433)	(3,835)	(4,298)
2006	215	(14,382)	(2,347)	(8,452)	(3,583)
2007	422	(10,897)	(2,746)	(9,789)	1,655
2008	464	(15,811)	(2,335)	(8,001)	(5,475)

Source: Central Bank of Kuwait, Quarterly Bulletin, Several Issues (1995–2008).

5.5 KUWAIT'S EXTERNAL TRANSACTIONS

Exploitation of oil in Kuwait has helped the country to participate in trade in the international market, and the State of Kuwait enjoys economic relations with various parts of the world, including the USA, Europe, Asian countries and the neighboring GCC countries. Kuwait has executed various economic agreements with many of these countries, enabling it to trade in oil and natural gas, and is considered a vital member in many international, Arab and regional trading organizations.

Kuwait imports most of its needs from the outside world to meet domestic demand. Its exports earnings are highly determined by oil revenues, which in turn are affected by the fluctuations in oil prices on the international market. Kuwait owns a very large oil reserve, which amounts to 10% of the world's reserves. Oil revenues play a major role

on the country's expenditure, and the country's fiscal budget spending is generated by its oil field. From the time oil began to be exploited in Kuwait, the country's economic performance has been influenced mainly by oil market prices.

Kuwait's foreign trade contributes a major part of the country's economic structure and has always been an important issue in the country's economic policy. While oil is the main source of export revenue, Kuwait imports most of the products and services it needs. Although it produces some light products, it still cannot meet the local domestic demand. The merchandise that it imports, whether for the purpose of consumption or for investment, forms a very important component in the country's economy.

The State of Kuwait therefore endeavors to maintain a very good trade relationship with other countries, and promotes a liberal trade environment with no restrictions on either exports or imports, except on some products that do not comply with sharia requirements.

5.6 KUWAIT'S MERCHANDISE BALANCE

The merchandise balance of a country is also referred to as the visible balance because it reflects the difference between the country's receipts from exports of goods and the expenditure on imports of goods. A country's receipts from its exports are recorded as a credit in the balance of payments accounts, while the imports payments are recorded on the debit side. If exports earnings exceed imports payments there will be a balance of trade surplus, but if imports exceed exports there will be a balance of trade deficit. A net balance between exports and imports is for a specific period.

In addition, a country's balance of trade will include other transactions such as revenues from investments in international assets. The balance of trade reflects the country's output and its local demand, and can be affected by the costs of production, commodity and raw materials, by exchange rate volatility, and by imported inflation. There may be other factors depending on the country's economic activities.

Kuwait's economic structure makes it intrinsically more open to trade with the world, and its international trade represents a major part of its economic activity. Oil accounts for almost 95% of the country's exports, and its oil revenues make almost 90% of the

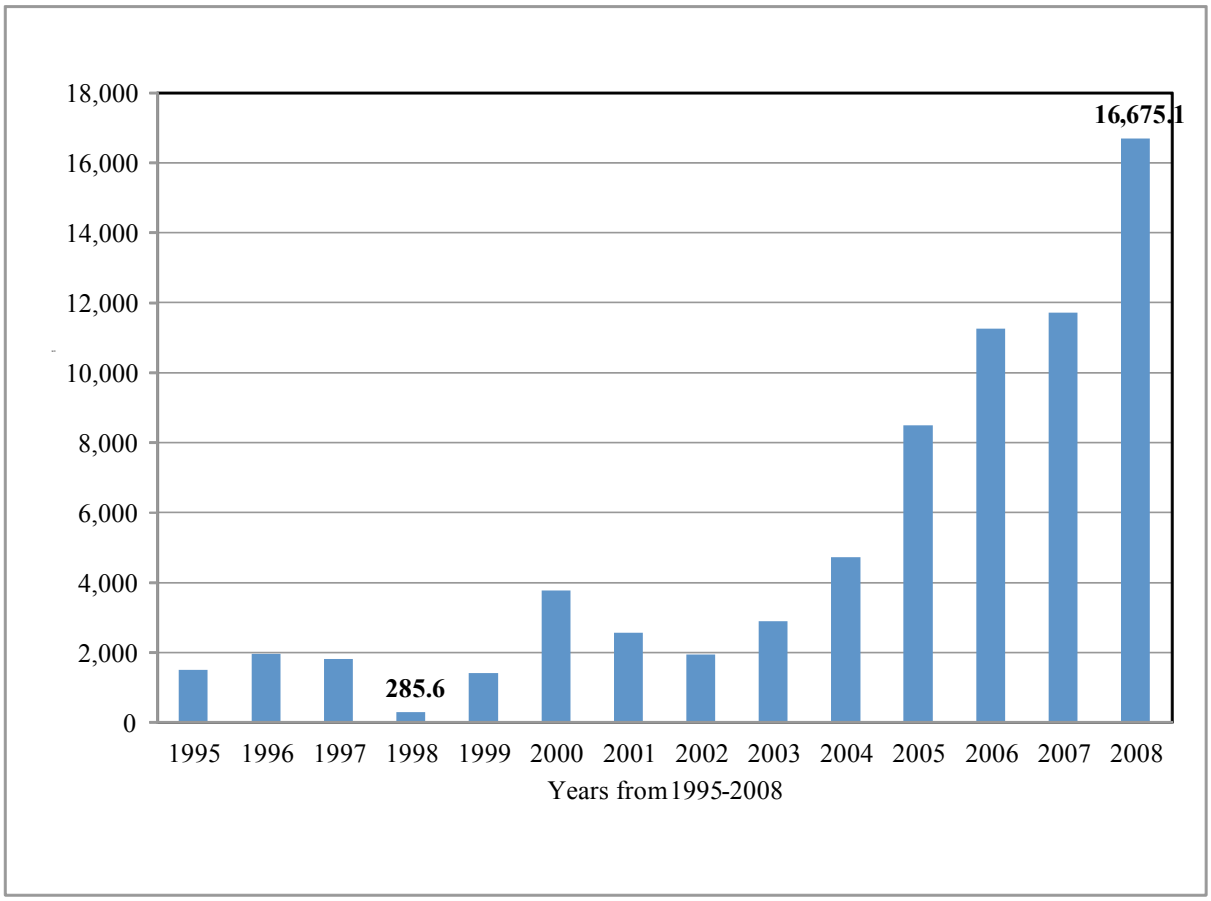
country's revenues. Kuwait's relatively small resources apart from oil make it dependent on other countries for goods to meet local demand and market needs. Kuwait's imports are very varied and include a large component of consumption goods. The country's import tax or tariff is very low, and goods imported from GCC countries are exempted from all customs tariffs.

Kuwait's recent trade surplus and growth has had an important effect on the country's different economic sectors. It has boosted the government's expenditure and increased the country foreign assets. These foreign assets are a very important addition to the country's national income, and have been of value to the current account when oil prices declined in offsetting government expenditure.

Kuwait's trade balance rose from KD 11,708 million in 2007 to KD 16,675 million in the year 2008, an increase of 42%. For the years of the period we have studied, we can see that Kuwait's trade balance has been a reflection of the country's main oil activities exports.

The mean trade balance for the period 1995–2008 was KD 5,067 billion and the maximum trade balance for one year was KD 16,675 million, achieved in 2008, which was a reflection of the high oil prices recorded on the international market and high international demand for oil. Trade surpluses have increased the government's expenditure and investment on foreign assets. Using the data we have for the years 1995–2008, we can see from the graph below that Kuwait's net trade balance has been on an overall upward trend. The year 1998 had the lowest trade balance surplus (KD 285.6 million) owing to a decline in oil exports and an increase in imports.

Figure 5.3 Kuwait's Trade Balance, 1995–2008



5.7 KUWAIT'S TRADE EXPORTS AND IMPORTS

Kuwait has made great efforts in recent years to improve trade relationships with partners regionally and internationally by entering and enforcing several trading agreements. These include:

- *Gulf Cooperation Council.* Promoting economic progress between GCC countries in all fields.
- *Common Gulf Market.* The ministers of finance and economy in the GCC countries have made several steps and decisions to enable GCC nationals to carry out economic activities such as trading, purchasing and profession.
- *Gulf Customs Union.* As of 1 January 2003, a unified customs union of all GCC members was introduced to remove all customs tariffs, eliminate obstacles of

commercial exchange, standardize imports and exports procedures, and treat the geographical area of the six member countries as one single customs zone.

- *On the Arab level.* The state of Kuwait entered into a pan-Arab free trade zone, which promotes trading activities among Arab countries.

- *On the international level.* Kuwait participates in several international organizations, and promotes negotiation agreements with major economies. It is believed that such agreements will have a major impact on Kuwait's trading activities with countries such as China, Japan, Turkey, India, the EU and EFTA economic communities.

Table 5.5 Kuwait's Trade Balance, 1995–2008

Periods	Exports	Oil Export	Non-Oil Exports	Fertilizers	Ethylene Products	Other	Total	Re-Export	Grand Total	Imports	Trade Balance
1995	3,814.6	3,597.1	217.5	53.8	-	94.6	148.4	69.1	217.5	2,323.1	1,491.5
1996	4,458.4	4,231.3	227.1	108.4	-	44.5	152.9	74.2	227.1	2,507.2	1,951.2
1997	4,314.4	4,085.4	229.0	30.3	7.7	105.6	143.6	85.4	229.0	2,501.6	1,812.8
1998	2,911.8	2,581.8	330.0	20.0	132.5	108.7	261.2	68.8	330.0	2,626.2	285.6
1999	3,703.2	3,356.5	346.7	17.2	161.5	103.4	282.1	64.6	346.7	2,291.0	1,412.2
2000	5,965.6	5,578.3	387.3	19.5	196.3	107.5	323.3	64.0	387.3	2,195.4	3,770.2
2001	4,972.9	4,590.8	382.1	21.5	190.3	107.9	319.7	62.4	382.1	2,413.3	2,559.6
2002	4,669.0	4,272.8	396.2	15.5	191.0	124.0	330.5	65.7	396.2	2,735.8	1,933.2
2003	6,165.4	5,663.5	501.9	31.6	188.4	156.6	376.6	125.3	501.9	3,274.1	2,891.3
2004	8,432.1	7,861.1	571.0	41.1	229.0	160.8	430.9	140.1	571.0	3,722.2	4,709.9
2005	13,101.6	12,392.6	709.0	56.0	311.0	162.0	529.0	180.0	709.0	4,613.9	8,487.7
2006	16,252.9	15,429.7	823.2	73.0	245.7	236.6	555.3	267.9	823.2	5,000.5	11,252.4
2007	17,770.1	16,780.0	990.1	82.2	307.6	257.9	647.7	342.4	990.1	6,061.5	11,708.6
2008	23,363.4	22,200.1	1,163.3	94.0	473.6	193.8	761.4	401.9	1,163.3	6,688.3	16,675.1

Source: Central Bank of Kuwait, Quarterly Bulletin, Several Issues (1995–2008).

Table 5.5 includes available data from 1995–2008 for the development of Kuwait's foreign trade activities, including exports of oil, non-oil merchandise, re-exports and imports. Kuwaiti exports are on a 'fob' basis for the year 2008. The value of exports in this year grew to KD 23,363 million, which was an increase of 31% over their value in 2007, when they were worth KD 17,770 million. Table 5.5 indicates that the year 2008 recorded the highest total exports for the whole period.

The average increase in exports was 18% for the entire period. The minimum growth rate was in the year 1998, which recorded a decline of 32%, and an export value of KD

2,911.8 million. And the maximum growth rate on total export value was an increase of 61% during the year 2000, when the value of exports increased by KD 2,262 million.

Oil exports for the year 2008 reached KD 22,200 million, compared to KD 16,780 million in 2007, which represents an increase of 32%. Moreover, the mean growth rate for oil exports was 18.7% for the period 1995–2008. Furthermore, oil exports achieved their maximum level of growth in 2000, which recorded an increase of 66.2%, and a total value of KD 2,2624 million. The lowest growth rate was in 1998, which recorded a decline of 36.8%, a decrease in value of KD 1,504 million.

Non-oil exports grew at a rate of 9% in 2007 to a value of KD 990.1 million, and 32% in 2008 to a value of KD 1,163 million. Non-oil exports had a mean growth rate of 14.4% for the period 1995–2008. The highest growth rate was 44.1% in 1998, and the minimum growth rate was a decline of –1.3% in 2001.

Kuwaiti re-exports in 2008 were KD 401.9 million, compared to KD 342.4 million in 2007, an increase of 17%. During the period 1995–2008 re-exports had a mean growth rate of 17.2%, but recorded their biggest decline of –19% during 1998.

Kuwaiti imports have continued to grow in recent years. They grew from KD 6,061.5 million to KD 6,688.3 million between 2007 and 2008, a growth rate of 10%. Imports had a mean growth rate of 8.9% for the entire period, and a maximum increase of 24% in 2005 and a maximum decline of –13% in 2002.

Table 5.6 indicates the correlation between different variables, such as exports, oil exports, non-oil exports, imports and the trade balance, and it calculates how each of these variables tends to increase or decrease according to the movements of the other variables. On the basis of the results below, we can deduce that the highest correlation coefficient (a positive correlation of r = 0.99) is between oil exports and total exports. Total exports tend to increase or decrease according to the movement of oil exports.

Variables such as non-oil exports had a negative correlation coefficient. Total exports had a very low negative relationship with non-oil exports (r = –0.018). However, re-exports had a positive correlation coefficient with total exports (r = 0.361). Imports had a very low positive correlation (r = 0.059) with total exports, but a higher correlation coefficient with re-exports (r = 0.5418), showing that re-exports tend to increase with

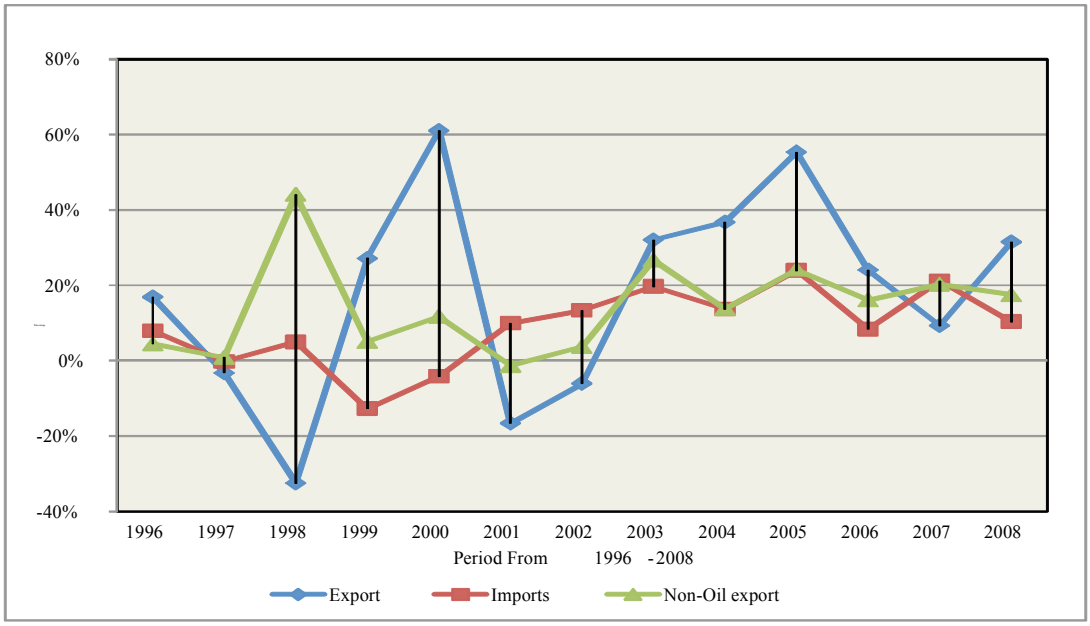
total imports. Non-oil exports had a positive correlation coefficient with total imports (r = 0.346).

Table 5.6 The Correlation Coefficient Between Different Variables (Exports, Oil Exports, Non-Oil Exports, Imports, and the Trade Balance), 1995–2008

Variables	Exports	Oil Export	Non-oil export	RE-Exports	Imports	Trade Balance
Exports	*1.00*	0.999	-0.018	0.361	0.0593	0.5747
Oil Export	0.999	*1.00*	-0.043	0.344	0.035	0.591
Non-oil export	-0.018	-0.043	*1.00*	0.205	0.346	-0.250
RE-Exports	0.361	0.344	0.205	*1.00*	0.5418	-0.0801
Imports	0.059	0.035	0.346	0.542	*1.00*	-0.5703
Trade Balance	0.575	0.591	-0.250	-0.080	-0.570	*1.00*

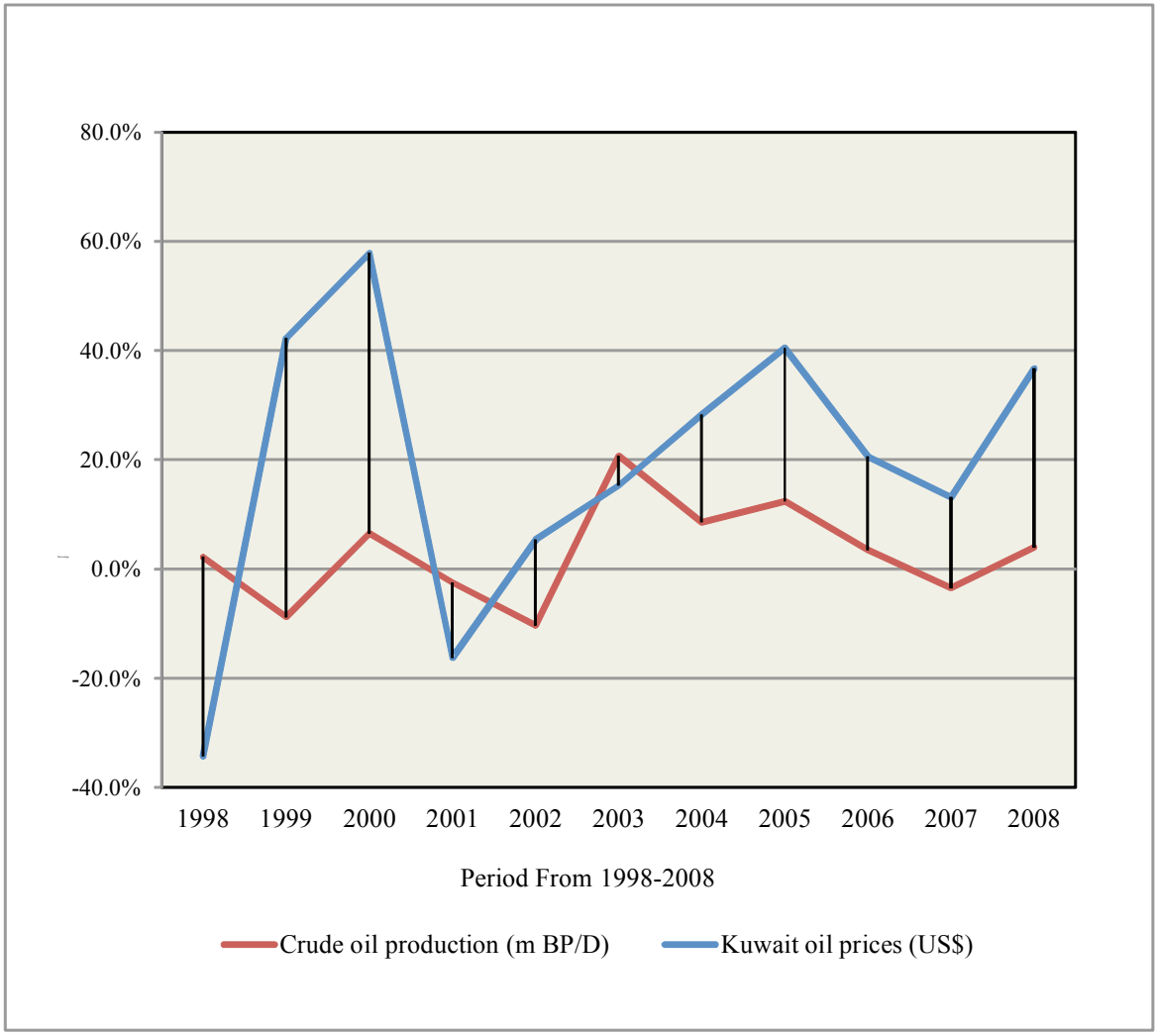
Kuwait's main export driver is oil, which accounted for 94% of exports in 2007, and 95% in 2008. Non-oil exports include fertilizers, ethylene products and other products, and re-export products.

Figure 5.4 The Percentage Change of Kuwait's Merchandise Balance, 1995–2008



Kuwaiti oil exports in 2007 were KD 16,780 million, and KD 22,200 million in 2008, an increase in value of KD 5,420 million, which was due to hikes in oil prices on the international market. Kuwait's exports registered a strong growth for the period 1997–2008, with an increase of 9% in 2007, and 31% in 2008. Oil exports continued to grow in recent years as a result of increased oil prices and oil production. Kuwaiti oil prices increased from US $69 to US $94 per barrel between 2007 and 2008, an average increase of 36%. After a decline in oil production of –3.4% in 2007 it grew by 3.9% in 2008. Thus increases in both oil production and oil prices helped the increase in Kuwait's oil revenues.

Figure 5.5: The Percentage Change of Kuwait's Oil Production and Oil Prices, 1998–2008



The graphs in figure 5.5 demonstrate the changes in both Kuwaiti oil prices and oil production. We can see that oil prices and production went through different changes over the period 1998–2008.

During the years 1997–2000 Kuwait's oil revenues followed different trends. Oil revenues in 1997 were KD 4,085.4 million, and were followed by a fall of –37% in 1998%. Because of a decline in oil production in 1997–1998, prices rose by 34% to $12.3 P/B. The years 1999 and 2000 both record an increase in oil revenues, resulting from increased oil prices, even though there was a drop in oil production of –9% in 1999 compared to the previous year.

The period 2001–2004 showed some fluctuations in oil export earnings, oil production and oil prices. The years 2001 and 2002 had the same level of exports earnings even though oil production was 10% lower in 2002 than in the previous year; however, oil prices were 5% higher in 2002. In the following two years exports earnings improved to reach to KD 7,861.1 million in 2004, an increase of 39% over the KD 5,663.1 million of the previous year 2003, owing to an increase in both oil production and oil prices.

A great improvement was recorded during the last four years, 2004–2008. Oil export earnings were very high compared to all the previous years, reaching KD 22,2001.1 million in 2008, as a result of both oil price hikes and a great increase in oil production.

The year 2008 witnessed a record high oil price of $94.5 BPD, which is much higher than the average oil price of $39 BPD for the entire period from 1997–2008, an increase of 42%. Moreover, oil production was 2,676 m/BPD, which was 28% higher than the average oil production of 2,086 m/BPD. The graph below 5.6 shows the quantity of oil production for the entire period 1997–2008.

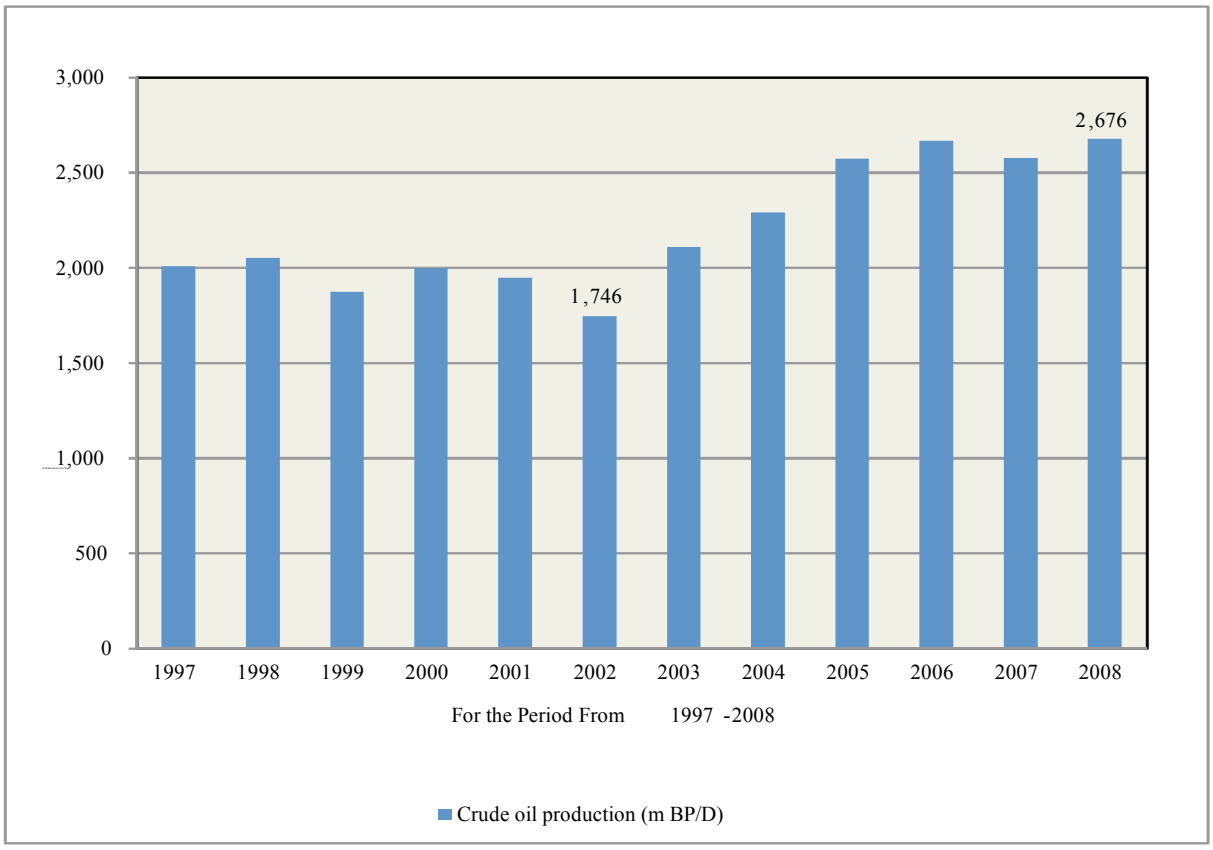
In the years 1997–2000 Kuwaiti oil revenues went through various changes. In 1997 oil revenues were KD 4,085.4 million, followed by a –37% drop in 1998% as a result of a fall in oil production, even though prices rose in 1988 by 34% to $12.3 P/B. The years 1999 and 2000 both recorded an increase in oil revenues despite a drop in oil production of –9% in 1999 from the previous year, but the increase in oil prices had a major effect on oil exports earnings.

The period 2001–2004 showed some fluctuations in oil export earnings, oil production and oil prices. The years 2001 and 2002 had the same level of exports earnings, even though oil production was 10% lower during the year 2002 than in 2001, but oil prices were 5% higher during the same period.

In the following two years exports earnings improved to reach KD 7,861.1 million in 2004, an increase of 39% on the KD 5,663.1 million earned in 2003, following increases in both oil production and oil prices.

A great improvement was recorded during the last four years 2004–2008. Oil export earnings reached a much higher level than in all previous years, reaching KD 22, 2001.1 million in 2008, as a result of oil prices hikes and the greatly increased oil production. Oil prices and oil production are the main factors leading to increased revenues from the export of oil in the period studied. Chart 5.6 below shows the historical data for the quantity of oil produced by Kuwait.

Figure 5.6 The Trend in Kuwait's Production of Oil, 1997–2008



Both Kuwaiti oil production and oil prices, as summarized in Figure 5.5, showed some steadiness during the years 2001–2005, but the following year underwent a drop as a result of the fluctuations in the global oil market. Then oil prices started to strengthen in 2005 and onwards owing to the high demand for oil on the international market and the increase in world commodity prices. In addition, as we can see in Figure 5.5, the trend in Kuwaiti oil prices over the period has been upward.

It is therefore clear that Kuwait's total exports depend on the country's export of oil, and oil exports are linked directly to the country's level of oil production and the price of oil. Historically, Kuwaiti oil exports have depended on the fluctuation of oil prices on the international market, and varied according to the international demand for oil and the level of the country's production of oil.

Non-oil exports have not contributed more than 11.33% of Kuwait's total export earnings, according to the data from 1995–2008. In 1996 non-oil export earnings were KD 217.5 million. From 1998 non-oil exports entered a new stage of development and continued to grow in value until 2008. Figure 5.7 shows that had the highest percentage increase for the entire period was an increase of 11% in 1998, which was due to a decline in the country's oil exports and an increase in imports that led in turn to an increase in the level of re-exported products to other countries.

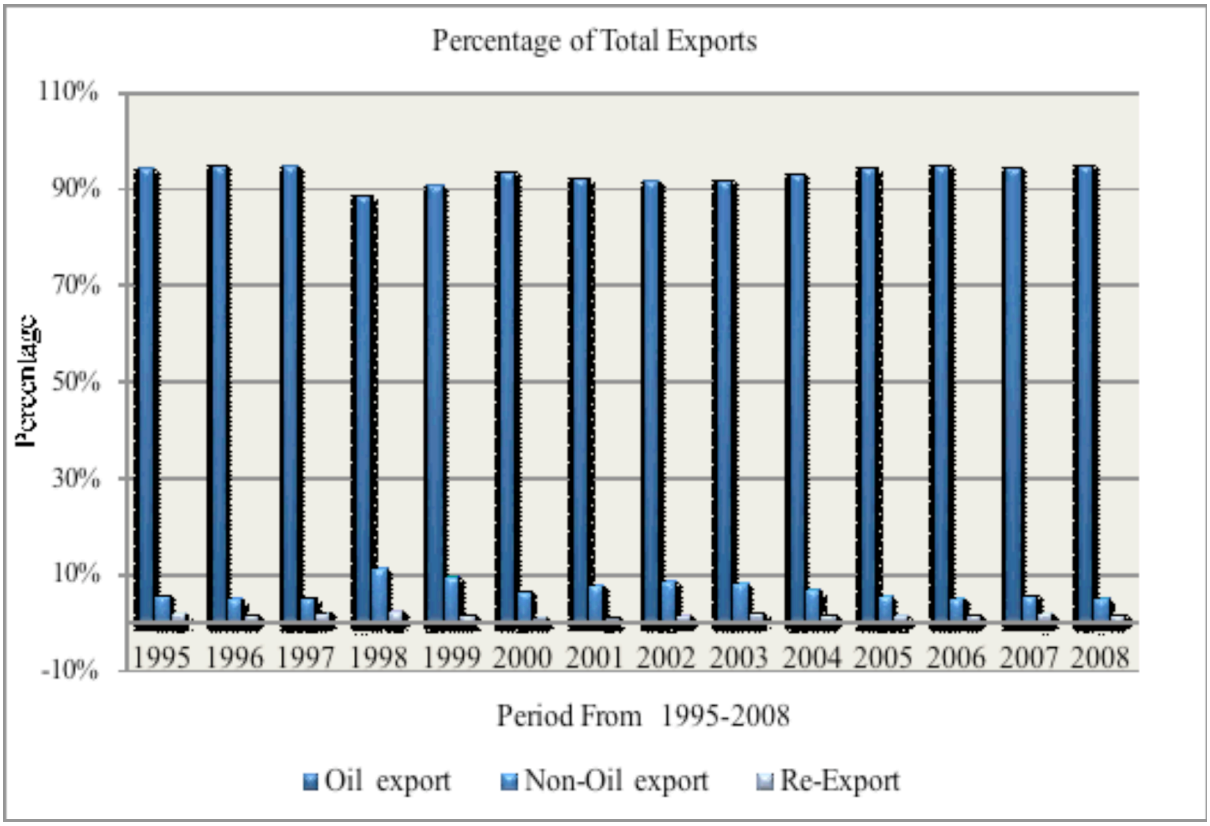
The State of Kuwait does not have many manufacturing activities except the production of some petro-chemical products and some other products such as fertilizers, rubber, plastic and base metals. Some re-export activities have enhanced non-oil exports, and the country has benefited from trade transactions with its neighbour Iraq.

In the development of non-oil export earnings for the period 1995–2008 the minimum value of such earnings was KD 217.5 million in 1995, the maximum value was KD 1,162.30 billion in 2008, and the average annual value was KD 456.39 million. Non-oil sector earnings were 17% higher in 2008 than in 2007. Non-oil exports have never counted for more than 10–15% of the country's total exports.

Figure 5.7 shows the distribution of the country's major export components, and demonstrates that oil exports consistently made up the highest proportion of the country's exports in the period from 1995–2008, with a mean of 93.36%, a maximum of 95.02% and a minimum of 89%. Conversely, non-oil exports had a mean of 7%, a

maximum of 11%, and a minimum of 5%. Re-exports had a mean of 2% of total exports, without very much variation from that percentage. The country has made some improvements over the years to re-export its petro-chemical products, and worked to diversify its economic activities.

Figure 5.7 The Percentage Share of Oil in Total Exports, 1998–2008



Since Kuwait began exploiting the oil, the country has made a great effort to strengthen its trading relationships with other countries. As mentioned earlier, Kuwait's major export is oil, which is sent to many different parts of the world. Table 3.4 below shows Kuwait's main trading partners.

According to the latest available data from the Economic Intelligence Unit for the period 1996–2008, the main destinations of Kuwait oil exports are Asia, the USA and Europe. Japan has long been the country's main trading partner, and has remained top of the list of importers of Kuwaiti oil. Oil exports to Japan increased by 14% to reach 15% of Kuwait oil exports in 2008, compared to a decrease of –5% in 2007. The USA has been one of Kuwait's main trading partners and has stayed within the top four importers

of Kuwait oil. The level of oil imported oil to the USA from Kuwait has been stable for the five years 2004–2008.

Table 5.7 Kuwait's Major Trading Partners, 1996–2008

Year		**1996**	**1997**	**1998**	**1999**
Japan		19.40	23.70	22.30	22.80
USA		10.9	12.8	14	11.5
Singapore		8.30	7.70	6.60	8.20
Netherlands		8.50	6.90	6.90	7.30
Year		**2000**	**2001**	**2002**	**2003**
Japan		23.20	24.80	24.90	20.90
South Korea		12.70	12.60	13.20	11.70
USA		13.90	12.40	12.10	10.70
Singapore		7.10	7.60	10.30	9.20
Year	**2004**	**2005**	**2006**	**2007**	**2008**
Japan	17.40	14.80	14.70	14.00	15.90
USA	11.60	11.60	11.70	12.30	12.00
Singapore	9.50	7.10	7.00	7.30	8.20
Netherlands	10.50	8.90	6.50	6.20	7.70

Source: Economic Intelligence Units.

Oil exported to the USA in 2008 decreased by 2% to reach 12%, compared to 12.3% in 2007. The lowest level of Kuwaiti oil exports to USA was 11.6% in 2005 and the highest was 12.3% in 2007. Another Asian country, Singapore, holds the third position as an importer of Kuwaiti oil. Oil exported to Singapore in the year 2008 increased by 12% to reach 8.2% of Kuwait's total oil exports. The highest level was in 2004 which recorded a percentage of 9.5% of total oil exports, and the minimum level was in 2006 when it was 7% of total oil exports.

The Netherlands is in the fourth position as a trader in Kuwait oil, importing 7.7% of Kuwait oil exports. Moreover, in 2008 these exports to Holland increased by 24% over the previous year. The lowest fall was in 2005, when exports to the Netherlands fell by 27%. Asian countries import the highest proportion of Kuwaiti oil, with Japan and Singapore accounting for 24.1%, followed by the USA at around 12%, and the Netherlands at 7.7%. The remaining exported oil goes to different parts of the world, including other Asian and European countries.

5.8 KUWAIT'S NON-OIL EXPORTS

Non-oil exports from the State of Kuwait consist of fertilizers, ethylene, re-export products, which are in large part petro-chemical products, and other light industrial products. The development of non-oil exports is analyzed in figure 5.9 below, and can be seen to move in almost the same direction as re-exports, which increase and decrease at the same time as non-oil exports.

Non-oil exports do not contribute more than 11.33% of the country's total export earnings, according to the data for 1995–2008, while the mean was 7% and the minimum was 5%. Re-exports contribute no more than 2% of Kuwaiti total exports, but also drop scarcely below that figure. Non-oil exports continued to grow in recent years. The value of non-oil exports was KD 990.1 million in 2007 and KD 1,163.3 million in 2008, which represents an increase of 9% from the previous year.

Re-exports contribute to total exports a mean of 2%, a maximum of 2%, and a minimum of 1%. The percentage of change for re-exports had a mean of 14% increase for the entire period, a maximum of 91% in 2003, when they had a value of KD 125.3 million, and a maximum decrease of –19% in 1998. Re-exports in 2008 were KD 761.4 million compared to KD 647.7 million in 2007, which is an increase of 28%.

Table 5.8 Kuwait's Non-Oil Exports According to SITC Value in KD Million, 1995–2007

Period	Foods & live Animal	Beverage and Tobaco	Inedible Crude Material	Minerals fuels & Lubr Related	Animal and Vegetable	Chemicals	Manufactured Goods	Machinery and Equipment	Miscellaneous Manufactored	Commodities & Trans Unclasified	Total
1995	8.2	0.3	12.7	11.7	1.4	77.8	39.8	54.4	11.1	0.1	**218**
1996	19.5	1.6	11.9	14.1	1.1	67.4	37.7	57.4	13.0	2.9	**227**
1997	14.0	1.1	12.7	16.6	1.4	61.8	37.2	66.2	15.3	2.3	**229**
1998	11.2	2.0	12.1	16.2	1.7	180.2	34.3	55.6	15.2	1.3	**330**
1999	14.2	1.0	12.3	0.4	1.5	213.7	35.8	47.3	17.5	2.5	**346**
2000	14.7	0.9	13.4	3.0	1.1	255.0	38.9	46.0	11.5	0.1	**385**
2001	14.2	3.0	11.5	3.2	1.4	246.5	40.2	43.9	14.8	0.1	**379**
2002	19.4	3.1	14.0	3.0	1.2	248.2	40.8	45.3	17.9	0.4	**393**
2003	22.3	5.2	19.9	3.4	1.0	264.6	68.9	89.4	21.7	2.1	**499**
2004	22.1	7.3	21.5	4.0	0.9	321.2	70.3	90.9	28.8	-	**567**
2006	29	3	30	3	2	414	90	208	44	11	**834**
2007	35.4	3.2	40.2	3.8	1.4	457.9	102.3	306.0	39.0	0.8	**990**

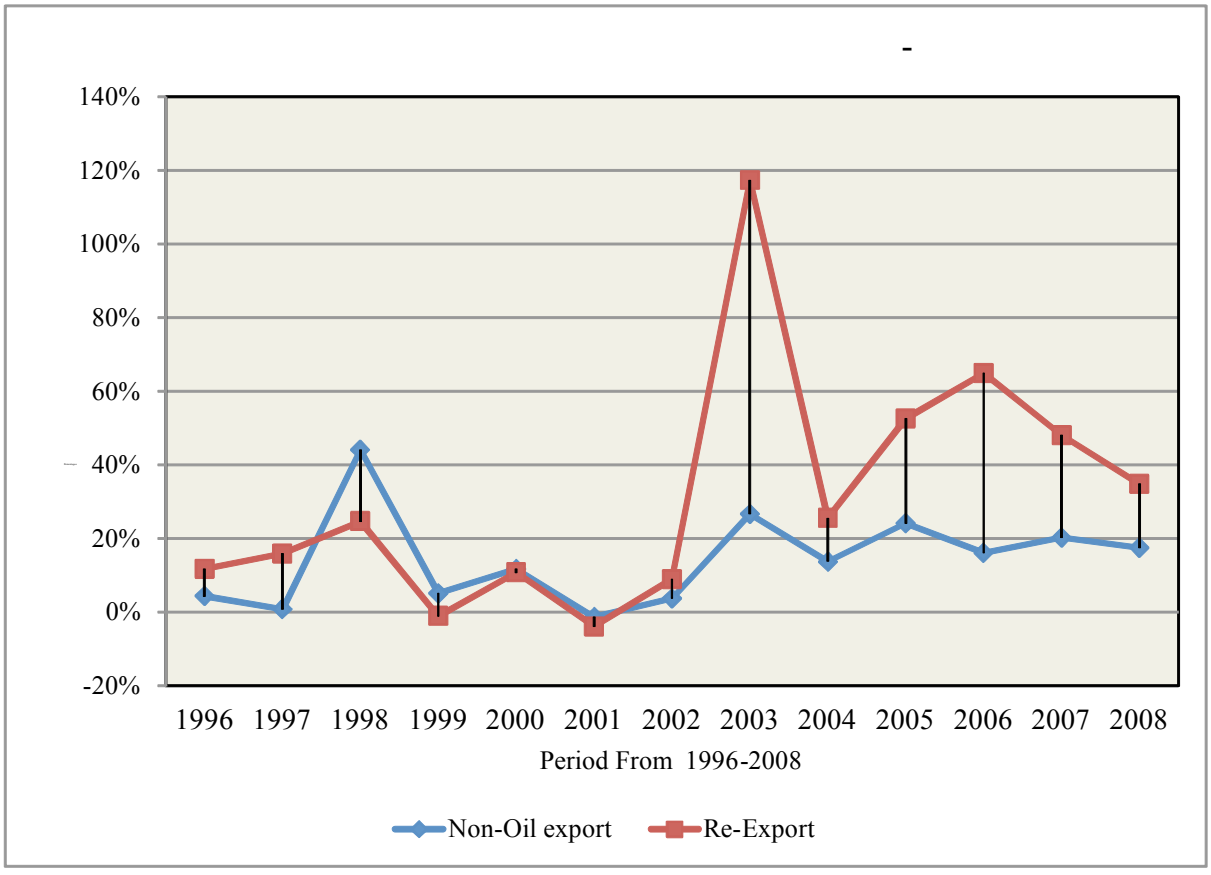
Source: Central Bank of Kuwait, Quarterly Bulletin, Several Issues.

Non-oil exports and re-exports are shown in Table 5.7 for the period 1995–2007. Non-oil exports grew at an average of 16% for the entire period, the maximum increase was

in 2006, and the minimum decrease of –2% was in 2001. The value of non-oil exports, which include re-exports, was KD 990 million, which is an increase of 19% over the previous year, when the value of non-oil exports was KD 834 million.

Figure 5.9 shows the development of the percentage changes of both non-oil exports and re-exports. It reveals a great increase in 2003 as a result of the war in Iraq, from which Kuwait benefited by being a hub providing transport facilities and a route for the re-export of products and services from Kuwait to Iraq.

Figure 5.8 The Percentage Changes in Non-Oil Exports and Re-Exports, 1996–2008



Kuwait's non-oil exports are listed in Table 5.9 below. According to the statistics, chemical products form the highest proportion of non-oil exported products. Chemical products exported from Kuwait had a mean of 0.507% of total non-oil exports, with a maximum level of 0.663%, and a minimum of 0.27%. These were followed by

miscellaneous manufactured products that had a mean of 0.48% of total non-oil exports, a maximum of 0.067%, and a minimum of 0.03%.

Table 5.9 Descriptive Statistics for Kuwait's Non-Oil Exports as a Percentage of Total Exports, 1995–2007

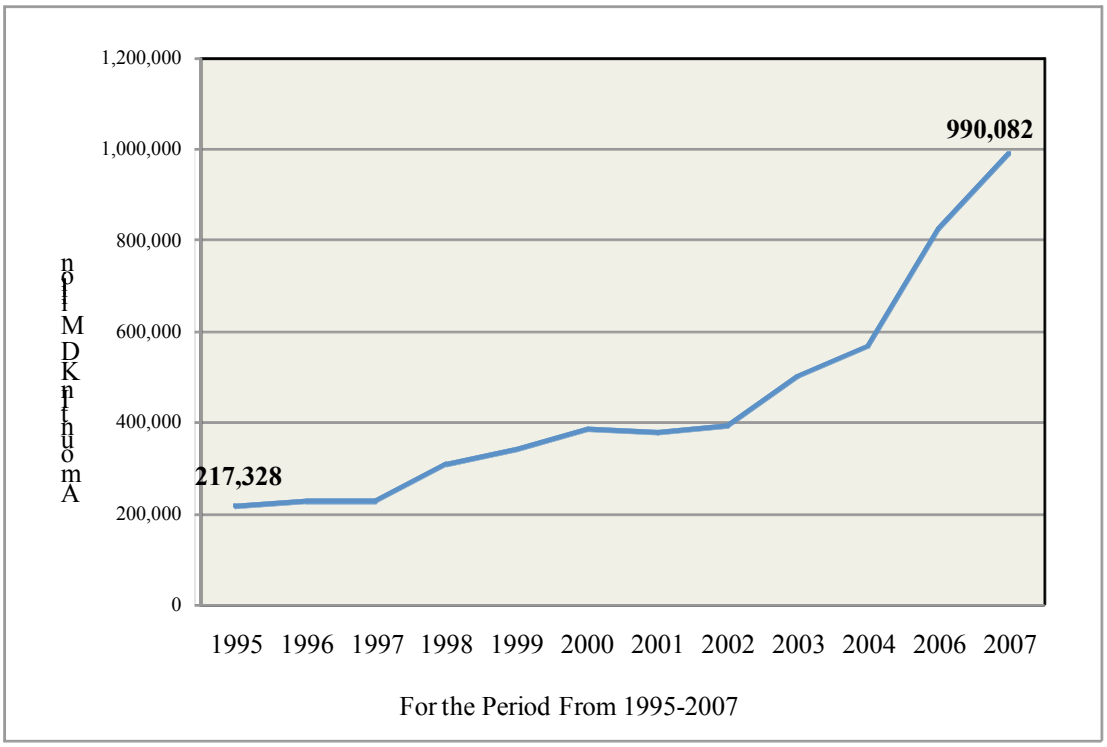
Items	Mean	Median	Std. Deviation	Range	Minimum	Maximum	Count
Foods & live animal	0.045	0.039	0.015	0.052	0.034	0.086	13
Beverage and Tobacco	0.006	0.005	0.003	0.011	0.001	0.013	13
Inedible crude material	0.041	0.037	0.009	0.028	0.030	0.058	13
Minerals fuels & Lubr related	0.024	0.008	0.027	0.071	0.001	0.073	13
Animal and vegetable	0.004	0.003	0.002	0.005	0.001	0.006	13
Chemicals	0.507	0.539	0.136	0.393	0.270	0.663	13
Manufactured goods	0.125	0.107	0.030	0.082	0.101	0.183	13
Machinery and equipment	0.196	0.174	0.071	0.194	0.115	0.309	13
Miscellaneous Manufactured	0.048	0.048	0.010	0.037	0.030	0.067	13
Commodities & Trans unclassified	0.004	0.002	0.005	0.013	0.000	0.013	13

Source: the author's calculation

Unclassified commodities and transactions formed the smallest proportion of non-oil exports, with a mean of 0.004%, and a maximum level for the entire period of 0.0013%. Kuwaiti non-oil exports rely on products imported from other countries and then re-exported to neighboring countries, along with some petrochemical products manufactured in Kuwait. Non-oil products are exported to other GCC and Arab countries, but also to other parts of the world such as the USA, Europe and elsewhere.

Figure 5.10 below shows the development of non-oil exports according to destination from 1995–2007. The total amount of non-oil exports increased tremendously over the years. Year 1995 recorded the lowest value of KD 212,327 million, but by 2007 this value had risen to KD 990,082 million. This figure was an increase of 20% compare to the previous year 2007, when non-oil exports were valued at KD 822,841 million.

Figure 5.9 Kuwait's Non-Oil Exports According to Destination, 1995–2007



A mean of 44.26% of non-oil products were exported to other Arab countries. In 2008 these were valued at KD 393,327 million, which compares with KD 482,916 million in 2007, and therefore showed an increase of 2% from the previous year. The maximum percentage of non-oil exports to other Arab countries in the entire period was 54.02% in 1997, and the minimum was 34.98% in 2000.

On average, Arab countries imported the highest proportion of non-oil products from Kuwait. The country which imported least was New Zealand, which accounted for a mean of all non-oil exports of 0.20%, a maximum of 0.85%, and a minimum of 0.01%. New Zealand's imports of non-oil products in 2006 were valued at KD 274 million, and decreased by 40% in 2007 to a value of KD 274 million.

Asian non-Arab countries hold second position as importers of non-oil products from Kuwait. In 2007 the region imported non-oil products to a value of KD 348,492 million, which was an increase of 10% over the previous year. The average percentage of these imports was 42% of all non-oil exports for the period 1995–2007, and the maximum was at 48.29% in 2002.

Table 5.10 Descriptive Statistics for Kuwait Non-Oil Exports According to Destination, 1995–2007

Descriptive Statistic	Mean	Median	Standard Deviation	Range	Minimum	Maximum	Count
Arab Countries	44.26%	44.31%	0.0570	19.04%	34.98%	54.02%	13
African Non Arab Countries	0.70%	0.66%	0.0048	1.64%	0.14%	1.78%	13
American Countries	4.87%	5.38%	0.0192	6.66%	1.24%	7.89%	13
Asian Non Arab Countries	42.70%	43.79%	0.0519	13.76%	34.53%	48.29%	13
European Countries	6.98%	7.05%	0.0262	8.32%	3.81%	12.13%	13
Westren European Countries	6.79%	6.65%	0.0272	8.48%	3.60%	12.08%	13
East European Countries	0.29%	0.21%	0.0029	0.91%	0.04%	0.96%	13
Oceanic Countries	0.50%	0.50%	0.0037	1.22%	0.07%	1.29%	13
Austalia	0.30%	0.27%	0.0023	0.57%	0.06%	0.63%	13
New Zealand	0.20%	0.08%	0.0025	0.84%	0.01%	0.85%	13

Source: the author's calculation

We can see from the data provided that Arab countries and Asian non-Arab countries account for almost 87% of Kuwaiti non-oil exports. The remaining 13% goes to different countries such as the USA, European countries, Oceanic countries and Australia.

Table 5.11 provides figures for non-oil exports according to SITC section. Chemical products reached KD 457.9 million in 2007, compared to KD 413.8 million in 2006, an increase of 10.6%. This increase is due to the development of petro-chemical manufacturing in Kuwait. Chemical products contribute an average of 50% of the country's non-oil export for the entire period 1995–2007, with a maximum percentage of 66.3%. Machinery and equipment re-exports contribute an average of 19.6%, with a maximum of 30.9% and a minimum of 11.3%.

Other sectors such as manufactured goods, inedible crude material, and foods and live animals contribute an average of 4–5% of the total non-oil exports. Other sectors, such as beverages and tobacco, contribute 2–3% of total non-oil exports.

Table 5.11 demonstrates that non-oil exports underwent an extremely rapid increase during 1995–2007. The components which relate to the oil sector's products are the main driver of Kuwait's non-oil exports, and refined products are consequently the country's major industrial activity. The development of petrochemical refined products is influenced by market oil prices, for an increase in the price of oil on the international market causes an increase in the value of Kuwaiti petroleum products.

Table 5.11 Kuwait Non-Oil Exports According to SITC in KD Million, 1995–2007

Period	Foods & live animal	Beverage and Tobaco	Inedible crude material	Minerals fuels & Lubr related	Animal and vegetable	Chemicals	Manufactured goods	Machinery & equipment	Miscellaneous Manufactored	Commodities & Trans unclasified	Total
1995	8.2	0.3	12.7	11.7	1.4	77.8	39.8	54.4	11.1	0.1	217.5
1996	19.5	1.6	11.9	14.1	1.1	67.4	37.7	57.4	13	2.9	226.6
1997	14	1.1	12.7	16.6	1.4	61.8	37.2	66.2	15.3	2.3	228.6
1998	11.2	2	12.1	16.2	1.7	180.2	34.3	55.6	15.2	1.3	329.8
1999	14.2	1	12.3	0.4	1.5	213.7	35.8	47.3	17.5	2.5	346.2
2000	14.7	0.9	13.4	3	1.1	255	38.9	46	11.5	0.1	384.6
2001	14.2	3	11.5	3.2	1.4	246.5	40.2	43.9	14.8	0.1	378.8
2002	19.4	3.1	14	3	1.2	248.2	40.8	45.3	17.9	0.4	393.3
2003	22.3	5.2	19.9	3.4	1	264.6	68.9	89.4	21.7	2.1	498.5
2004	22.1	7.3	21.5	4	0.9	321.2	70.3	90.9	28.8	0	567
2006	29.4	3.4	30.3	2.9	1.7	413.8	89.8	208	44	10.8	834.1
2007	35.4	3.2	40.2	3.8	1.4	457.9	102.3	306	39	0.8	990

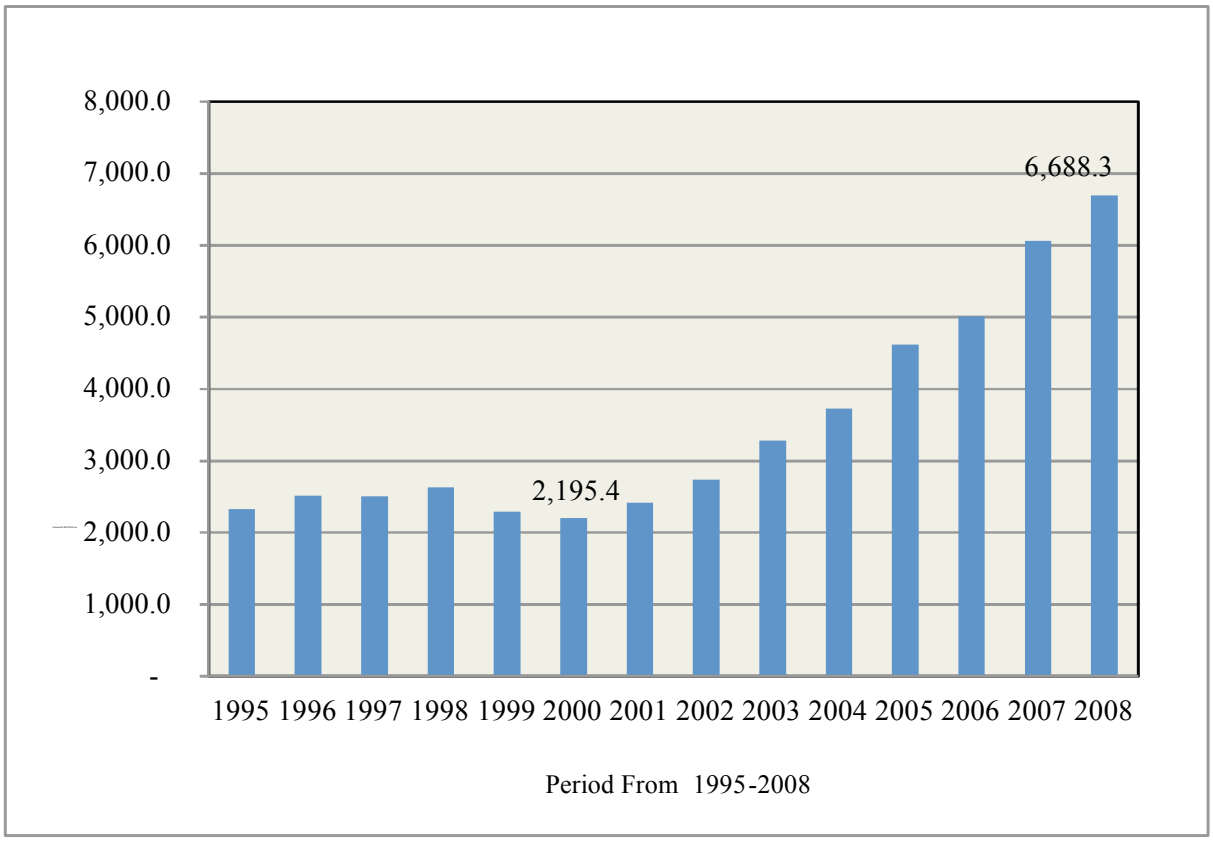
Source: Central Bank of Kuwait, Quarterly Bulletin, Several Issues.

5.9 KUWAIT'S IMPORTS

Strong economic activities and expansion have had a great impact on Kuwait's imports over the last few years. As discussed earlier in this chapter, Kuwait imports most of the products it needs to meet the local demand. Imports come from different parts of the world, and Kuwait has several economic agreements with other countries to enhance trade. Because of its restricted agriculture, Kuwait depends for most of its agricultural products and food on countries such as Jordan, Lebanon, Syria and Iran.

Imports are summarized in Figure 5.11 for the period 1995–2008. The recent expansion of the Kuwaiti economy in recent years has boosted imports from abroad, especially since Kuwait is not an industrial country. Imports in 2008 were worth KD 6,688 million, the highest value of imports for the entire studied period. The lowest value of imports (KD 2,195 million) was in 2000, and the average value was KD 3,496 billion. The level of imports increased tremendously from the year 2005.

Figure 5.10 Kuwait's Non-Oil Exports According to Destinations, 1995–2008

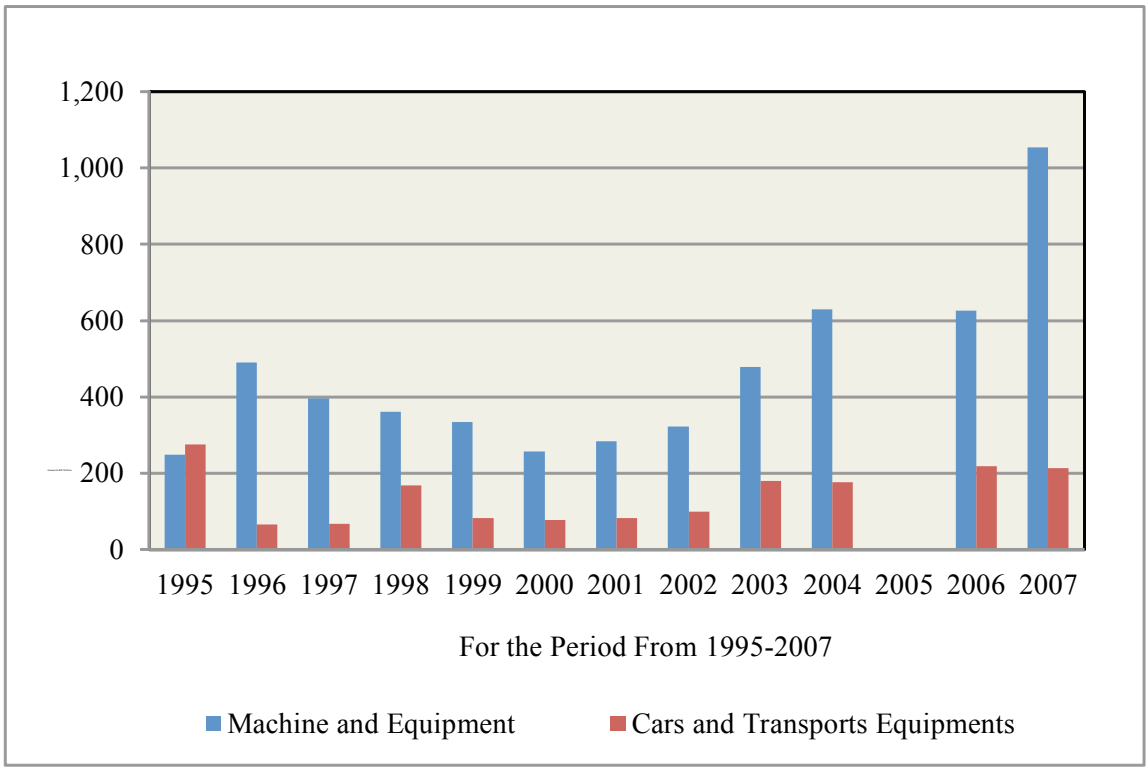


Imports for the years 2008, 2007 and 2006 grew by 10%, 21%, and 8% respectively. Consumer goods made up the highest proportion of Kuwait's total imports, with an average of 43% for the period 1996–2007. Intermediate goods came second with an average of 37%, and last are capital goods with an average of 19%.

Capital goods in 2007 were worth KD 1,266 million, compared with KD 899.00 million in 2006, which shows an increase of 50%. Capital goods include machinery, equipment, transport equipment and cars. Imports for machinery and equipment in 1995 were almost the same as cars and transport equipment. But in the following years machinery and equipment imports developed much faster, especially in 2007 when they increased tremendously.

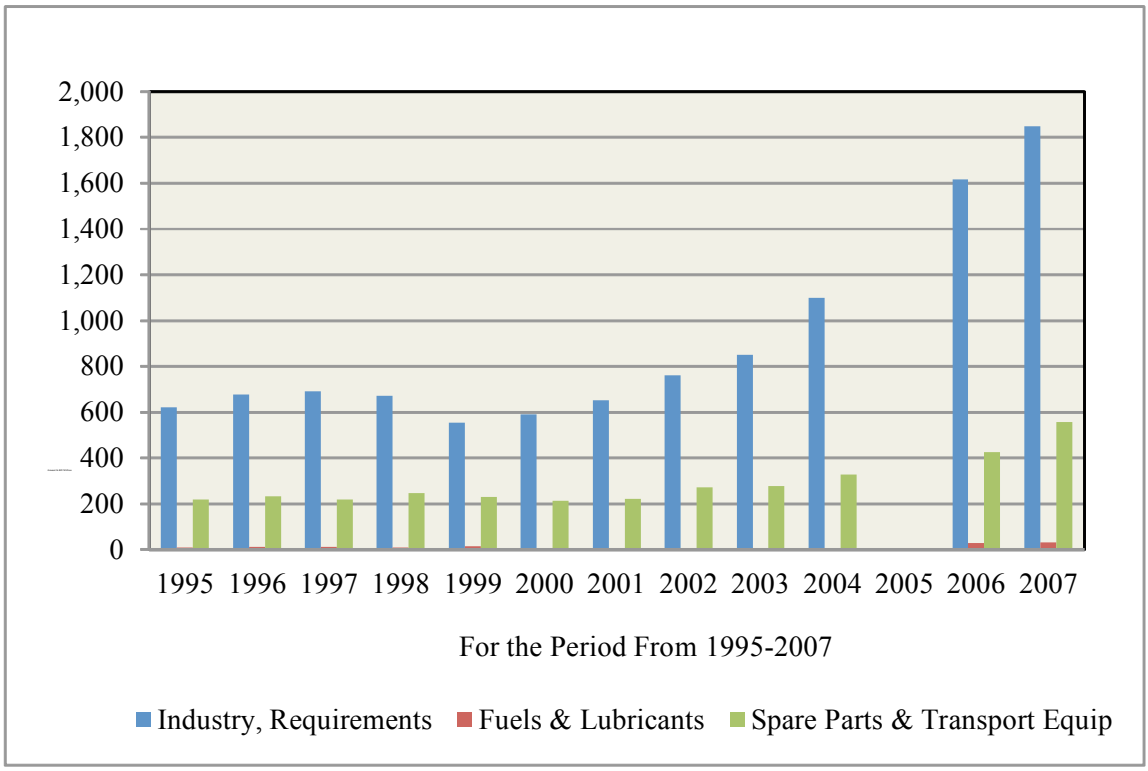
Kuwait imports machinery and equipment from developed and industrial countries. Imports of machinery and equipment in 2007 were KD 1,053 million, compared to KD 626 million in 2006, while cars and transport equipment were KD 213 million in 2007, and KD 218 million in 2006.

Figure 5.11 Kuwait's Import of Capital Goods, 1995–2007



Intermediate goods, including industrial requirements, fuels, lubricants, spare parts, and transport equipment, are the second largest sector of the country's imported products from abroad. Intermediate goods formed 40% of the total imports in 2007, with a value of KD 2,435 billion, compared to KD 2,067 billion in 2006, thus showing an increase of 18%. Intermediate goods achieved a record of 45% of total imports in 2006, compared with a minimum proportion of 34% in 1999. Figure 5.12 analyses the components of imported intermediate goods for the entire period and shows the progress in each sector.

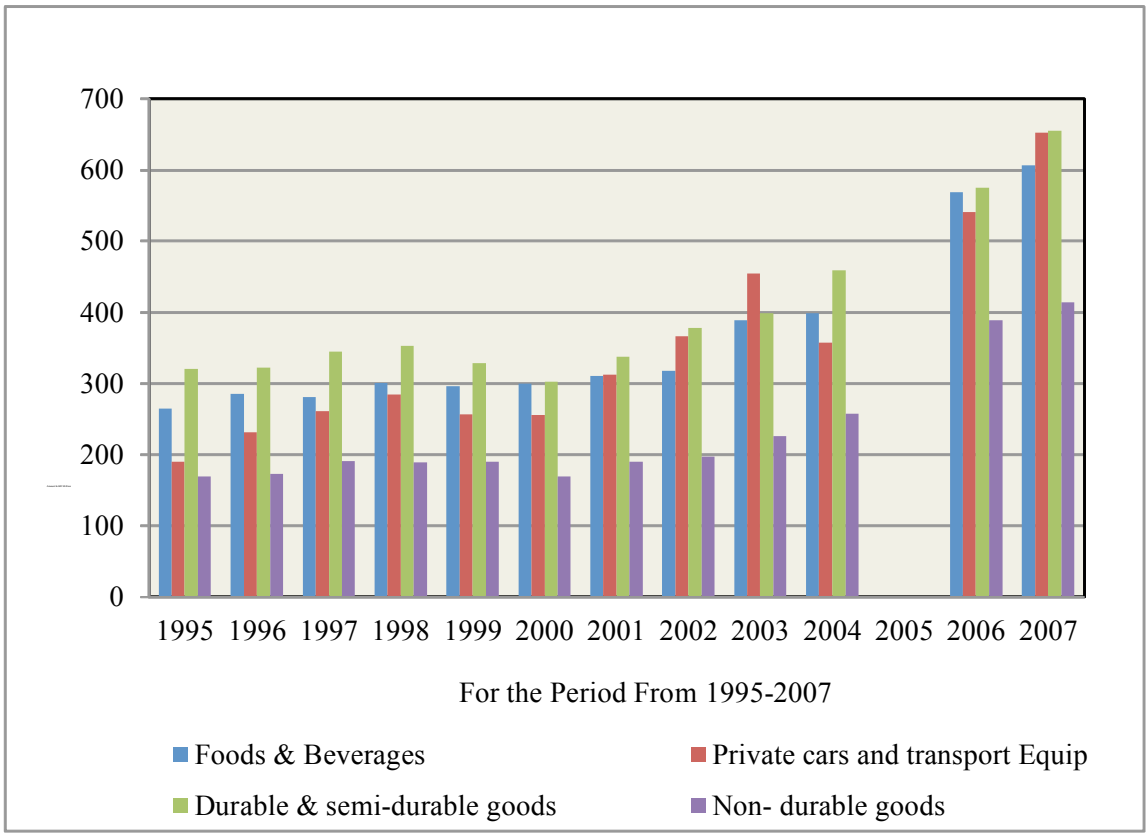
Figure 5.12 Kuwait's Import of Intermediate Goods, 1995–2007



Industrial requirements make up the largest proportion of intermediate goods, followed by spare parts, transport equipment and lastly fuels and lubricants. Kuwait has a petro-chemical industry based on its oil resources, which needs certain fuels and lubricants.

The state of Kuwait has a very limited agricultural and food production. Another important sector of the country's imports is consumer goods. Consumer goods in 2007 were worth KD 2,327 million, compared to KD 2,072 million in 2006, which represents an increase of 12%. The highest percentage increase was 41% in 2006, and the largest decrease was –5% in 1999. Consumer goods recorded the highest percentage (48%) of total imports in 2001, and the lowest percentage (38%) in 2007.

Figure 5.13 Kuwait's Import of Consumer Goods, 1995–2007



Foods and beverages make up the highest proportion of imported consumer goods, followed by durable and semi-durable goods. Also imports are needed to meet the local demand for private cars and non-durable goods.

Most of Kuwait's imports from abroad are needed to meet domestic demand. Table 5.12 classifies Kuwait's imports for the period 1995–2007. (Data for the year 2005 and 2008 were not available.)

Table 5.12 Kuwait's Imports by Economic Classification in KD Million, 1995–2007

Items		1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Capital Goods	Machine and Equipment	249	490.4	395.7	361.1	334.4	257.3	282.8	322	477.9	628.9	0	625.6	1052.7
	Cars and Transports Equipments	275.2	64.3	66	167.6	81.8	78.1	81.6	98	179.5	177.1	0	218	213
	Total	524.2	554.7	461.7	528.7	416.2	335.4	364.4	420	657.4	806	0	843.6	1265.7
Intermediate Goods	Industry, Requirements	619.2	675.2	689.8	669.6	553.7	589.7	650.1	761.3	849.6	1098	0	1614.6	1846.6
	Fuels & Lubricants	8.7	10.8	9.9	8.5	12.3	2.5	2.8	2.9	3.4	1.2	0	27.4	31.7
	Spare Parts & Transport Equip	217.7	231.8	218.2	245.9	230.8	213.1	219.8	270.8	277.3	326.6	0	425.1	556.8
	Total	845.6	917.8	917.9	924	796.8	805.3	872.7	1035	1130.3	1425.8	0	2067.1	2435.1
Consumer Goods	Foods & Beverages	264.6	285.1	280.7	300.3	295.9	300.1	310.5	317.8	388.8	398.2	0	568.3	606.1
	Private cars and transport Equip	189.8	231.4	260.8	284	256.2	255	311.9	365.7	454.5	357.4	0	541.1	651.8
	Durable & semi-durable goods	320.5	322.2	345	352.5	328.3	302.4	337.4	377.7	398	458.9	0	574.6	655.1
	Non- durable goods	169.1	172.5	190.7	189	189.9	168.7	189.5	197	226.4	257.1	0	388.4	413.9
	Total	944	1011.2	1077.2	1125.8	1070.3	1026.2	1149.3	1258.2	1467.7	1471.6	0	2072.4	2326.9
	Non- specified goods	9.3	23.5	44.7	47.7	34.9	28.7	27	22.8	18.7	18.9	0	17.4	33.1
	Grand Total	2323.1	2507.2	2501.5	2626.2	2318.2	2195.6	2413.4	2736	3274.1	3722.3	0	5000.5	6060.8

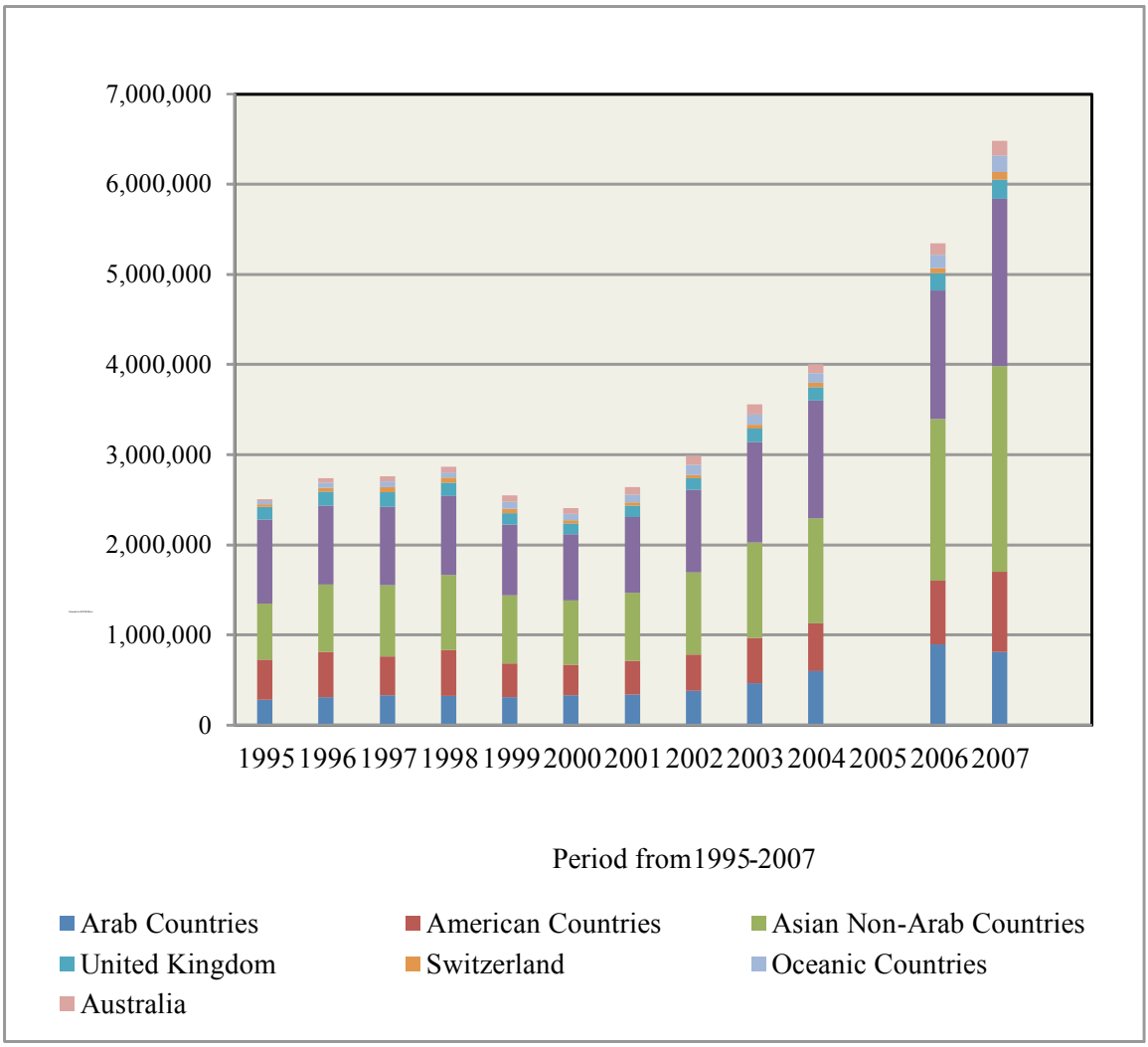
Source: Central Bank of Kuwait, Quarterly Bulletin, Several Issues, 1995–2007.

5.10 KUWAIT'S TRADING PARTNERS

Imports and trade relationships with different regions play a major role in the Kuwaiti economy. Major trading partners are set out below in Table 5.13 the descriptive statistics show that European countries account for the highest proportion of exports to Kuwait. For the entire studied period the average proportion of goods and services imported from European countries was 33.6%, with a maximum percentage of 40.35%, and a minimum percentage of 28.54%. Imports from European countries in 2007 were worth KD 807,344 million, compared to KD 895,553 million in 2007, showing an increase of 1.8%.

Imports from Europe in 2006 experienced their sharpest decrease of –6.6% contrasting with their highest increase of 3.7% in 2000. Within European countries France, Italy and Germany are the major exporters to Kuwait.

Figure 5.14 Kuwait's Import Trading Partners, 1995–2007



Asian non-Arab countries hold second place as exporters to Kuwait. The average proportion of services and products imported from Asian non-Arab countries was 31.6%, with a maximum percentage of 37.69%, against a minimum percentage of 26.56%. Imports from Asian non-Arab countries in 2007 were KD 2,284,764 million, compared to KD 1,794,988 million in 2007, i.e. with an increase of 1.8%.

Imports had their highest decrease of –2.8% in 1999 and their highest increase of 4.8% in 2006. Within Asian non-Arab countries Japan, India, China and South Korea are the major exporters to Kuwait.

Table 5.13 Descriptive Statistics of Kuwait's Major Import Partners, 1995–2007

Items	Arab Countries	American Countries	Asian Non-Arab Countries	European Countries	United Kingdom	Switzerland	Oceanic Countries	Australia
Mean	14%	16%	32%	34%	5%	2%	3%	3%
Median	14%	15%	32%	34%	5%	1%	3%	3%
Standard Deviation	2%	2%	3%	3%	1%	0%	1%	1%
Range	6%	6%	11%	12%	3%	1%	3%	3%
Minimum	12%	14%	27%	29%	3%	1%	1%	1%
Maximum	18%	20%	38%	40%	6%	2%	4%	4%
Count	**13**	**13**	**13**	**13**	**13**	**13**	**13**	**13**

Source: the author's calculation

American countries hold the third place among exporters to Kuwait. The average proportion of products imported from American countries was 16.14%. The maximum was 19.88%, and the minimum was 14.04%. Imports from American countries in 2008 were worth KD 888,342 million compared to KD 701,961 million in 2007, showing an increase therefore of 6%. Imports from American countries suffered their biggest decrease of –5.2% in 1999, and their highest increase of 2% in 1998. Within American countries, the United States of America, Brazil and Canada are the major exporters to Kuwait.

Arab countries hold fourth position among exporters to Kuwait. The average proportion of products imported from Arab Countries was 13.84%, the maximum was 17.91% and the minimum 11.91%. Imports from Arab countries in 2007 were worth KD 807,344 million, compared to KD 895,553 million in 2006, thus showing a decrease of –4.6%. Imports had their biggest decrease of –4.6% in 2007, and their highest increase of 3.1% in 2000. Among Arab countries, Jordan, Lebanon and Egypt are the major exporters to Kuwait.

Other countries such as Switzerland, Australia, and Oceanic countries also export goods to Kuwait, and the average percentage of products imported to Kuwait from these countries varies from 1.6% to 3%.

5.11 KD EXCHANGE RATES AND EXTERNAL TRADE TRANSACTIONS

The Central Bank of Kuwait has followed different exchange rate regimes over the past years, and has fixed the KD's exchange rate on the basis of the currency's fluctuations on the foreign markets. It has used fixed exchange rate regimes against both a basket of currencies and the US dollar alone. Kuwait has followed free trading systems, in which there are no controls over capital movements or transfer.

Currency stability and maintaining the value of the KD has been the Central Bank of Kuwait's main responsibility. This has been especially important both because Kuwait is a single product producer, with oil as the main driver of the country's economy, and because the import of goods is also a very important component of the country's economic activities.

As we discussed earlier in this chapter, because Kuwait exports oil and receives payments on US dollar terms, the value of USD/KD rates is important and one of the Central Bank's targets is to maintain the value of USD/KD to prevent the country's income from falling. Oil revenues averaged 92% of the country's total revenues for the period 1995–2008, and the oil revenues increased as the value of USD/KD exchange rates appreciated. The oil revenue payments were received in US dollar terms and therefore we can see that oil revenues increased in the last few years because the KD appreciated in value against the US dollar.

The average USD/KD exchange rate for the in 2004 was 294.07 fills to the US dollar, but in the following years the KD fell to a value of 268.535 fills against the US dollar. But it is worth mentioning that as the US dollar declined against other major currencies such as the euro, sterling and the yen, the KD appreciated against the US dollar, and this had a great impact on the Kuwaiti consumer price index, which has increased to a record high in the past few years.

As we saw earlier in this chapter, countries such as the USA, European countries, the UK and Japan are major trading partners, and any fluctuations of the KD exchange rate against their currencies in either direction will have a considerable impact on the country's economy.

One of the main economic indicators for the Central Bank of Kuwait is inflation, and the bank is always striving to keep it very low. It uses its monetary tools to guard against imported inflation and to maintain the purchasing power of the national currency. Imports increased over the period under consideration, a large proportion of which were capital and durable goods, and when the costs of these goods increased a great inflationary pressure was brought to bear on the currency. Exchange rate fluctuations in the international market affects the value of the KD. Historical data have proved that from the year 2003, when the exchange rate of the KD declined against the world major currencies, imported goods were affected by inflationary pressure.

The Central Bank of Kuwait uses fixed exchange rate regimes against a basket of major currencies and against the single US dollar, and it revalues the KD exchange rate against major currencies daily on the basis of international market movements. When fixing the exchange rate against a basket of currency regimes, the Central Bank had considerable flexibility to revalue the KD. However, when it used a fixed exchange rate against the US dollar and the value of the US dollar started to decline on the international markets, the value of the KD fell against major currencies such as the yen, euro, Swiss franc and sterling, and inflationary pressure was imported.

5.12 CONCLUSION

On the basis of the previous discussion, we can conclude that the state of Kuwait's economy relies heavily on the income it earns from the export of oil, which is the country's main driver of economic expansion, and on its net income from overseas assets. The economy of Kuwait has a direct link with the country's oil revenues, and the increase in oil prices has had a positive effect on the country's economic growth.

Kuwait has limited export transactions beside its oil exports, but it produces other petro-chemical products for export to the international market. The country has no other exports except some very light industrial products.

Kuwait's trade balance surplus and growth has had an important effect on the country's various economic sectors. The trade balance trend over the studied period has been upwards, and it reached its peak in 2008 with a value of KD 16,675 million owing to the

increase in oil prices. As we saw earlier in this chapter, the year of the lowest net trade balance was 1998 owing to a decline in oil exports and an increase in import.

Kuwait holds a large investment portfolio abroad. Income from overseas assets has played a major role when the country's oil revenues declined. The amount invested overseas by the Kuwaiti government is influenced directly by the country's income from oil. Kuwait made great improvements in the country's investment portfolios during the times when a high income was received as a result of the hike in oil prices.

Oil revenues account for almost 92% of the country's income, and income from foreign assets is the country's second main source of income. In addition, the foreign investment portfolio increased as the oil revenues increased, and Kuwait put into effect an investment strategy which involved using some of its oil revenues for investment locally and abroad.

Kuwait has put a great deal of effort into enhancing its trade relationship with other countries, from which it imports a wide range of products and services. Trading partners with Kuwait are divided into two categories: oil importer countries and industrial exporter countries. Kuwait exports oil to different parts of the world and at the same time imports products to meet local demand. Kuwait has no barriers to trade, as we saw earlier in this chapter. It imports capital goods such as machines, cars and transport equipment; intermediate goods to meet local industry requirements, such as fuels, lubricants and spare parts; and consumer goods, such as foods and beverages. Trading partners are from different regions, but the majority are in Europe, Asia, the Arab world and the United States.

It is important to the country's economy to maintain a stable KD rate against the US dollar and the other major currencies with which Kuwait deals. Owing to the country's import activities, the CBK has fixed the KD exchange rates against the currencies of trading partners to prevent imported inflation. The exchange rate with the US dollar is well managed, as we have seen in the discussion of data and the review of literature in Chapter 3.

When the KD fluctuated against the US dollar and other major currencies, and the Central Bank of Kuwait pegged the KD to the dollar, the KD suffered its highest depreciation against the dollar. It had its highest value against the US dollar when the

Central Bank re-valued its exchange rate regime to switch back to a basket of currencies. The bank did not have the flexibility to control the value of the KD against the major world currencies, as the value of the US dollar was declining.

The Central Bank of Kuwait had to adopt its old fixed exchange rate regime which pegged the dinar to a basket of currencies of countries with which Kuwait had significant trading activities. Since that time the exchange rate of the KD was re-valued against the major currencies, and thus inflation was stabilized.

Thus the KD exchange rate policy has been a significant factor in enhancing income and reducing inflationary pressure. Income from oil earnings is also sensitive to the exchange rate of the KD against the US dollar since oil exports are paid for in US dollars. Imports are also based on the KD exchange rate value, for the cost of imported goods is less if the KD is stable against the major currencies. However, the KD value can increase or decrease, according to the fluctuation of the KD exchange rate regimes policy followed by the Central Bank of Kuwait.

Chapter 6 DATA AND METHODOLOGY

6.1 INTRODUCTION

The Gulf Cooperation Countries signed the Unified Economic Agreement to improve the coordination and integration of their economic activities in 1982. The agreement included the decision to establish the Gulf Monetary Union. To enable the GCC to achieve single monetary union, the GCC council developed economic convergence criteria for member countries to follow. These include monetary and fiscal convergence and strict discipline in monetary and fiscal policies.

One of the requirements of joining a monetary union is acceptance of union policies, rules and criteria. The objective of a single currency union is to allow all member countries to enjoy better trade between each other. However, joining a monetary union might be difficult sometimes for countries owing to the inter-dependency of the member countries' trade activities, and local monetary and fiscal policies.

In this chapter, we discuss the use of qualitative analysis to assess the implications for the State of Kuwait of adopting the policy developed by the GCC council and joining a monetary union. The analysis is applied to the responses given in semi-structured interviews with decision-makers in the Central Bank of Kuwait and relevant ministries, as well as in Kuwaiti investments banks and private companies. The details of the responses and their implications will be discussed in the following chapter.

In the course of this chapter we will make clear why we chose to use qualitative analysis and semi-standardized (or semi-structured) interviews. In doing so we will answer the following questions:

- What is qualitative research analysis?
- Why use interviews? And what are the different types of interviews?
- Why use semi-standardized interviews?

- What are the procedures of a semi-standardized interview? And how did we select the sample group?
- What are the advantages and disadvantages of using semi-standardized interviews?

6.2 QUALITATIVE ANALYSIS

Qualitative research is a tool of social science, and includes an array of different methods such as interviews and observations. It is one of the ways of collecting and transforming qualitative data, and is usually based on interviews. In defining qualitative research, Bruce L. Berg (2009: 36) cites work done recently by Denzin, who remarks:

> Qualitative research, as a set of interpretative activities, privileges no single methodological practice over another. As a site of discussion or discourse, qualitative research is difficult to define clearly. It has no theory or paradigm that is distinctly its own … multiple theoretical paradigms claim use of qualitative research methods and strategies, from constructivists to cultural studies, feminism, Marxism, and ethics model of study. Qualitative research is used in many separate disciplines… it does not belong to a single discipline. (Denzin & Lincoln, 2008: 8–9)

In addition, Spencer et al. (2003: 3) say qualitative analysis

> Aims to provide an in-depth understanding of people's experience, perspectives and histories in context' and it is usually characterized by concern to find the actors' perspectives, semi-structured context-sensitive methods, rich data, explanations at the level of meaning and how and why questions.

Nahid (2003: 597), in his working paper about the validity and reliability of qualitative research, quotes the following definition of qualitative research:

> It is research that is used by researchers who use logical positivisms or quantity research and employ experimental methods and quantitative measures to test hypothetical generalizations. (Hoepfl, 1997)

Robert Gittens, in his paper "An investigation into methods and concepts in qualitative research", quotes a definition given by Immy Holloway (1997), who calls it

> a form of social inquiry that focuses on the way people interpret and make sense of their experiences and the world in which they live.

The above definitions show that qualitative analysis and research can be useful for getting inside a particular topic. We use it in this thesis to investigate the opinions of the different people who are involved in and have a view on the decision taken by the State of Kuwait to enter a monetary union. We will discuss their responses in Chapter 7.

Qualitative analysis is flexible in terms of receiving different kinds of information in a particular topic or field, and including the different experiences, backgrounds and opinions of interviewees. In allowing interviewees to relate their experiences to different theories, qualitative research makes it possible to achieve different outcomes for a particular question.

Researchers use qualitative analysis for different areas and topics. It can be used in fields relating to other sciences and having a numerical aspect. Peshkin (1993: 23–29) draws upon work done in the field of qualitative research methods to show that this kind of analysis can provide a wide range of possible outcomes. The author concludes, "There is no prototype qualitative research must follow, no mold we must fit in, to ensure that we are bound on the right track", (1993: 28). This indicates that there should always be flexibility and openness to different methods when using qualitative analysis to ensure a high quality of outcome.

Jick also discusses the use of both qualitative and quantitative methods, or 'triangulation', which is the use of different methodologies for a particular study of the same phenomenon (Denzin, 1978: 291, as cited in Jick, 1979: 602–611). He considers the advantage of using both qualitative and quantitative analysis mixing, and concludes that triangulation can be sufficient and useful but not for all researchers. The mixed use of two different methods can produce a strong outcome and an increased efficiency of results.

Scholars use qualitative analysis in different fields and for different purposes. Pope and Mays (1995: 42–45) focus on the range of different techniques of qualitative analysis,

the value of these techniques, and how it can complement quantitative analysis. In addition, they used qualitative analysis to survey health care and the health care services. They conclude that qualitative analysis gave more insight into the complexity of health care, and provided supportive information to their quantitative analysis.

Historically the use of qualitative analysis and research has played a vital role in the literature of social science. Iztok et al. (2010: 77–84) use ground theory to gather information on the basis of the description of people, events and situations. They look at work carried out previously by different authors and identify what different methods were used in their research. By reviewing the literature prior to their study they found that there had been a great number of studies that used qualitative research methods. In fact, more than half of the papers reviewed by the authors used qualitative research mixed with other methods. Their literature review shows that qualitative analysis is a way of gathering data from individuals who are involved in a specific area in their real life, and in addition provides more details in answering questions raised by researchers.

Other studies have used quantitative analysis in the field of monetary union, but in our study, we used both qualitative and quantitative analysis, and we believe this mixture of methods will make it distinct. We have used the interviews for our research analysis, and particularly semi-standardized (or semi-structured) interviews, and we have used qualitative analysis to find the answers for different questions on such topics as monetary policy, fiscal policy, investment, the labour market, political issues, and other issues relating to Kuwait's interest in joining the monetary union.

6.3 INTERVIEW OPTIONS

One of the commonest methods used by researchers in qualitative analysis is the interview. Interviews can serve different purposes and produce reliable information based on the researcher's questions.

There are different types of interviews, and each type is chosen according to the researcher's aims. Information and data collected from the interviews can be tape-recorded and then transcribed, or can be recorded by taking notes during the interview. In our survey, I have used notes to record the information delivered by the interviewees.

(However, the notes do not include discussion which was not strictly relevant but was continued for the sake maintaining a conversation.)

Some interviews lay out a list of questions with alternative responses for the interviewee to select from. Another type of interview is 'non-directive', and allows the interviewee to answer freely the questions in conversation (Drever, 2003: 1).

Bruce L. Berg in his book *Qualitative Research Methods* (2009) cites various authors who identify different type of interviews. Rubin & Rubin (2004) mention "the family of qualitative interviews", in which acknowledgment by the interviewee of the structure of the interview is a requirement. Other scholars mention only two types of interview, i.e., 'formal and informal' (e.g. Fitzgerald & Cox, 2002: 118–119). Finally Berg highlights the work done by Babbie (2007), Frankfort-Nachmias (2007), Merriam (2001), Nieswiadomy (2002), and Polit & Hungler (1995), all of whom identify three types of interviews: 'standardized'(or 'structured'), 'semi-standardized' (or 'semi-structured'), and 'un-standardized' (Berg, 2009: 104).

For the purpose of our study, we will review these three different types of interviews, highlighting some of the features of each type, and focusing on the semi-standardized (semi-structured) interview that we chose for the purpose of our survey.

Table 6.1 Interview Structure: Continuum of Formality

Standardized Interviews	Semi-standardized Interviews	Un-standardized Interviews
• Most formally structured.	• More or less structured.	• Completely unstructured.
• No deviations from questions order.	• Questions may be reordered during the interview.	• No set order to any questions.
• Wording of each question asked exactly as written.	• Wording of questions flexible.	• No set wording to any questions.
• No adjusting of level of language.	• Level of language may be adjusted.	• Level of language may be adjusted.
• No clarifications or answering of questions about interview.	• Interviewer may answer questions and make clarifications.	• Interviewer may answer questions and make clarifications.
• No additional questions may be added.	• Interviewer may add or delete probes to interview between subsequent subjects.	• Interviewer may add or delete questions between interviews.
• Similar in format to a pencil-and-paper survey.		

Source: Berg, 2006: 105.

Table 6.1 distinguishes the different types of interviews. The semi-standardized interviews focus on a list of key topics or questions about which the researcher is interested to receive the respondent's views. For example in our research, we were interested to hear the views of decision-makers in the Central Bank of Kuwait and other relevant ministries, as well as in investments banks and private companies. These decision-makers were asked questions relating to the following areas:

- Monetary policy
- Fiscal policy
- Trade

- Investment
- Labour markets
- Other general issues

Our aims and objectives were set before choosing the interview type. The semi-standardized interview would allow the respondent to add new information, but still the main questions or topic would be the key objectives of the interview. In the semi-standardized interviews a detailed set of questions is prepared in advance. General questions are set at the beginning and lead on to the more detailed questions. In our survey the issue of monetary policy was one of our priorities, and within this topic we asked questions about, for example, interest rates and exchange rates. (See the questionnaire in the Appendix).

Semi-standardized interviews fall between standardized and un-standardized interviews. This type of interview allows the same kind of questions to be asked of different people, in the same ordered set. However, the interviewee is free to answer as they want, and there are no restrictions or set options for them to follow. By using semi-standardized interviews respondents are given the right to explore their thoughts and opinions.

During the course of carrying out our survey, we found that there was no standard answer for any particular question. But at the same time there were similar views or responses to some of the questions.

6.4 SEMI-STRUCTURED INTERVIEWS

Researchers interested in qualitative analysis have to use the semi-standardized interview in a form of survey interviews for certain purposes. The rationale for the use of semi-standardized interviews has been expressed by different authors. Carruthers (1990: 1) discusses the use of semi-structured interviews for researchers and graduate students, and how it is useful for providing answers to specific questions.

The author conducts a study on 102 new and intern secondary school teachers. He also highlights the advantage of using semi-structured interviews by referring to other

authors such as Borg and Gall (1983), who find interviews are effective in achieving particular objectives. Bugher (1980) finds that "person-to-person interviews" are the best way to discover people's in-depth opinions (Carruthers, 1990: 65). Carruthers explains also his personal experience in carrying out interviews.

He finds them demanding and costly in terms of money spent, but on the other hand he points out the advantages of having the opportunity to meet respondents and receiving information from different sources.

Drever (2003) explains the benefits of semi-structured interviews at the scale of small businesses. Such interviews, even if only one person is interviewed, can produce viable data, such as factual information and the opinions and life experiences of interviewees.

While conducting our survey we discovered that the data produced by the flexible semi-standardized interview was very useful. It allowed us to focus on particular areas we were interested in, which made the interviews powerful tools to support our arguments.

We used semi-standardized interviews for our research because we believed that they would provide data that would complement the quantitative analysis which we have presented in the previous chapter. We were able to meet people with different backgrounds and experience, and gain information which quantitative analysis could not have provided. We realized during the course of the interviews, however, that they were time-consuming and costly, and required a lot of arrangement and follow up.

6.5 PROCEDURES FOR THE INTERVIEWS

In the literature of conducting semi-standardized interviews researchers have followed certain steps and procedures to achieve the objectives required of the interviews. But the procedures are not fixed. Most authors discussed objectives, designing and developing interviews, selecting samples, interview schedules, and how to carry out interviews.

1. Objectives of the study

The aim of this survey is to explore what people think about the decision made by the State of Kuwait to join the Gulf Monetary Union. Using semi-standardized, one-to-one interviews we sought the views of local senior officials on the issue of monetary union. The survey was about the main challenges and changes that may affect the decision taken by the State of Kuwait to be part of a monetary union.

Our aim was to receive informative data from people with different work experience and backgrounds on the subject of monetary union. Kuwait's membership of the monetary union was the focus of our study, and the questions were designed to provide an insight into the views of different people.

2. Design and development

The methodology used was a semi-standardized interview. The interviews were usually based on a schedule to discuss questions of our particular thesis topic and to explore responses in detail. All participants received the questionnaire before the interviews. To achieve the required results from the interviews it was very important to focus on the type of question asked in the survey. Therefore, prior to carrying out the interviews, we had to review some of the literature on the issue of monetary union, to understand the theoretical issues relating to our research, and to develop and design the questions that would be asked.

The interviews questionnaire was constructed after reviewing the theory of Optimum Currency Areas (OCA) and other related articles on the topic of GCC currency union. By reviewing the literature and the theoretical background on GCC currency union, we were able to design and develop questions which focused on Kuwait's national interest, and would enable us to achieve the aims and objectives of the thesis.

3. Sampling

The target participants of our thesis were senior government and non-government professionals who would have an educational background and work experience in the field of economics, finance and investments, and also professionals who had been

involved in research in the area of monetary union and economic integration. Our own background in finance and banking was very useful in providing contacts in government and financial institutions who would serve as participants in the qualitative research.

Sixteen participants were selected on the basis of the following:

1. Key decision-making government officials.
2. A minimum of five years' experience.
3. Professional government employees of the Central Bank of Kuwait, who would have the knowledge and understanding of the effects of adopting a single currency.
4. Senior professionals at multinational financial institutions.

Table 6.2 provides detailed information about the work and educational backgrounds of the interviewees who were selected.

Table 6.2 Interviewees' Work and Educational Backgrounds

Type of Organization	**Number of Institutions**	**Number of Participant**
Government Authorities & Ministries	2	2
Commercial Banks & Investment Banks	4	9
Islamic Banks	2	2
Foreign Banks in Kuwait	1	1
Economic Research institutes	1	1
Consultations & advisory	1	1
Total	**11**	**16**
Original background of interviewees	**Number**	**Average number of experience**
PHD in economics & finance	2	above - 20 years
Master in economic & finance & other	3	above - 15 years
Business & finance & Accounting	10	Between 5-15 years
Computer science	1	above 6 years
Total	**16**	

Source: Information provided by the interviewees

Our main focus was to interview professionals who had been involved in transactions beyond the State of Kuwait, were aware of the regional rules and regulations, and had experience of institutions with potential expansion plans within the region, or already had locations in different countries.

4. Interview schedules

The interview schedules are one of the most important issues when planning to carry out a survey. First we had to determine the objectives of our research, and develop the questions needed to reach our objectives. Once we had identified our area of interest we were able to draw up the questions. The questions were developed in a sequential order, and all participants were to receive the same questions set.

After identifying the sample participants, the next step was to schedule the interviews, and have a time set to discuss the questions. We contacted the interviewees first and sent them the questionnaire to review before scheduling the interview time. The interviewees had time to review all the questions and were able to schedule the interviews according to their convenience. Some of the identified participant refused to be interviewed, and others accepted.

All interviews were held in the interviewees' offices, and interviewees were allowed the flexibility to change or amend the interview's schedule.

5. How the interviews were carried out

The average time spent on each interview was between 45 and 60 minutes. But the actual time required for each interview spent was around two hours, including time spent commuting from and to the interview location. Prior to the interviews a confirmation was obtained, to avoid any mismatches with the interviewee schedules.

Furthermore, before starting any interview we carefully read the questions in the same order in which they were received by the interviewee. We also familiarized ourselves with the interviewees' background and work experience. We had to bear in mind the time constraints and limitation of each interviewee, for, as we mentioned earlier, interviews are time-consuming and sometimes take more time than expected. It is always important to appear before the interview start with enough time.

Most of the interviews were not recorded, but some of the answers were summarized after the interviews. It was sometimes necessary to maintain the discussion during the interviews and with some interviews some deviation from the main topic occurred. It is always the case that some of the interviewees answer some questions with a simple yes or no. But overall the interviews provided plenty of information for the researcher's purposes.

We have learned that one of the most important aspects of conducting interviews is collecting and analyzing the data. Interviews had to be transcribed, and a complete record of the discussion had to be made immediately after the interview to ensure no part of it was forgotten. Other issues that had to be considered were the consistency of interviewees' answers, their deviation from the main topics, and their refusal to answer some of the questions. All of these considerations were necessary to produce useful data analysis from the interviews.

6.6 THE ADVANTAGES AND DISADVANTAGES OF INTERVIEWS

Interviews or semi-standardized interviews are one method of receiving data in qualitative analysis. Like any other method of collecting data, they have their own

advantages and disadvantages, as we learned from the interviews conducted for this research.

The advantages of the interviews were as follows:

- Semi-standardized interviews were a very useful way of gathering information and receiving people's opinion about Kuwait's decision to join the GCC monetary union. In addition, the interviews allowed us to explore the opinions of participants with widely different experiences and backgrounds, which made the research more interesting.

- Semi-standardized interviews sometimes allow the participant to express their personal opinions without reference to the vision or policies of the institutions they represent.

- Giving the same questions to all participants did not always produce the same answers, thus allowing the researcher to receive a wide variety of views.

- One of the advantages of the interviews was the privilege it gave the interviewer of meeting people, especially key decision-makers who could provide information that is not available from public sources.

- By conducting semi-standardized interviews we were able to receive some feedback on the topic of our research, and were also given some directions on areas for future research.

The disadvantages were as follows:

- One of the most crucial issues when you decide to conduct an interview survey is the time spent. Interviews require a lot of time, starting from preparing the questions until the end of transcription of the interview.

- Lack of experience in conducting interviews requires the development of certain skills, which we may not all have.

- Some of the participants were not enthusiastic at the time of the interview, which could possibly affect the value of the data.

- Selecting the sample group makes interviews more difficult. We had some cases where interviews were cancelled without any advance notice. If someone dropped out of the participants' lists he or she had to be replaced, which meant that more time was spent. Some relevant data may not have been gathered.

6.7 CONCLUSION

In summary, qualitative analysis is a tool of social science, and it includes different techniques, such as interviews and observations. It is one of the ways of receiving and transforming qualitative data. Berg (2009), Spencer et al (2003), Nahid (2003), and Hope (1997) are different authors who define qualitative analysis. Berg 2009 defines qualitative analysis and research as a set of interpretative activities, which privileges no single methodology over another. Spencer et al (2003) define qualitative research as a tool researcher use to achieve in-depth understanding of people's experience, perspectives and histories in a given context, and it is usually characterized by concern to find the actors' perspectives. Nahid (2003) defines it as an approach used by researchers who use logical positivism, experimental methods and quantitative measures to test hypothetical generalizations. Furthermore, the definition of qualitative analysis shows that the analysis is used by researchers to understand the inside of any particular topic they are interested in.

In qualitative analysis one of the most common methods used is interviewing, and interviews can serve different purposes and produce reliable information. There are different types of interview, each of which has its own advantages and disadvantages. The choice of interview type depends on the researcher's aim . The different type of interviews are structured interviews, semi-structured interviews, and un-structured interviews. For the purpose of our research, we used semi-structured interviews because we believed that they would generate the most efficient data from the responses and it would provide the best support for the quantitative analysis.

When they use semi-structured interviews researchers have to follow certain procedures. According to the literature these procedures are not fixed, but most commentators agree that they should fulfil certain requirements on each of the following: objective of the study, design and development, sampling, and interview schedule.

The literature reviewed before conducting our survey suggested that the use of qualitative analysis in the form of semi-standardized interviews could provide a very valuable insight into some of the unanswered questions in our research. From the use of such interviews, which allowed some flexibility in the way questions were answered, we were able to acquire a good understanding of the participants' opinions. In addition, the interviews were able to cover a range of different topics within the questions asked, which made it a very useful tool for understanding how professionals responded to the decision taken by the State of Kuwait to join the monetary union. The advantage of semi-structured interviews is that they are a very useful way of gathering information and opinions from people of very different backgrounds. While answering the same questions, participants are free to express themselves freely. Asking the same question of different people always generates very different answers. In our particular especially study, the approach was especially useful since the interviews were with people who had very practical background knowledge and experience of the topic of research.

Researchers who chose to use semi-structured interviews need to understand that there are also disadvantages. They proved to be very time-consuming, and some less-than-enthusiastic interviewees were reluctant to provide the information we were looking for. The use of qualitative analysis and especially interviews is not a skill that everyone has, and for non-professionals who lack experience and training, conducting successful interviews can is far from easy.

Chapter 7 SURVEY RESPONSES

7.1 INTRODUCTION

The Kuwaiti government is implementing its decision to join the GCC single monetary union. Since Kuwait and the other GCC countries made this decision there has been a great deal of debate at various levels to assess its implications. For the purposes of this study our intention in this chapter is to review the opinions of Kuwaiti nationals on the subject of monetary union.

The chapter is a continuation of the previous one, in which we discussed the use of semi-structured interviews to gather information about the effects of Kuwait's entry into a single monetary union. From the interviews we conducted, we received different views as to whether the decision Kuwait made to be part of the GCC monetary union was in the national interest.

Despite the similarities among the GCC states within the union, there are still some differences between their economic policies. An inevitable consequence for any country entering a monetary union is that it has to follow the economic policy agreed by the member states and therefore loses some of its sovereignty. It is clear that most of the GCC countries rely on natural resources of oil and gas, and Kuwait does so to a considerable degree.

The state of Kuwait generates almost 90% of the country's revenues from the export of oil, gas and refined petrochemical products. However, the financial market in Kuwait is also well-developed, and income from external investment activities is, compared with that of other GCC members, a major part of the country's balance of payments.

In this chapter, we will review the answers of the participants of the semi-structured interviews, which were conducted for this study.

The chapter will include seven sections. Each section will relate to a different topic which we prepared our questionnaire to cover. Each section will include a main question for general consideration, and then will include more detailed questions on different areas. Section 7.2 covers monetary policy issues; Section 7.3 deals with fiscal policy; Section 7.4 considers trade; Section 7.5 covers investment; Section 7.6 looks at consequences for the labour market in Kuwait; Section 7.6 will consider other matters, such as political and related issues that the government of Kuwait may be affected by; finally, Section 7.7 will conclude the chapter.

7.2 MONETARY POLICY

The Central Bank of Kuwait (CBK) is the only authority in Kuwait that manages the country's monetary macroeconomic stability, and it does so by using the bank's monetary tools. CBK's main responsibility is to shield the country from economic crisis, to maintain the stability of the KD and the Kuwaiti economy. Since Kuwait has taken the decision to enter into a new monetary union, CBK will have less or no control over monetary policy, and will have to adopt the monetary policy of the Gulf Central Bank.

For this reason, a survey was conducted to discover participants' answers to the question: what will be the effect on monetary policy when Kuwait joins the GCC monetary union? Interestingly, we received different opinions from professionals working in government authorities and the private sector.

Most participants agreed that Kuwait would lose some sovereignty by joining the GCC monetary union. It would have less control on exchange rate policy, interest rates and the money supply, since a unified monetary policy would be set by the Gulf Central Bank. For example, until recently Kuwait was the only country in the GCC union that had its own exchange rate policy.

CBK has now pegged the Kuwaiti dinar against a basket of the world major currencies, especially those with which Kuwait once had a trade relationship. The basket is not disclosed but it can be assumed that the US dollar occupies the largest place in the

basket, along with other currencies such as the euro, sterling, the Swiss franc, and the Japanese yen.

In addition, the other GCC countries followed a US dollar pegged exchange rate regime. Therefore, most participants thought that the US-dollar-pegged exchange rate policy was likely to be adopted by the union.

A large number of respondents thought Kuwait would gain from joining the union, and believed the Gulf Central Bank would give the region more credibility, higher efficiency, lower costs of currency intervention in case of devaluation or re-valuation, and greater economic stability.

However, the views on price stability were as follows. Some participants thought that there would be no effect on price stability in Kuwait, and although others thought that at the beginning of integration there would be some instability, they believed that in the long term price stability would be achieved. Some thought that prices would be more stable as a result of a more transparent central monetary and fiscal policy of the GCC central banks and authorities.

On the other hand, some considered that price stability was not a function of monetary policy, but that an adopted exchange rate regime could have a direct impact on prices. For example, Kuwait has a different exchange-rate regime from that of other GCC countries, but when it adopted the single US dollar exchange rate as a step towards a unified exchange-rate policy, the result was that inflation was imported into the country. Because of the depreciation of the US dollar against the world major currencies during the US-dollar-pegged exchange rate, most GCC countries recorded an unprecedented inflation rate.

In addition, as one participant pointed out, price stability would depend on the level of economic integration, for if economic integration became fragmented it was likely that prices would suffer, but if the GCC union were more integrated than the European Union prices would be affected less. However, the fact is that monetary union requires a joint effort to keep inflation within certain limits, for if a member country faces inflationary pressure it is hard for other members to control their own inflation rates.

Thus, price stability will depend on a number of factors, such as the level of spending by the governments, exchange rate policy, and macroeconomic stability. Local prices in Kuwait will depend on the level of inflation in the regions, oil prices, income, competition, consumer confidence, and supply and demand.

Exchange rate policy is one of the monetary tools that CBK uses to control inflation and enhance the country's economy. The CBK has succeeded in the past in controlling the country's inflation by adjusting the value of the KD against the US dollar and other major currencies. If Kuwait were to adopt a US dollar exchange rate regime, as other GCC countries have done, what would be the cost for the country?

Some of the participants believed that since the KD was already pegged to a basket of currencies, with the US dollar as the largest portion of the basket, to be fully pegged to the US dollar would have a small impact. However, others held the view that to switch from a basket of currencies to a US dollar basket would cost Kuwait according to the exchange rate of the US dollar at the transition date.

In fact, a senior treasurer at one of the Kuwait based banks believed that the Kuwaiti dinar stayed level with the US dollar and had not changed much for a long time. Given that at the same time there was a major fluctuation between the KD and other major world currencies, he therefore felt that a basket of currency exchange rate regimes would cost Kuwait less than one that was pegged to the US dollar alone.

Another government official expressed the view that since Kuwait is heavily dependent on the import of goods and services, an exchange rate regime adopted by the union, unlike a basket of currency exchange rate regimes, would have an adverse impact on the country's economy and increase the chance of imported inflation. In the view of some, a basket of major world currencies could be more flexible than a unified exchange rate.

The cost to Kuwait of pegging the KD to a single US dollar rather than to a basket of currencies would link the Kuwaiti economy very closely the US economy, and make it vulnerable to any economic shocks experienced by the US. One recent example was the instability of US dollar exchange rate against the major world currencies during the sub-prime mortgages crisis, which increased the level of inflation in Kuwait and the region.

Almost all the participants agreed that by entering into a monetary union the country would lose some of its sovereignty. Moreover, Kuwait would have to follow the central monetary policy set by the union. However, participants varied in their assessment of the cost to Kuwait. Some thought it would be minimal, while others believed that a monetary policy set by the union would cause the Kuwaiti economy to lose one of the main tools that could preventing the country from importing inflation.

7.3 FISCAL POLICY

Government macroeconomic policy affects the country's economy, which expands or contracts according to the country's revenues and expansion. Kuwait generates most of its income from its natural resources of oil and gas. All member countries of the monetary union will coordinate with each other, an independent fiscal policy will no longer be used, and convergence criteria will have to be met to avoid any future problems.

Fiscal policy will be determined collectively, not independently, and through expenditure the fiscal deficit will be controlled. In this way no member country is allowed to expand, or to finance its deficit by more than what is set by the union. Some interviewees considered that the credibility of the region would increase as a result of its stricter discipline and adherence to the GCC's central fiscal policy.

Others said that the GCC economies were not developed enough to follow a collective fiscal policy, and because all of the countries generated income from oil, the effect of the fiscal policy would be minor, especially in view of the fact that government taxes in some of the countries are very low if not non-existent.

One respondent pointed out that the GCC countries would assume a more conservative oil price when setting their budgets, and this would avoid any future economic shocks, and a more rapid expansion than is justified by the real income from oil exports. Most participants compared the economic structure of the GCC countries and that of the European Union and appreciated that the GCC economies were different in that they were all driven by oil exports, and that fluctuations in oil prices on the market had a direct impact on the countries' expansion and investment.

Another question put to interviewees was: how will the monetary union impact upon Kuwait's fiscal policy? Some expressed the view that the effect would be minor since Kuwait does not carry a budget deficit and has maintained a healthy budget surplus for so long. Therefore, there would be no need for fiscal debt or external debt, according to the government's assumptions, unless oil prices dropped to below $40 per barrel.

In addition, Kuwait is not like European countries where taxes are a very important element of the countries' income. However, although at present the government of Kuwait does not rely on income from taxes, in the future it may need to impose taxes, which would then have some effect on the Kuwaiti economy.

Another participant pointed out an important difference between Kuwait and other GCC countries. Whereas the Kuwaiti budget usually requires the approval of parliament, other GCC countries do not have a parliament and their fiscal budgets need no approval besides the Government's. This might cause some conflict between the government and parliament, but others thought that being part of the union would give Kuwait the advantage of gaining from other countries' experience, and from the increased discipline of the region. One participant pointed out that the government had already received approval from parliament to enter into the monetary union.

Kuwait may have some advantages to gain from following the union fiscal policy as the economies of other member countries expand. At the same time, their contraction might also affect the Kuwaiti economy. A number of participants agreed that the fact that the GCC countries had already set the fiscal criteria, and had maintained the agreed ratios of fiscal deficit and fiscal debt, there should not be any negative effect. However, if another country failed to meet the fiscal convergence criteria, this might have a negative impact on Kuwait (as the Greek debt problem did in the European Union).

After the responses to questions about the likely effect of union on Kuwaiti fiscal policy were received, another question was put to interviewees concerning how well the union fiscal policy would serve the Kuwaiti economy. We received some responses suggesting that the Kuwaiti economy would not be well served by following the union fiscal policy, but that it would gain from greater transparency. Moreover, if Kuwait benefited from any introduced fiscal policy by the union, and if the union in future imposed some taxes,

Kuwait's income would increase and would make it possible for the government to increase spending and investment.

A clear set of policies imposed by the union will create more business confidence in Kuwait, which will increase trade, investment, and encourage foreign investors to invest in Kuwait. Moreover, it will create a more stable economy, and increase economic cohesion. On the other hand, a large number of participants believed that Kuwait and other GCC countries were still not pursuing common fiscal policies, and since a few countries like Bahrain and Dubai impose some taxes, it is not very clear how Kuwait economy could benefit.

7.4 TRADE

Kuwait's exports are mainly oil, petrochemical products, and some other light industrial products. It imports most of its durable and non-durable goods from abroad, and the country depends highly on imports to supply the domestic needs. Kuwait imports goods from all over the world, but only a small proportion of its imports come from other GCC countries. Most of Kuwait's imports come from the USA, European countries, Japan, and Asian countries.

When Kuwait enters a monetary union what will be the effect on trade in general? One of the main objectives of monetary union is to increase intra-regional trade among the member countries and reduce the exchange rate risk. GCC countries have an almost stable exchange rate, with very limited fluctuation. For this reason some interviewees considered there would be a very limited or no effect on trade as a result of exchange rate variation. But trade between GCC countries could be increased by agreements signed by the union to unify taxes and eliminate any import taxes on goods bought from other GCC countries. Others believe that trade will be much easier, and more competitive.

Most respondents agreed that eliminating transaction costs, the exchange rate risk, and taxes among members of the union would increase regional trade. Also movements of goods freely within the union would promote trade, and competitiveness on prices would increase. An official from the Central Bank of Kuwait considered that since the

GCC countries are heavily dependent on oil products, and most of them are oil producer countries, there would be no major effect on trade at the regional level.

Kuwait has trade with both regional and other countries: would it be affected when the country joins the union? Different participants gave different answers to this question. Some participants thought that the effect on Kuwait's trade would be very minimal. They tended to agree that since Kuwait is an oil exporting country like other GCC countries, unless Kuwait enhances its industrial sector to produce products at competitive prices, trade will stay the same. And international investors will feel more confidence in trade since they are dealing with one currency for the union.

On the other hand, some considered that Kuwait's geographical location close to Iraq and Iran would enhance re-export from Kuwait to those two countries. Otherwise they thought trade in general would not be affected because 90%–95% of Kuwait's trade was with the rest of the world and only 5%–10% with GCC countries.

Usually trade is affected by the stability of the exchange rate, and the Kuwaiti dinar exchange rate value against other GCC countries is almost stable. A unified currency which eliminated all fluctuation risk and reduced transaction costs would have an impact. Other issues, such as transportation, tariffs, and other trade agreements signed by the union, would have greater impact on trade for Kuwait.

Other interviewees considered that the mobility of goods and services between GCC countries would affect Kuwait companies. Since Saudi Arabia, like some other countries, has much lower production costs, Kuwait would import goods from Saudi Arabia and this could have a negative impact on Kuwaiti trade. The opposite view is that Kuwaiti trade with GCC and the rest of the world would increase because of exchange rate stability among member states.

Competitiveness is another issue when dealing with trades. Will the new currency enhance Kuwait's competitive position? The answers to this question were as follows. Regional and foreign investors are concerned with exchange rate fluctuation and the laws of the investment environment in which they place their investment. The advantage that monetary union will have for investment companies is that it will allow them to trade freely within the monetary area, which will boost Kuwait's competitive position and enhance its trade. But at the same time, if Kuwait does not have the same

investment laws and regulation as other GCC countries, such as Dubai in the Emirates, there could be a negative impact.

A mix of responses to this question was received, but almost all participants believed that monetary union would put Kuwait in a better competitive position. Their argument relies on the fact that foreign countries and companies will be encouraged to trade with a country which is part of a monetary union, especially if they already have trade relationships with other countries within the union. They will find it much easier to expand and move business between the countries if they find a competitive opportunity.

Other interesting views looked at the benefits Kuwait will gain in its competitive position when the KD is replaced by a GCC single currency. In particular, since the KD holds the highest value of all the GCC currencies against the US dollar, the cost of trade and travelling to Kuwait could be cheaper once a single currency is established.

Kuwait's entry into a monetary union will enhance market efficiency, and reduce currency risk and transaction costs. Market efficiency is at present questionable in the GCC areas since most of the markets are still developing. Being part of the union can increase market efficiencies, and this is one of the important issues traders will look at. The Kuwaiti financial market and prices for domestic assets will certainly respond favorably.

One of the participants thought that owing to the similarity between the oil and gas producing GCC countries which are US-dollar-based, the competitive advantage for Kuwait would be very minor. However if Kuwait developed other industries with a reduction of transaction costs, elimination of currency risk, and mobility of goods and services, then Kuwait could gain from the competitiveness of being part of a monetary union.

One of the government's senior officials thought it was not easy to predict how Kuwait's competitiveness would be affected by entering into a monetary union because the country's main trading activity is oil, which is controlled by OPEC quotas. However, he agreed that competitiveness would be increased with the elimination of currency risk.

But a majority of the participants believed that a single currency would have a positive impact on Kuwait's trade competitiveness. And trading with both the GCC countries and the rest of the world would be enhanced.

7.5 INVESTMENT

Investment and foreign direct inflows are a priority for any country, and Kuwaiti investors are very active in Kuwait and abroad. Income from investment contributes a large portion of Kuwait's balance of payments. Historically Kuwait holds a large investment portfolio locally and internationally, and foreign companies have made some investment transactions in Kuwait.

Would investment activities for Kuwait be affected by entry into a monetary union? There were different responses to this question. Some agreed that intra-GCC investment would increase as a result of economic co-operation. Investment within the region would be much easier and smoother if there were a structural investment policy for the union, helping the flow of funds to move easily between each of the member countries. In addition, investment decision-makers would have a broad view of the region rather than of a single country. With the reduction of the exchange rate risk, a foreign company would look at the region as a whole when making its investment decisions.

Other groups of people answered that the effect should be positive, and that investment would increase. With the low interest rate, which will be controlled by the central authority, and the free mobility of money, and the emergence of all markets for banks and financial institutions, there will be a much healthier investment environment, in which investors will have more options to borrow.

One of the senior investment banking officials thought that cross-border investment within the GCC might improve, owing to the lifting of present restrictions imposed by the authority.

However, at the same time he mentioned that government expansion at the beginning might be required. Professionals within the investments companies believe that investment is very important to the GCC economies. An investment manager in one of

leading local banks in Kuwait mentioned that when the monetary union is created investors who are already investing in different continents will be encouraged to move their investments to the GCC region if higher production costs in another country outside the region were the result of currency fluctuation.

Another portfolio manager believed that there would be a positive effect on investment in the region. He thought that the major risks investors face now when they invest in different countries within the region are the exchange rate risk and transaction costs. A single monetary union would encourage portfolio managers to invest freely in the different countries within the union.

A Central Bank official said that monetary union would send positive political stability signals to the international financial market, and help enhance the flow of investment into the region. The union will have fewer restrictions on mobility of funds between countries, which will have a directly positive impact on investment in the region.

Next, how will Kuwaiti investment change when the union is established? Is investment going to increase or decrease in Kuwait? One response was that Kuwait's investment level within the country is low compared to that in the international financial market. Others thought that investment in Kuwait would depend on the investment policies of the union: if these are friendly, the level of investment will rise.

Investment in Kuwait would increase if the government of Kuwait moved all obstacles to investment in real estate, for at present most land is owned by the government and only 6% is released to the public. If the government changed its policy and allowed foreign investors to own and invest in real estate some investment opportunities would be created in the market.

Some bankers argued that investment in Kuwait would be driven by skilled labour, tax, structural issues, and bureaucracy rather than by the creation of the single currency, which they believe would not have much influence on investment in Kuwait.

Some of the participants were more concerned with the taxes applied to foreign companies by the Kuwaiti government. They believed that if the structure of the investment policy adopted by the union was sound, then Kuwait would benefit. A

currency risk is not the only issue investors are concerned with. The competitiveness of Kuwait among other GCC countries would also affect the level of investment.

Only a few people thought that the investment level would not change. The majority agreed that investment in Kuwait would increase for several reasons, including greater transparency and political stability, and more attractive investment opportunities.

What is also interesting is to find out how participants thought the value of the assets in Kuwait would react to monetary union. Would prices of assets in Kuwait react positively or negatively?

Participants answered this question in different ways, and each one had his own opinion with regard to the prices of assets in Kuwait. Some believed that the market would react negatively in the short-run but would pick up in the long-run once the market had absorbed the introduction of the new currency. Another view was that it would depend on the value of the new currency as compared with that of the KD when the conversion took place. The prices would react, but most probably they would fall. Others predicted that real estate asset prices would benefit the most, and other sectors would be affected less owing to the shortage of supply in real estate assets.

Another group thought that the price of assets would be more stable, and would not be affected, unless portfolio managers considered the region as an investment territory for their portfolios and shifted some of their assets from the international market to the regional markets.

The opinion of some investment managers was that there might be a shift or an adjustment to the currency value in either direction which would reflect the prices of the assets.

A mixed answer from different senior bankers thought asset prices would depend on the development of the financial and bond market in the region and in Kuwait. One person thought that prices would not change, but that if they did it would just be in the short-term after the introduction of the currency. Moreover, prices are predicted to move in both directions initially, but in the long run to reflect the stability of the underlying economic situation.

7.6 LABOUR

GCC countries depend heavily on expatriate labour, and countries within the GCC co-operation still cannot provide sufficient labour to satisfy the market need. Most labour comes from elsewhere in the world, but the majority of the workforce are Asians, Arab nationals and Westerners.

Asian labourers fall within the low wages sector. Other Arab nationals provide more advanced labour such as teaching, engineering, and other professional skills. Foreigners from the USA and European countries also contribute a small portion to the labour market in the GCC with very high technical and other high advisory positions in the banking sector, and oil and gas industries.

The labour market in the GCC is facing a shortage of professionals to carry forward the regional development, which is one of the most important sectors within the economies. We discussed the labour market in the GCC with our participants to ascertain their views of the labour sector in general. Seven of the participants thought that there would not be a major effect on the labour market in general as a result of joining the GCC monetary union. Even though in theory monetary union should enhance the mobility of labour within the GCC union, it will not be the case while the market is highly dependent on foreign labour.

Labour laws within the GCC need to be changed to take account of foreign workers, who are still not allowed to move between the GCC countries. GCC nationals already have freedom of movement and are treated the same within the union, which will therefore have little effect on them.

One of the investment managers believed that the opening up of the labour market would depend on whether GCC countries coordinated their policies for expatriates, which he thought was unlikely. In addition he thought that there might be a unique opportunity for GCC nationals to take advantage of salary differentials between GCC countries.

Another portfolio manager thought that the two countries which would benefit most from the mobility of labour were Saudi Arabia and Bahrain, which have the highest unemployment rate among GCC countries. There would, he thought, be an increased

demand for foreign labourers, and wages would therefore increase for nationals from Saudi and Bahrain moving to other GCC countries, which will continue to treat them as their own nationals.

Supporting this view, another senior investment manager raised the importance of the labour market within the GCC, and thought also that Saudi Arabia would benefit most from the mobility of labour.

At the moment Kuwait and Qatar offer the highest labour wages, and would therefore be under pressure to receive GCC labour within their countries. Nationals coming from a low-wages environment would consider looking at opportunities with countries with high wages, according to the investment manager's view of the labour market in general.

The rest of the responses were mixed in their opinions of the labour market. They thought labour workers would reevaluate their worth with respect to others. And the mobility of labour would allow labour to move from recession economies to work in booming economies. And the union would develop and help diversify the economies from oil to non-oil economies.

The responses considered so far concern the labour market in general, but we were also interested to collect data and information about the effect of the union on the local Kuwaiti market. Some of the participants again thought that there would be a limited or no effect at all on the local Kuwaiti labour market, especially since a large number of workers work for the government. But others had different views. One participant thought that the labour market in Kuwait would be affected by the regional wages structure, and that workforce mobility would depend on the increase of wages in the different countries.

Further, would employment increase or decrease? Participants looked at the labour market in Kuwait differently. The Kuwaiti government employs and guarantees work for Kuwaiti nationals, and therefore most of the responses predicted very limited changes in the employment rate in Kuwait.

One participant thought that Kuwait would have a higher unemployment rate, because high wages in Kuwait would make it more attractive to other GCC nationals to compete

for opportunities in the local market. The majority of the participants believed that the government employment plan would be the main factor determining the employment rate.

7.7 OTHER GENERAL ISSUES

Kuwait's entry into a monetary union has other implications besides the economic ones. Some questions on general issues were answered by participants in the semi-structure interviews as follows.

What would be the political risk of Kuwait's decision to join a monetary union? In answering this question some participants thought that because GCC countries were already co-coordinating in different areas, the regional interest was already being considered by the member countries, and therefore they did not believe there was any political risk in Kuwait's decision to join the monetary union.

Two participants raised the democracy issue. Kuwait is the only country among all GCC that has a parliament in which all members are elected by the Kuwaiti nationals rather than being appointed by the government. They therefore thought that Kuwait's democracy might be affected and that there could be some loss of sovereignty.

In addition, some thought that there might be some political implications for Kuwait's foreign policy, especially since the government of Kuwait takes into consideration parliament's views, even though they do not have to on some issues. The parliament in Kuwait is very active and the government has had experience of many disputes historically.

Furthermore, almost all participants agreed that there were political implications for Kuwait's democracy, which sets it apart from other GCC countries, but most thought the government of Kuwait would be able to deal with these. A senior government official added that countries with large economic and political influence within the union would have greater sway over policy, which could be a cause of contention between member countries.

Oman and the United Arab Emirates have both withdrawn from the monetary union. How will their decision impact on the union? We received different answers to this question: for example, that to delay the union implementation might cause it to fail, that it would create a window for other members to leave if they felt they were losing bargaining power, that it was a sign the union would never happen, or that in fact its negative impact would be minimal.

One of the senior investment managers thought that Oman and UAE would gain most benefit from the union while maintaining their own financial independence. But another investment banker disagreed, believing that they would miss out on the advantage of being part of a monetary bloc. In addition, one participant mentioned that Oman's withdrawal from the union was not surprising given that historically Oman had always been conservative and cautious in taking major decisions about GCC cooperation.

Other group of participant had a mixture of views in this regard. Some thought the union would be stronger with Oman and UAE. Government officials believed their absence would give a negative signal to the international markets.

In the same line of questioning we also asked when they thought the new currency would be introduced? Some participants thought it was difficult to predict when the new currency would be introduced, believing that more fiduciary work needed to be taken into consideration before introducing the new currency. But the majority felt that it would take between five and ten years from the time of these interviews for the new currency to be in circulation. And other participants thought that the new currency would never be introduced.

In addition, some participants thought that the new currency would be introduced if clear guidelines were set by the union authority to make it easier for members to reach the introduction criteria. A government official who expected the new currency to be introduced in 2015 said there could be no further political disputes among member countries since the economic convergence criteria had now been set.

Our survey also included the question: what signal will be sent to the international market when the GCC monetary union is established? And how will the international world look at such a union in this region? A large number of participants believed that the GCC monetary union would send a positive signal, and the region would benefit

from the establishment of the union. It would also create a strong political and economic bloc which would give the union a stronger position when dealing with international treaties and trade activities.

GCC monetary union will control most of the natural oil and gas resources in the world as a whole. Some government officials predicted that the union would create a healthier investment climate which would help the inward flow of investment to the region, and that the union would be better able to face the political and economic challenges of globalization.

Furthermore, the GCC monetary union would become a more attractive place for foreign investors, owing to the large oil and gas reserves under its control. It would also be in a much stronger position to negotiate in the international market to support oil and gas prices. All the participants predicted that the union would send a positive signal to the international market. Only one out of all the interviewees thought that the union would not be established.

7.8 CONCLUSION

In summary we can see from the data provided by the interviews that there are various likely costs and benefits attaching to Kuwait's decision to join the GCC single monetary union. The responses reflect the interviewees' own point of view and not necessarily that of the institutions to which they belong. A summary of their responses is as follows:

- *Monetary issues*. Kuwait will lose its independence and will have no control over the monetary tools. It will follow the union's monetary policies, which involve changes to local prices, increased inflation, and less currency stability. But at the same time Kuwait will benefit from adhering to a more disciplined monetary policy, with a lower cost for intervention should it be needed. In addition, Kuwait will have to maintain the union target for inflation and interest rates, which should have a positive effect on the country's economy.

- *Fiscal policy*. Kuwait will not have its own fiscal policy, and this may affect the country's expansion and investment. Also, the cost of servicing the government's

debt might increase if the government needs to finance some of its expansion projects. Furthermore, the adoption of a set fiscal policy may require Kuwait to impose some taxes, which is not the case now, and the change of fiscal policy may not serve the Kuwaiti economy. At the same time Kuwait will gain from the union a set fiscal policy, which will increase transparency for the international market. Also Kuwait will gain from other countries' experience in implementing the fiscal policies.

- *Trade*. Entering a monetary union may put Kuwait in a less competitive position than other GCC countries which have much lower production costs.

- *Investment*. A single currency may affect the country's income if the value of the introduced currency is less than the value of the previous local currency. And it might encourage investors to move to other countries within the region that have less complex rules and regulations. But investment in Kuwait may benefit from the greater transparency of the investment guidelines set by the union, and the elimination of transaction costs and currency risk.

- *Labour market*. Kuwait may face some challenges to recruit other GCC nationals which could increase the recruitment of Kuwaiti nationals. At the same time Kuwaiti nationals will consider moving to other countries within the region to work since the currency will be unified. This would have the effect of decreasing government spending on wages.

- *Other issues*. Kuwait could have to adopt the regional foreign policy, and thus lose some of its independence. Also Kuwait will have a less powerful position than some other countries, such as Saudi Arabia. But it will gain from being a member of a larger political and economic bloc.

Kuwait's decision to join a monetary union will bring both costs and benefits to Kuwait, but it is clear that the benefits will outweigh the costs.

Chapter 8 KUWAIT AND THE GCC CONVERGENCE CRITERIA

8.1 INTRODUCTION

The creation of the single monetary union in the Gulf Cooperation Council will require member countries to give up their own monetary and fiscal policies and adopt union policies. According to the Unified Economic Agreement signed between GCC countries in 2002, members shall seek to coordinate their fiscal and monetary policies. The Supreme Council (26th session, Abu Dhabi, December 2005) approved certain criteria for achieving economic convergence and financial and monetary stability. The monetary convergence criteria concern inflation rates, interest rates, and sufficiency of the foreign cash reserves. Financial convergence criteria concern the annual deficit ratio of government finance to GDP, and the ratio of public debt to GDP.

In this section, Kuwaiti monetary and fiscal policies are analysed on the basis of the economic convergence criteria set by the GCC council. We will also consider whether the State of Kuwait is ready to join the GCC single monetary union.

The GCC convergence criteria were set after the decision to create a single monetary union had been made. In this sense the GCC is different from the European Monetary Union, which required that European countries meet the convergence criteria before joining.

In addition, we will answer the following questions. Is it possible for the State of Kuwait to meet the requirements of GCC fiscal and monetary convergence? If yes, what will be the cost to Kuwait?

8.2 ECONOMIC CONVERGENCE

The subject of convergence arose in the analysis of transition economies a decade ago, and has gained more significance in recent years. Consequently, the definition of convergence has recently become part of economic and monetary union literature. In recent years, the economic convergence definition has been used to show that two or more economies have reached a similar level of development and wealth.

Economic convergence leads to the erasure of differences in economic standards between particular countries or regions. The term economic convergence therefore requires an exercise in economic policy comparison, and focuses on economic differences and how economic policies change over time.

The concept of economic convergence raises the question of how narrow or wide the convergence is between particular countries. In the next section we will consider GCC economic convergence as it has been understood to apply by the GCC council to its member countries, and we will focus the discussion on Kuwait.

Before further considering the GCC economic convergence criteria, it will be interesting is to look at the European Union experience, which provides the most recent model of monetary union. Table 8.1 shows the European economic and monetary convergence criteria.

There has been much debate in the literature about forming monetary unions. The fact that European countries have to fulfil certain economic convergence criteria before joining the European Union has made economic convergence in this case more difficult. Some writers have discussed what can be achieved by convergence if convergence criteria are set, and whether convergence criteria should be fulfilled in the years leading up to convergence, or whether they can be met just prior to the formation of the union.

Table 8.1 European Economic Convergence Criteria

Items	Convergence Criteria
Inflation Rate	Target inflation rate must not exceed that of the three best performing economies by more than 1.5%
Exchange Rate	Exchange rate stability with normal fluctuation margin based on the performance of the last two years
Interest Rate	Long-term interest rate should not exceed by more than 2% the three best performing countries
Fiscal Deficits	Government deficits must not exceed 3% of the GDP
Fiscal Debt	Government debt must not exceed 60% of GDP

Source: European Central Bank, Convergence and Economic Monetary Union

The example of the European Union suggests that prior convergence was an important step to be taken by the member states to achieve a sound monetary union. Bayoumi & Mauro, 1999, mentioned that the Maastricht Treaty includes four convergence criteria, namely, interest rate, inflation, exchange rate target, and government debt and deficits.

Inflation rate was targeted at 1.5% above the average of the best three performing economies in the year prior entering the union. An inflation target was a goal for the European Union so as to create a low inflation zone. The European Union expects its long-term interest rate to be no more than 2% of the average three best economies.

The interest rate criterion was set for member countries within the European Union who wished to enter the EMU. Exchange rate stability is another requirement, and countries have to maintain a stable exchange rate for almost two years before joining the union.

Government debt and fiscal debt in member countries also has to be under control. The Maastricht Treaty ensures that government debt should not exceed 60% of GDP and the fiscal deficit not more than 3% of GDP.

The Maastricht Treaty economic convergence criteria were developed to create a healthy economic zone, with inflation and interest rates within target, a stable exchange rate, and government debt and fiscal deficit under control. Moreover, it was mandatory for countries who joined the union to attain the target criteria. Economic convergence makes losing some degree of independence less costly when joining the union.

GCC countries have developed economic convergence criteria for member states. Table 8. shows that GCC countries adopted similar rules to those of the Maastricht Treaty. However, owing to the different economic structure of the GCC countries and the European countries there have been some differences in the convergence criteria.

The European Maastricht Treaty criteria focus on six economic criteria. In addition, member countries are obliged to maintain targets for exchange rates, inflation, interest rates, and government debt and deficit before entering the European Monetary Union.

The GCC countries used the EMU as a model in deciding their convergence criteria. Because the economic structure of the GCC countries is different from that of European countries, they had to alter some convergence criteria accordingly.

The European economies were more complicated than the GCC economies. Above all, most of the GCC economies share the same source of income for most of them are oil producers, with some hydrocarbon production activities.

Table 8.2 shows the first draft of the GCC economic convergence criteria, but until this time there has been no official documents laying down the final criteria. Nevertheless, the convergence criteria discussed below are being looked at seriously by the GCC technical board for the single currency.

Table 8.2 GCC Economic Convergence Criteria

Items	Convergence Criteria
Fiscal Deficits	Budget deficits no more than 3% below GDP
Fiscal Debt	Public debt-to-GDP ratio lower than 60%
Interest Rate	Interest rate should not exceed the average of the lowest three countries' rate by more than 2%
Foreign Reserve	Currency reserve in excess of at least 4 months imports
Inflation Rate	Inflation rate not more than 1.5% higher than the average six states

Source: GCC Secretariat Council Areas of Cooperation Achievements, Economic Cooperation, Monetary Union and Single Currency.

As we can see from the GCC conversion criteria, the stability of the exchange rate is not discussed here, owing to the fact that most GCC countries use a US dollar pegged exchange rate regime. Kuwait is an exception, since it uses an exchange rate regime pegged to basket of currencies, which includes the US dollar as an anchor currency.

In a step to achieve a unified monetary policy among member states, Kuwait adopted a similar exchange rate regime from January 2003 to May 2006, but, owing to inflationary pressure, Kuwait dropped the single US dollar and re-adopted its old exchange rate regime pegging the currency to a basket of major currencies.

GCC countries have followed the path of the European Union in terms of economic convergence, and adopted the Maastricht Treaty as a guideline, though with some changes. The concept behind GCC economic convergence is to apply a similar fiscal and monetary policy throughout the union. In fact, it intended that

all the differences in financial policies amongst member countries should be removed.

A further GCC aim towards monetary union is to establish a Central Government Bank that decides unified policies for the member states. GCC economic convergence will help member countries to narrow the gap between their different polices, and boost the possibility of a smoother launch.

Although economic convergence will not solve every single problem that might arise in the future, it will maintain control of the main economic indicators of the GCC member states. We will now analyse the GCC economic convergence criteria from a Kuwaiti prospective, and examine the country's progress towards economic convergence over the past decade. Data for the period 2000–2008 is examined to find out the answer to our main questions.

8.3 GCC FISCAL CONVERGENCE

The fiscal convergence criteria provide a test of the country's financial situation by highlighting ratios of both the budget deficit to GDP, and the public debt to GDP. The fiscal deficit is a measure of the country's total revenues versus its expenditure, and the debt-to-GDP ratio is a measure of the its total public finance and debt in relation to its GDP. Both fiscal deficits and public debt ratios are measured in relation to the country's GDP.

8.4 KUWAIT'S FISCAL DEBT

Kuwait's fiscal budget is determined on the basis of the country's expected revenues from oil and from investments abroad. Because oil revenues are the country's main source of income, the country tends to expand its budget balances when oil prices are expected to be high. Kuwaiti fiscal balances for the past decade have experienced a surplus fiscal balance, owing to the increase in oil prices, oil production, and income from investments.

The fiscal budget deficit is a major indicator of the country's financial situation. The GCC fiscal criteria (see Table 8.2) require that the State of Kuwait maintains a fiscal deficit which is no more than 3% below the GDP. The State of Kuwait over the past decades has maintained a positive surplus fiscal surplus, thanks to the hike in oil prices on the international market, and the return on foreign investments.

Kuwait had a balance deficit during the early 1990s just after the Iraqi invasion, when the government had to spend considerably to rebuild the country's infrastructure from the damages of the war. After those few years, a hike in oil prices enabled the government to meet their expansion plans and invest in the country without facing a deficit balance account. Figure 8.1 shows Kuwait's fiscal balance for the period 2000–2008. We can see that the fiscal balance has been on an upward trend.

The Kuwaiti fiscal surplus balance as a percentage of GDP has also had a positive trend for the same studied period. At its highest it was 32% of GDP, and at its lowest it was 17%. Kuwait can therefore fulfil this criterion as long as oil prices are above the government's budget balance projection, and the country's revenues exceed its expenditure.

Figure 8.1 Kuwait's Fiscal Balance in KD, 2000–2008

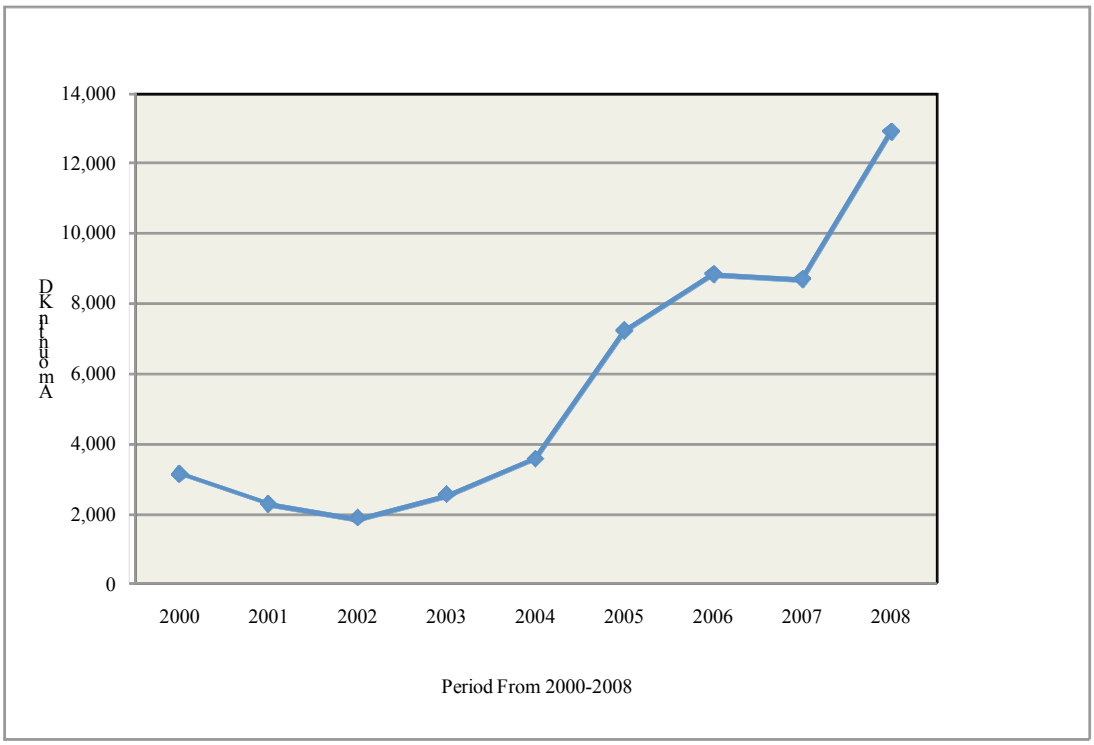
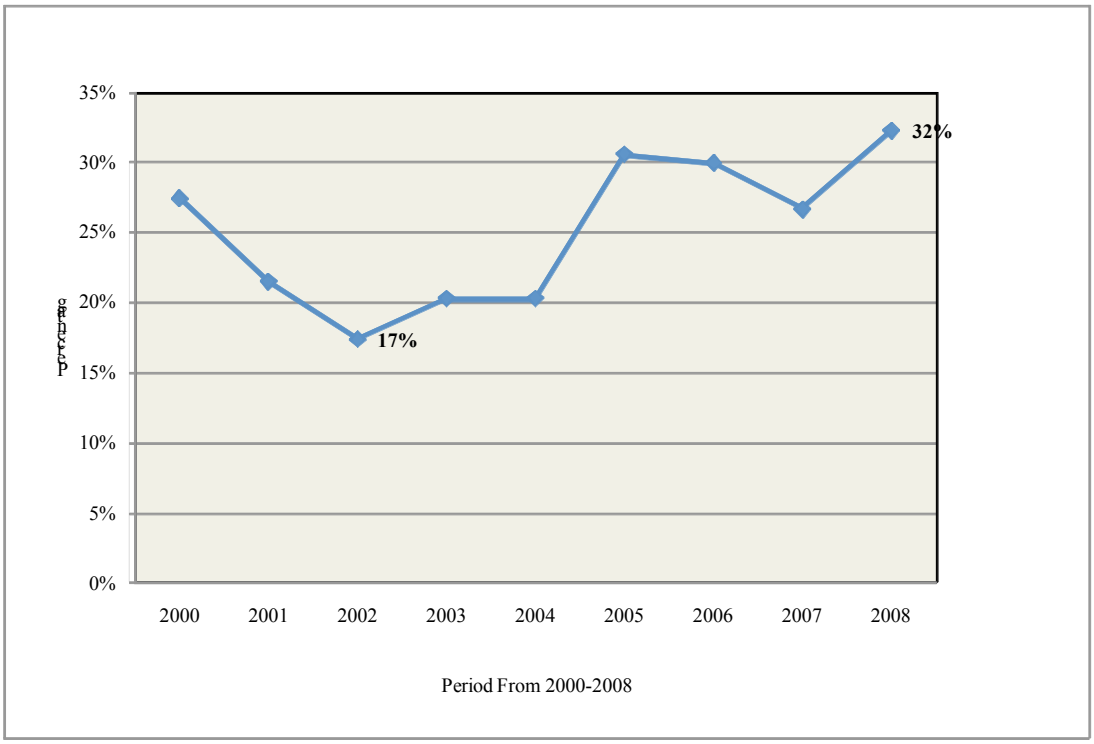


Figure 8.2 Kuwait's Fiscal Balance as a Percentage of GDP, 2000–2008



Kuwait's fiscal debt is another criterion of GCC convergence. The debt-to-GDP ratio has been kept relatively low, owing to the government's income from oil and its expansion policies. Kuwait had a very low debt-to-GDP ratio for the period 2000–2008.

Figure 8.3 shows that Kuwait's public debt has decreased. The country's oil revenues helped it to do so despite the government's policy of economic expansion. The figure moreover shows that Kuwait's debt-to-GDP ratio has been sufficiently to satisfy this criterion also.

Figure 8.3 Kuwait's Public Debt in KD, 2000–2008

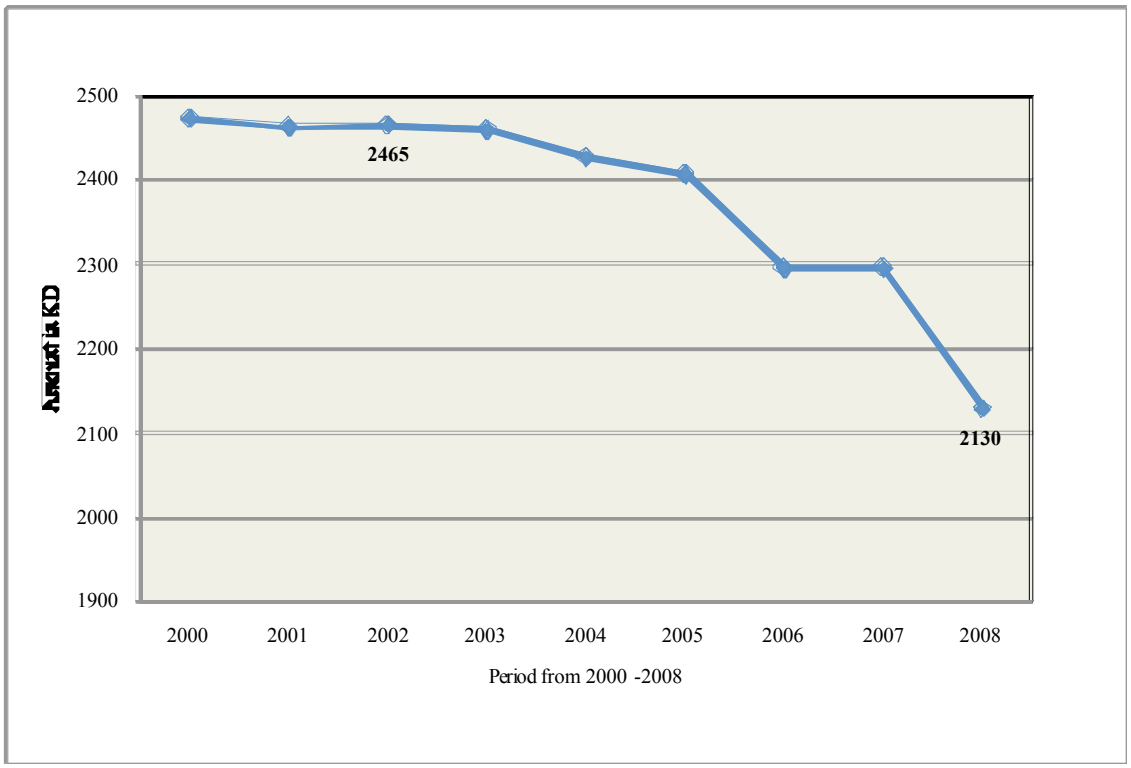
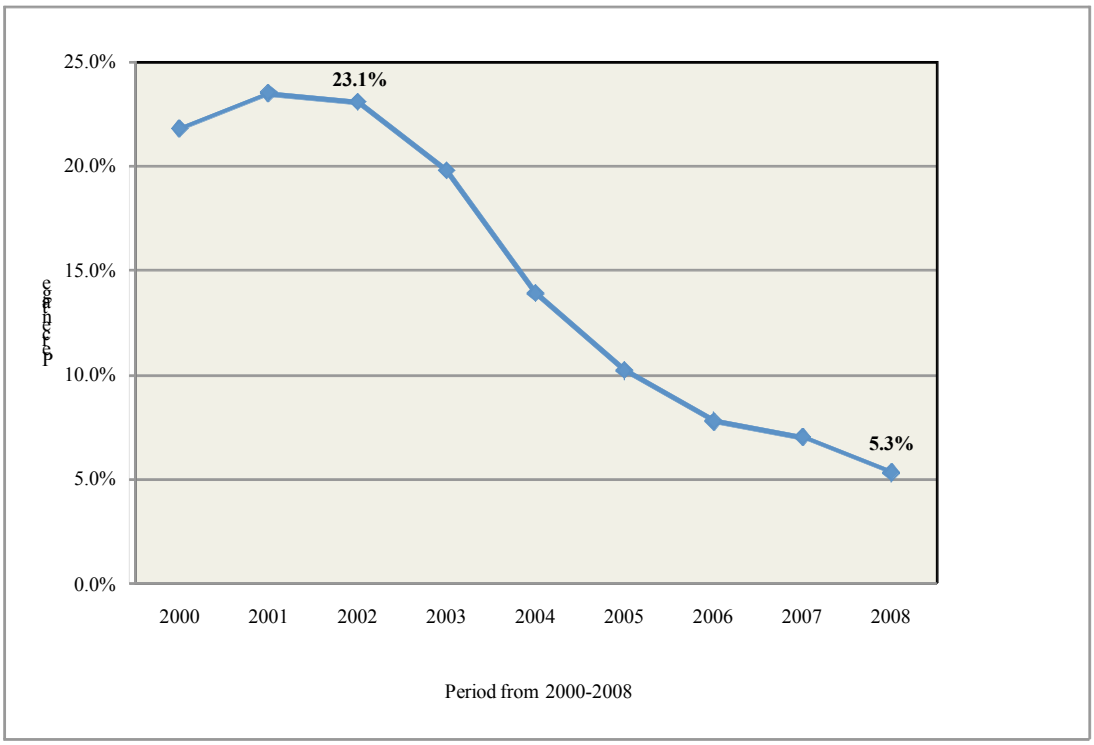


Figure 8.4 Kuwait's Public Debt as a Percentage of GDP, 2000–2008



8.5 KUWAIT'S MONETARY POLICY

The main target of Kuwait's monetary policy is to maintain local economic stability and prevent imported inflation. Kuwait is not highly industrialized. Its main exports are oil and gas natural resources, which provide almost 90% of the countries revenues, and it imports most of its domestic needs. Kuwait's monetary policy is therefore less effective than that of more developed economies.

In order to achieve monetary union, it is very important for GCC countries to coordinate their monetary policies. Kuwait took a step towards a unified monetary policy when it adopted a US dollar pegged exchange rate regime for the period from January 2003 until May 2007, as we discussed in Chapter 3, although it then reverted to a previous regime in which its exchange rate was pegged to a basket of currencies. Given that the US dollar exchange rate regime is followed by all other GCC countries, Kuwait declared that it would be ready to re-adopt a similar GCC exchange rate policy at a later stage of monetary integration. GCC monetary and

exchange rate policy will continue to be influenced by the United States Federal Reserve Bank.

The currencies of Bahrain, Oman, Qatar, Saudi Arabia and UAE have been pegged to the US dollar since the 1980s and some of them since the 1970s. Bahrain, Qatar, Saudi Arabia, and UAE have pegged their local currencies to the Special Drawing Right (SDR), with the consideration of ±7.25% margin for Bahrain, Qatar and UAE. Table 8.3 shows the different exchange rate regimes used by the GCC countries.

Table 8.3 GCC Exchange Rate Regimes

Country	Period	Exchange Rate Policy
Bahrain (BHD)	Prior -2001	Pegged to IMF's Special Drawing Rights (SDR)
	After 2001	Official Pegged to US dollar
Kuwait (KD)	Jan-2003 to May 2007	*Official Pegged to US dollar
	Prior-2003 & After May 2007	Official Pegged to Basket of Major Currencies
Oman (OMR)	Prior -2001	Pegged to IMF's Special Drawing Rights (SDR)
	After 2001	Official Pegged to US dollar
Qatar (QAR)	Prior -2001	Pegged to IMF's Special Drawing Rights (SDR)
	After 2001	Official Pegged to US dollar
Saudi Arabia (SAR)	Prior -2001	Pegged to IMF's Special Drawing Rights (SDR)
	After 2001	Official Pegged to US dollar
UAE (AED)	Prior -2001	Pegged to IMF's Special Drawing Rights (SDR)
	After 2001	Official Pegged to US dollar

Source: National Central Bank. * Kuwait set a parity margin for the KD to change within ±3.5%.

Owing to the similarity in their monetary policies, the exchange rate between the GCC countries has been stable. This explains why in the GCC there has been less concern with exchange rate issues than was the case in the European Monetary Union, where the countries experienced considerable currency fluctuation between themselves.

8.6 EXCHANGE RATES

The history of the GCC exchange rates are summarized in Figures 8.5 and 8.6. For more than three decades GCC currencies have maintained a stable exchange rate against the US dollar. With the exception of Kuwait Gulf's currencies have maintained a US dollar pegged exchange rate since the 70s.

Preventing the import of inflation is one of the main objectives of the monetary authorities in the GCC states. It was for this reason that, in response to the decline of the US dollar in the past few years, the State of Kuwait re-valued the KD and dropped the US dollar pegged exchange rate regime.

By the start of the year 2003, all the GCC countries followed a similar US dollar pegged exchange rate policy as a step towards the single currency that was due in 2010.

Figure 8.5 Qatar, Saudi Arabia and UAE Average Exchange Rates against the US Dollar, 2000–2008

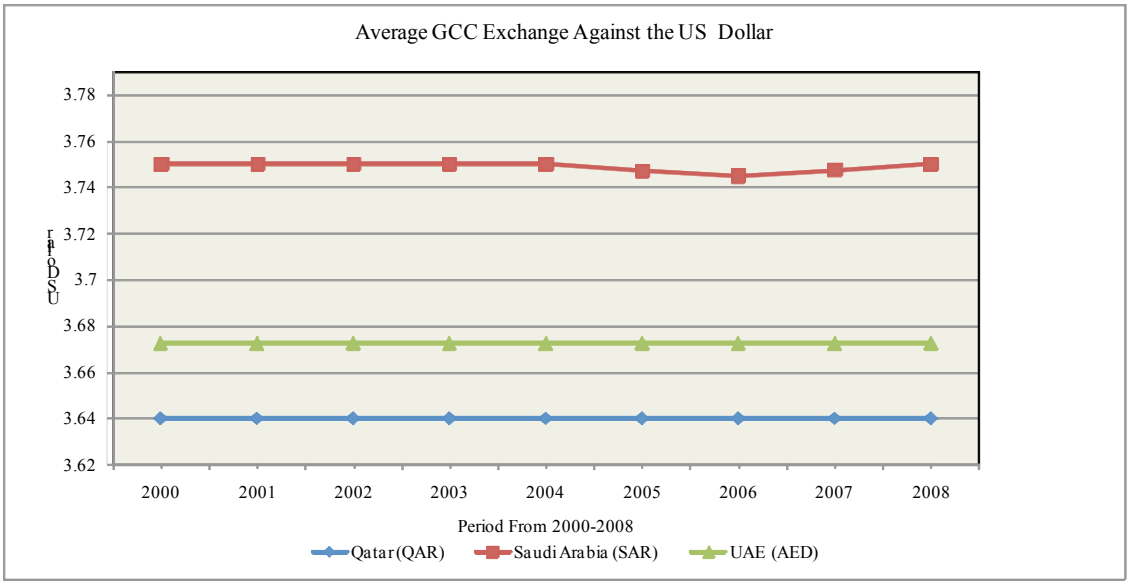
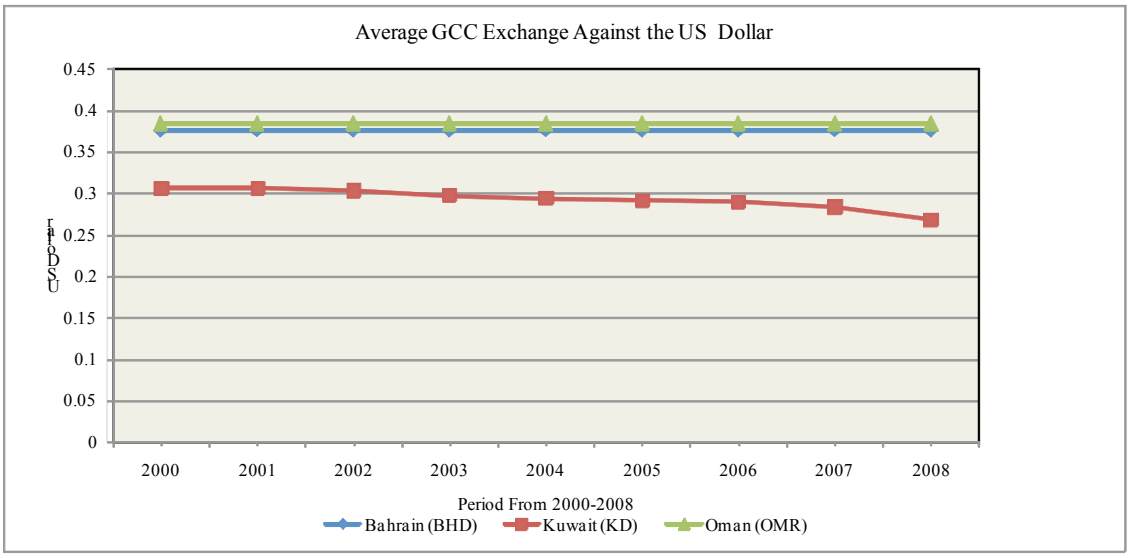


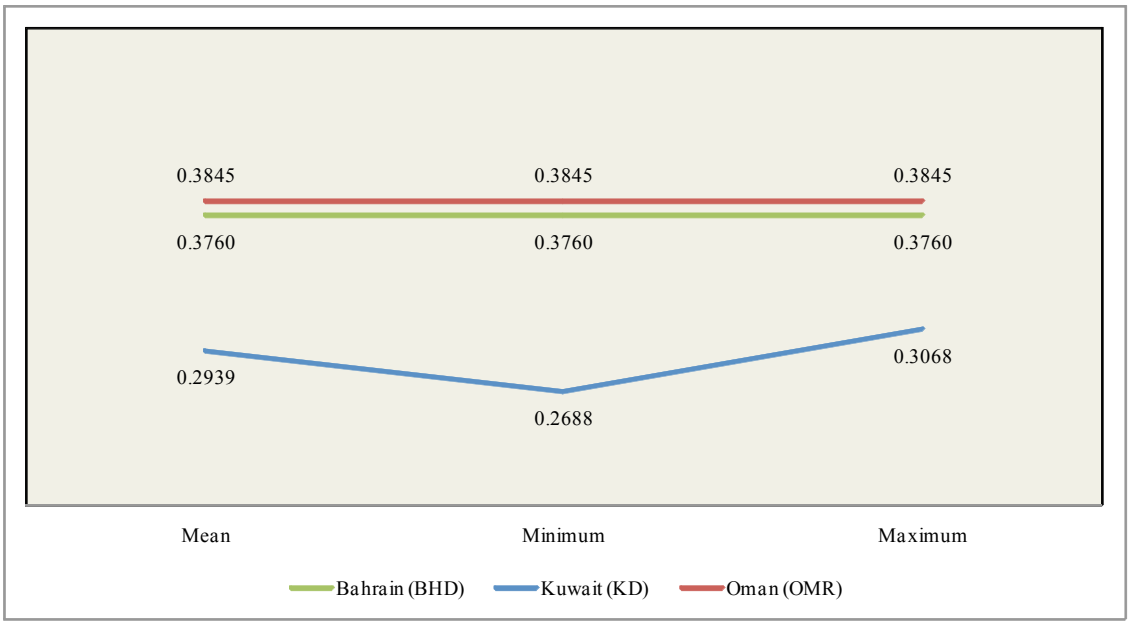
Figure 8.6 Bahrain, Kuwait and Oman Average Exchange Rates against the US Dollar, 2000–2008



As we can see in Figure 8.6, Bahrain, Kuwait and Oman have always assured the stability of the exchange rate. The average exchange rate for the Bahraini Dinar (BHD) was $0.3760 for the entire period 2000–2008, during which its currency was pegged to the US dollar.

The KD average exchange rate for the entire period was 268.8 fils per US dollar for the period 2000–2008. However, it reached its minimum exchange rate in 2008 while it was pegged to a basket of currencies, and, owing to the decline of the US dollar against the world major currencies, the CBK took the decision to revert to its old exchange rate regime and drop the US dollar peg. The US dollar's highest appreciation was in 1970, when the average exchange rate for the year was 357 fils per US dollar, which represents an appreciation of 23% against the KD.

Figure 8.7 Bahrain, Kuwait and Oman Average Exchange Rates against the US Dollar, 2000–2008

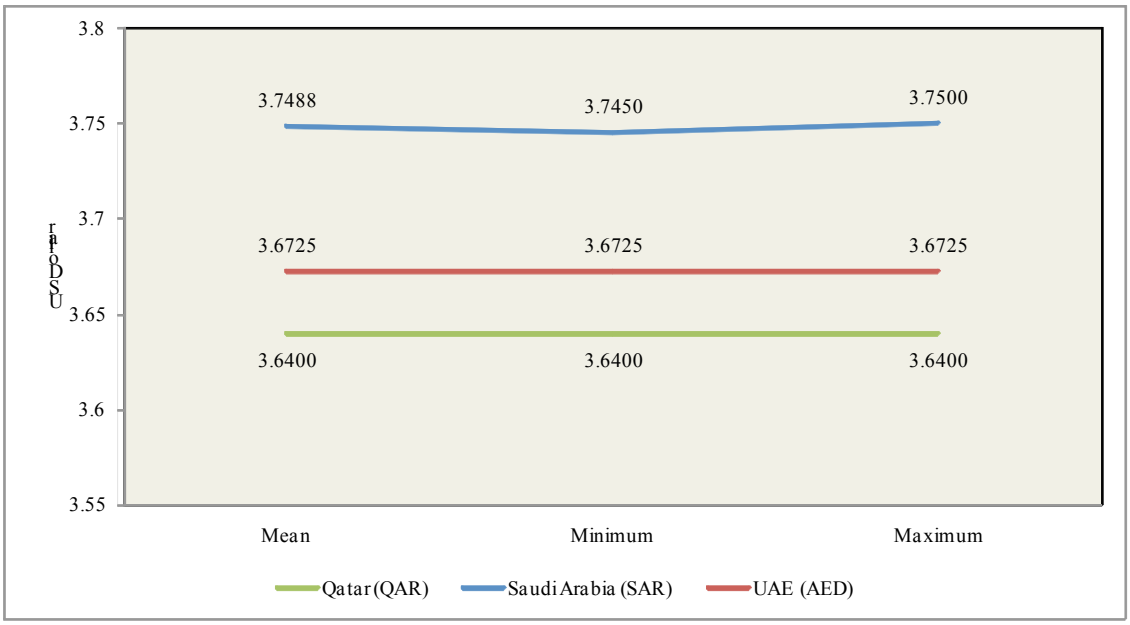


The average exchange rate of the Oman riyal (OMR) for the entire period was 0.3845 OMR to the dollar. The exchange rate was re-valued by the Central Bank of Oman in the mid 80s. The Central Bank of Oman has maintained the stability of the exchange rate from the year 2000 onwards.

The Qatari riyal similarly maintained a steady exchange rate of 3.6400 QAR to the US dollar for the period 2000–2008. The Central Bank of Qatar has used a US dollar peg for the entire period since the 80s.

The Saudi Arabian riyal (SAR) also stayed within the maximum rate of 3.7500 and the minimum of 3.6400 per US dollar. The average exchange rate was 3.7488 per US dollar.

Figure 8.8 Qatar, Saudi Arabia and UAE Average Exchange Rates against the US Dollar, 2000–2008



Finally, the UAE dirham (AED) has maintained a US dollar pegged exchange rate regime like the rest of the GCC countries except Kuwait. The stability of the AED has been achieved by the central bank authority, with a consistent exchange rate of 3.6725 AED per dollar for the entire period.

Most of the GCC countries are oil-exporting countries and share a similar economic structure. Moreover, since their oil revenues have been on an upward trend over the past decades as a result of the hike in oil prices, most of the GCC countries have supported their US dollar pegged regimes to maintain exchange rate stability and avoid a current account deficit even when the US dollar declined.

An accumulated large foreign exchange rate reserve among the member countries has increased economic stability and confidence for the GCC countries, even though there is no official arrangement within the GCC to protect any currency against speculative attack.

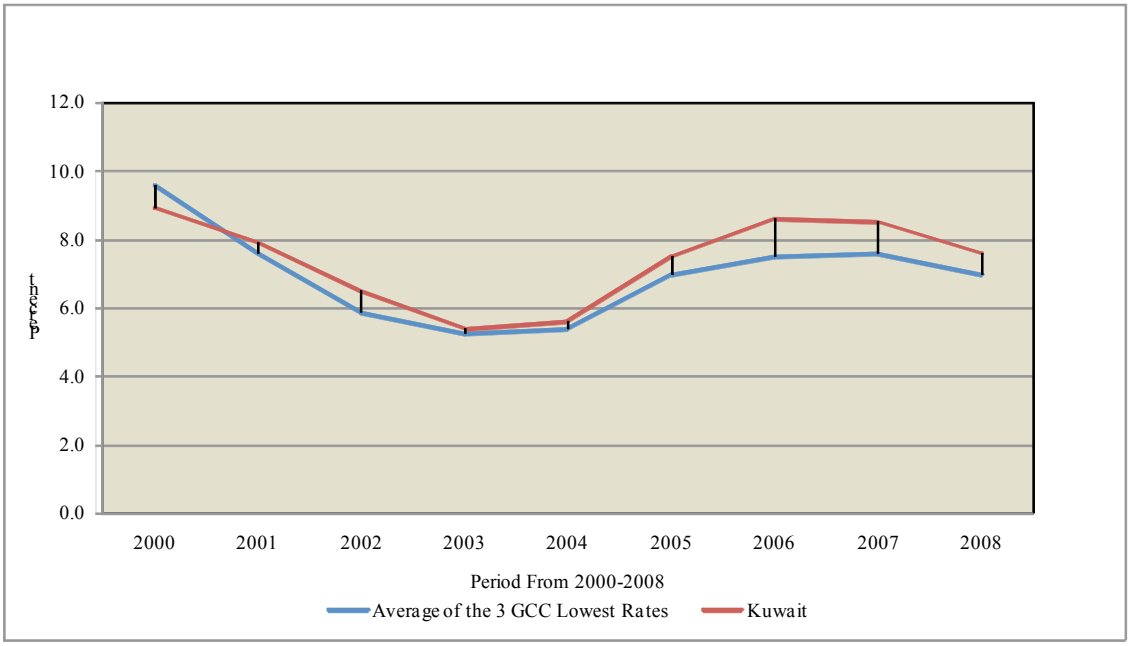
Since oil is also priced in dollars and is the main export trading activity for most GCC countries (except UAE, which has a more diversified economy), the economic policies of the GCC states are also priced in US dollars.

From the above we can conclude that the US dollar pegged exchange rate regime have proved to be a successful exchange rate policy for GCC countries and one of the reasons for the stability of their currencies over the past decades. Although their currencies experienced inflationary pressure as a result of the declining value of the dollar in the past few years, the stability provided by the dollar pegged exchange rate regimes has left its mark on GCC revenues and accounts surpluses.

8.7 INTEREST RATES

One of the the CBK's objectives has been to maintain sufficient liquidity in the local market, and to ensure the availability of credit to finance the country's economic activities. It therefore set a target interest rate to be charged by the local banks by influencing the liquidity level on the market. The interest rates for long-term loans are summarised in Figure 8.9.

Figure 8.9 Kuwait's and GCC's Average Exchange Rates, 2000–2008



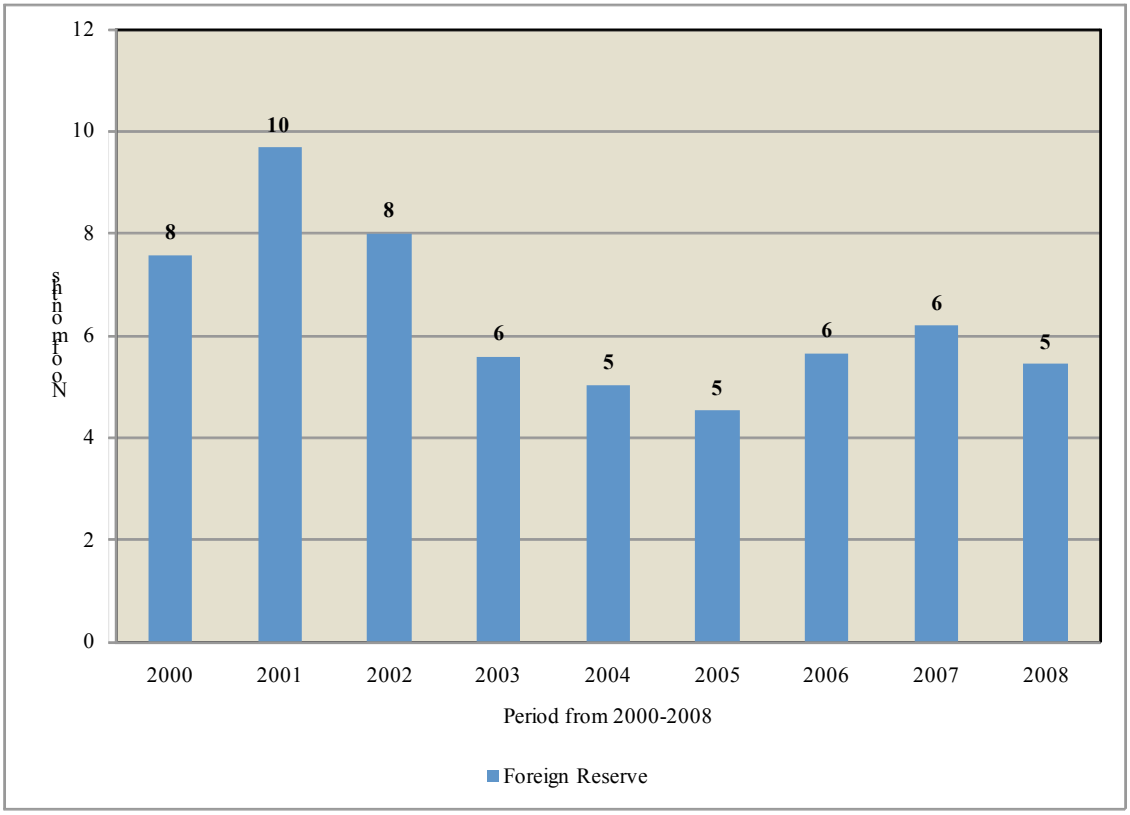
The trend on the interest rate over the studied period proved that Kuwait's long-term interest rate has been commensurate with the interest charged in other GCC countries. The similarity of the GCC countries' exchange rate policies and

monetary policies made the interest rate criterion not difficult for member countries, including Kuwait, to achieve.

8.8 FOREIGN RESERVES

The foreign reserve criterion was formulated because of the similar oil-dependent economic nature of the GCC countries. Kuwait's accumulated foreign reserve was not a major problem for the country to maintain. As we discussed in Chapter 5, Kuwait has very limited industrial production and imports most of its goods and services from abroad. Figure 8.10 shows that Kuwait fulfilled this criterion for the whole studied period.

Figure 8.10 Kuwait's Accumulated Reserve, 2000–2008



8.9 INFLATION RATES

Over the past decades the average inflation for the GCC countries has been very low and unlikely to be a threat. The average inflation was 10.51 per cent for the years 2000–2008, but the inflation rate increased over the past few years with the increase in the global inflation rate, hike in the price of oil and commodities, and the depreciation of the US dollar against the major currencies.

As we saw in Chapter 5, Kuwait has a good relationship with other countries, especially those industrial countries providing the products Kuwait needs. Kuwait's exchange rate policy has played a part in pushing up inflation over the past few years, especially when the US dollar depreciated against the major currencies.

The exchange rate has been a very important monetary tool to prevent the country from importing inflation. The value of the KD exchange rate against the US dollar and other major currencies, especially those with a good trade relationship with Kuwait, have been very carefully watched by the CBK to prevent hikes in inflation.

Figure 8.11 Kuwait's and GCC's Average Inflation Rates, 2000–2008

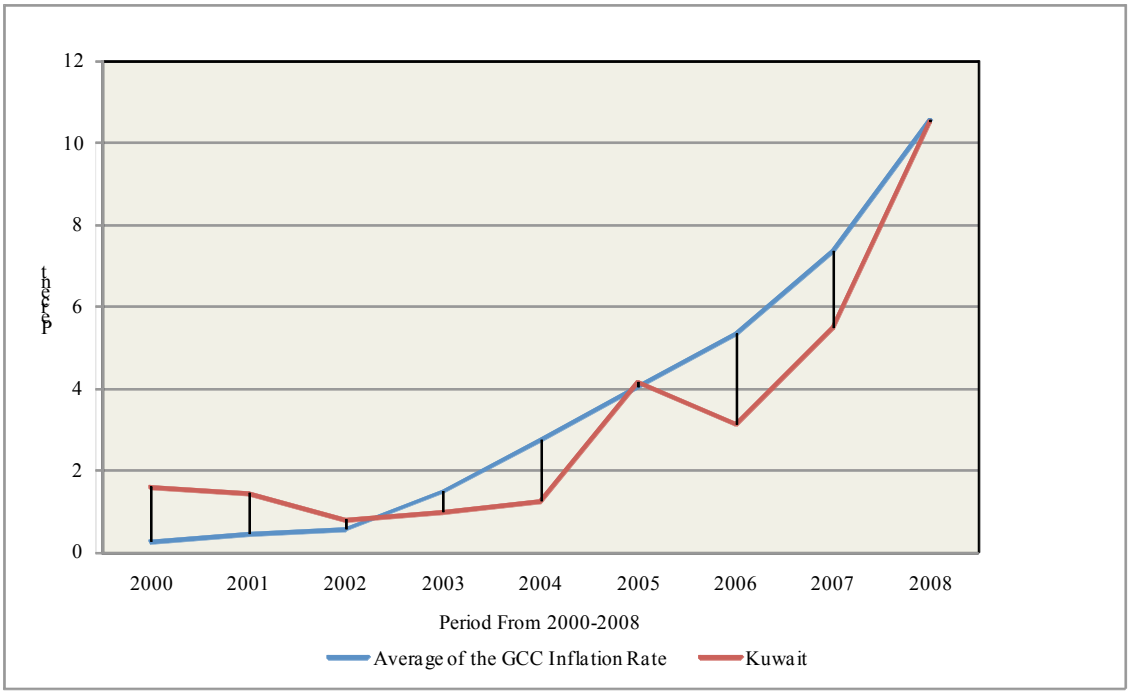


Figure 8.11 shows that Kuwait's CPI index has kept a parallel trend with that of other GCC countries, and there has not been much difference between Kuwait and other GCC countries in their inflation rates. Because they import many goods from abroad and receive most of their income in US dollar for the export of oil, the inflation rate has been an especially important criterion for convergence. The State of Kuwait did not meet the inflation criterion in the years 2000–2003, but from 2004 until the end of 2008 it has shown that it can do so.

8.10 CONCLUSION

We can conclude that over the past decades Kuwait has fulfilled all the convergence criteria, and that the country is now in a position to join the GCC monetary union. The only possible concern may be over Kuwait's exchange rate policy, which has been successfully pegged to a basket of currencies for the last few years as a means to resist inflationary pressure. Kuwait has to consider what the consequences would be if the GCC monetary authority decided to impose a single US dollar pegged exchange rate regime on all its members.

Table 8.4 shows that Kuwait has fulfilled all the convergence economic criteria during the studied period, with the exception of the inflation criterion in 2000, 2001 and 2003.

Table 8.4 Kuwait's Fulfilment of GCC Convergence Criteria, 2000–2008

Items	2000	2001	2002	2003	2004	2005	2006	2007	2008
Fiscal Balance (% of GDP)	27%	21%	17%	20%	20%	31%	30%	27%	32%
Fiscal Balance (% of GDP) Qualification	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Debt-to-GDP Ratio	21.8%	23.5%	23.1%	19.8%	13.9%	10.2%	7.8%	7.0%	5.3%
Debt-to-GDP Ratio Qualification	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Interest Rate	1.569	1.448	0.797	0.986	1.257	4.12	3.092	5.465	10.5
Interest Rate Qualification	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No
Foreign Reserve	7.583	9.676	8.009	5.591	5.035	4.53	5.659	6.202	5.448
Foreign Reserve Qualification	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Inflation Rate	8.9	7.9	6.5	5.4	5.6	7.5	8.6	8.5	7.6
Inflation Qualification	No	No	No	Yes	Yes	Yes	Yes	Yes	Yes

Source: International Monetary Fund, World Bank, Economist Intelligence Unit, Author Calculation For Fiscal Debt & Debt-to-GDP Ratio.

Chapter 9 DISCUSSION AND CONCLUSION

9.1 INTRODUCTION

The GCC was established to facilitate policy cooperation and integration between its six member states (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates). GCC member states have entered into several agreements to bring about co-ordination in different areas. They have signed an Economic Agreement which includes the decision to establish monetary union with a single currency by January 2010. The deadline to achieve single monetary union was not met on the expected dates, and some government officials predict that 2015 will be the new date to launch the GCC single currency.

Two of the GCC member countries (Oman and the United Arab Emirates) have dropped their commitment to join the GCC single currency, but they are still active and participating on the economic technical board for the new currency. Some analysts predict that both Oman and the United Arab Emirates will join the GCC single currency one day, once the GCC single currency has been launched. Meanwhile the other GCC member countries (Bahrain, Kuwait, Qatar, and Saudi Arabia) are still committed to the project.

The State of Kuwait is a member of the GCC council, has been active on the GCC single currency technical board, and has continued to pursue the goal of achieving a single currency union. The main objective of this thesis has been to investigate the various costs and benefits to Kuwait of its decision to join the single monetary union. We have used both quantitative and qualitative methods to arrive at the following conclusions.

9.2 IS KUWAIT READY TO JOIN AN OPTIMUM CURRENCY AREA?

The preparedness of Kuwait to join an optimum currency area can be discussed from the theoretical perspectives of Mundell (1961), McKinnon (1963) and Kenen (1969). Mundell (1961) developed the OCA theory to evaluate the costs and benefits of currency union, and to explain how two or more countries could benefit from a single currency union. He argues that currency union reduces the cost of money valuation by fixing the exchange rate between member countries. Moreover, where there is mobility of both capital and labour the dangers of asymmetric shocks and price instability will be reduced. McKinnon (1963) goes further to discuss the concept of a country's economic openness. He argues that such openness is measured by the ratio of traded goods to accumulated domestic non-tradable goods. He points out that with a flexible exchange rate regime and a high level of economic openness to the international market, any shift of demand from domestic non-traded goods to traded goods will cause devaluation, which in turn will increase the price of traded goods and decrease the price of non-traded goods. Kenen (1969) introduced another criterion to the theory of OCA, arguing that diversification of products could define an OCA. A currency union therefore relies not only on the mobility of factors of production but also on economic similarity and the products that members of the union produce. He also argues that the more diversified economies will have less exposure to external shocks and disturbances. He suggests that establishing an OCA would enhance economic integration.

On the basis of OCA theory and the literature reviewed on the subjects of monetary union and exchange rate determinants, we can conclude that a country's political, economic and currency stability have an important effect on its exports, imports, investments and employment. Therefore countries need to consider whether the decision to join a monetary union will generate sufficient benefits. In addition, most of the literature reviewed concludes that there are more benefits than costs in entering a currency union, especially for small economies such as those of the GCC members.

The International Monetary System was created to facilitate transactions between nations, in particular the import and export of goods and services. The International Monetary System has been through different stages of development, which have been characterized by different economic circumstances and needs.

In studying the different stages of the International Monetary System and the theory of optimum currency areas, it is necessary to consider the economic consequences of exchange rate fluctuation between countries using different exchange rate regimes. There are two basic types of exchange rate regime: fixed and floating. In a fixed exchange rate regime countries peg their currencies to the US dollar, and capital controls are used to prevent currency speculation. In a floating exchange rate regime currencies are allowed to float freely, but, owing to the importance of the exchange rate value, governments do not allow currencies to float completely freely but rather manage floating so as to avoid excessive fluctuation.

As the financial system developed through different stages, a new monetary system was created called monetary union. The importance of the exchange rate system to a country's economy made a monetary union necessary as a means of preventing the negative effects of currency fluctuation and speculation. The history of monetary unions includes several successful examples. The most recent is the European Monetary Union, which started with 11 countries and has had others joining once they have fulfilled the economic criteria.

After the creation and execution of the European Monetary Union, other regions looked at the new European economic bloc as a model which they could replicate. The GCC was one such region and the member countries went on to sign an agreement to establish their own monetary union. Several scholars have since been investigating and the probable costs and benefits.

The literature on the GCC monetary union has raised a number of issues with regard to the establishment of the union, such as: the choice of a proper exchange rate regime; security issues with neighbouring countries, notably Iran and Iraq; the establishment of a central statistical system; the necessity of establishing a supra-national institution; the costs and benefits of creating the union; the encouragement of intra-regional trade; the possibility of external shocks; the methodology of establishing a conversion value; and various political concerns, such as the need for each country to cede some of its independence to union central policy and to give up its national currency for the new regional currency. With regard to the latter, the CBK dropped the basket of currencies regime to adopt the US dollar pegged exchange rate policy as a step towards the GCC single currency union. However, the CBK over the years has been successful in

maintaining the value of the KD against the US dollar, using both fixed exchange rate regimes, and floating within a margin of ±3.5 per cent. US dollar pegged exchange rate regimes were less favourable to the KD during the period 2003–2005. And the CBK found it appropriate to revert to pegging the KD against a basket of major currencies, which proved to be a more flexible control against imported inflation. The increase in commodity prices globally, and the depreciation of the US dollar against the major currencies put pressure on the Kuwaiti economy, which made the CBK revert to the basket of currencies exchange rate regimes

In addition, the economic structure of the State of Kuwait is similar to that of other GCC countries. Kuwait is deeply dependent on its main export oil, and non-oil exports are minimal. Oil accounts for almost 90% of the country's income and is Kuwait's main driver of economic expansion. Furthermore, most of the GCC countries hold a sovereign wealth fund and they are very active investors regionally and globally. Kuwait holds a large investment portfolio abroad, and overseas assets are the country's second largest source of income. In addition, it has been shown that the investment portfolio has increased as oil revenues have increased. Investment activities for the State of Kuwait are US dollar based, and therefore income from investments tends to increase when the KD is appreciating against the dollar. Oil revenues are also sensitive to the KD's value against the dollar.

As we saw from the literature review, all GCC countries are exporters of a single product, which is oil. Kuwait's trade relationships with the rest of the world divide into two categories: those with oil importer countries account for the biggest portion of the country's exports; those with industrial exporter countries account for the imports which supply most of Kuwait's local needs.

At the same time, GCC countries hope to enhance the intra-regional trade among the member states, but owing to their limited industrial production, Kuwait's intra-regional trade with GCC countries is not as high as with the rest of the world, and exports to GCC countries are very low compared to the oil exports to industrialized countries. Therefore, the choice of exchange rate regime for the State of Kuwait should help to enhance the country's non-oil exports. Kuwait's exports will increase, especially to other members of the monetary and economic union.

The KD exchange rate value against the currencies of countries like the US that Kuwait has important trade relationships with is the main factor in enhancing income and reducing inflationary pressure. In addition, income from oil is sensitive to the exchange rate of the KD against the US dollar because oil exports are paid for in US dollars.

Imports to Kuwait are also based on the KD exchange rate value, for the cost of imported goods is less if the KD is stable against the major currencies. The KD value can either appreciate or depreciate according to the changes in the KD exchange rate regime policy used by the Central Bank of Kuwait. The theories of economic and monetary union and integration suggest that entering into a monetary union would help the country's trade, especially with countries within the currency area. However, because the main driver of Kuwaiti exports is oil, exports tend to increase if oil production and oil prices increase, and vice versa.

Another important economic activity for Kuwait is the import of a wide range of products from different parts of the world to meet local demand. European, non-Arab Asian and American countries are Kuwait's major trading partners. Kuwait's imports from Arab and GCC countries are the lowest of all. The exchange rate value of the KD was historically controlled by the Central Bank of Kuwait's use of different monetary tools, such as the exchange rate, the discount rate, and intervention to prevent increases in interest rate or hikes in inflation.

Therefore the CBK worked towards stabilizing the KD's value. By its choice of exchange rate regime, the Central Bank of Kuwait has in past decades successfully protected the country from inflation. Over this period, the CBK has used an exchange rate regime pegged sometimes against a basket of major currencies, and sometimes against the US dollar alone as part of the GCC unified single currency project. Global inflation and hikes in oil prices and commodity prices have in recent years brought what is known as 'imported inflation' to Kuwait, especially during the US dollar pegged exchange rate regime, when the KD value depreciated against the world major currencies owing to the fluctuation in the value of the US dollar.

Monetary policy governing, for example, the exchange rate, the money supply, and the discount rate, provides the CBK's main tools for maintaining the stability of prices and preventing inflation. In addition, the financial sector in Kuwait includes a large number

of financial institutions, and the number of newly established investment companies has increased over recent years as a result of the country's economic growth. The CBK supervises and monitors the banks very closely. The CBK's role has been to provide and manage liquidity to the financial institutions. It has introduced different instruments to control lending, borrowing and cash position in the financial market.

Our qualitative survey has shown that Kuwait's decision to join a monetary union will bring both costs and benefits to Kuwait, though it is clear that the country will gain more than it loses. There are several factors which support the conclusion that the State of Kuwait is ready to join an optimum currency area with the other GCC countries. Kuwait's economy is an oil-based economy like those of other GCC countries, and the country trades at both regional and international levels. Kuwait has been an open economy for the past decade and historically has been known for its trading activities, and there is now less competition with GCC countries, especially after the execution of the Economic Agreement which aims to enhance trade among member countries by removing all barriers and unifying the customs tariffs.

The exchange rate of the KD has been very stable against the GCC currency values, and there is not much fluctuation between the currencies. Thus an important criterion for entering a monetary union has been fulfilled. Inflation has also been under control for a long time, despite the recent global inflation pressure and hikes in commodity prices.

It is important that the GCC countries adopt a unified fiscal policy, and it is fortunate that Kuwait and the other GCC members are similar in terms of fiscal balances. The State of Kuwait over the period studied recorded a fiscal surplus almost every year, and the country's oil revenues have made it almost unheard-of for the country to use external debt. Because oil revenues are US dollar based, Kuwait, like other GCC countries, has enjoyed a large foreign exchange reserve and a high income from foreign assets.

The labour market in Kuwait, like that of other GCC countries, is controlled by the government and the private sector. Kuwaiti nationals are guaranteed to have a job by the government, but the private sector is increasingly important for the labour market, and the government in recent years has encouraged the private sector to recruit more Kuwaiti nationals. The labour force in Kuwait is mostly expatriate, coming mainly from

Asian countries. GCC nationals are treated as Kuwaiti nationals, and, conversely, Kuwaitis have no restrictions on working in other GCC countries.

Thus Kuwait's economy is not different from other GCC economies, and for some time the GCC region has been acting as a single bloc in both political and economic issues. The similarity of Kuwait's economy structure with that of other GCC countries make it less difficult for Kuwait to join the single currency union, and this union will give Kuwait a significantly stronger position in the global market.

9.3 LESSONS FROM THE GCC EXPERIENCE

Establishing the GCC monetary union has been considered in relation to the formation of monetary unions in the past, and to their successes and failures. Each monetary union is different from all others, but all share one thing in common, which is that they enhance economic growth within the member countries, and create a single economic bloc. GCC authorities have focused on the European Monetary Union as a model for forming a GCC monetary union, and have sought to learn from the EMU experience. The objectives of establishing the GCC monetary union is to create a wider economic integration among the GCC countries. There are a number of things we can learn from the GCC experience so far. Similarities of language, religion and culture make it easier for the countries to enter into a monetary union. All the GCC countries have an oil-based economic structure, and therefore the production and price of oil and natural gas are the most important factors for growth within their economies. The development of oil prices has had a positive impact on GCC revenues, and the hike in oil prices in recent years has produced a long-term current account surplus on the GCC balance of payments.

Over the past few decades GCC interest rates have moved in a similar direction, owing to the similarity of exchange rate regimes. All the GCC countries have adopted a single US dollar for their exchange rate regimes, except for Kuwait which has used a basket of currencies with the US dollar as the highest component in the basket. Thus interest rates have been linked to dollar rates. GCC countries maintain a very low spread between the US dollar rate and local interest rates.

Additionally, most of the GCC countries have accumulated large foreign reserves and these have had a direct impact on the stability of the exchange rate, even though there is still no official arrangement between GCC countries to protect their currencies from speculative attack. Most GCC central banks hold a large exchange rate foreign reserve which produced more most GCC countries.

Furthermore, fiscal policies for the GCC are less developed than those of the European Union, for GCC countries rely heavily on revenues from oil. Government budgets are based on the prediction of the minimum price of oil per barrel. Government expenditure expands during periods of high oil revenues, usually in line with rises in oil prices, and most GCC countries have the same source of income.

At the same time, we all realize that the GCC political stability and risk has been very carefully watched and discussed by the GCC member countries. Political risk from neighbouring countries Iraq and Iran make it more important that the union should be established to create a political and economic bloc. Most GCC countries are small compared to the Kingdom of Saudi Arabia and the United Arab Emirates. When the Union is formed all GCC countries will have the privilege of belonging to a larger political and economic bloc.

Also we have found that progress towards GCC monetary union has been slow compared to the formation of the European Union, but the lack of experience of GCC countries has made it difficult to progress faster. The challenge that the GCC faces is to achieve single monetary union even if it does not fulfil all the criteria proposed by the theory of optimum currency areas. The GCC countries did not have much intra-trade when they thought to establish monetary and economic union, but they realized the importance of having the power and influence to act as one economy, especially because the region controls very large oil and gas reserves.

In view of the above-mentioned facts, we believe that, if the GCC countries succeed in launching the single currency, and proceed to create a single supra-national authority to manage and control the union's monetary and fiscal policy, they will present a challenge to other groups of countries to follow the GCC example and establish their own monetary union.

9.4 CONTRIBUTION OF THE STUDY TO THE EMPIRICAL LITERATURE

Most of the literature reviewed on monetary unions has concerned the GCC in particular. We believe that this thesis will add to the literature on this subject by focusing specifically on Kuwait's national interest, and by studying the costs and benefits from a Kuwaiti perspective. Having the opportunity to investigate the empirical data on Kuwait's monetary system, the history of the KD, the country's external transactions, balance of payments, and the development of the monetary authority, has made it possible to provide some detail to the examination of likely costs and benefits for the State of Kuwait in joining the GCC monetary union.

9.5 LIMITATIONS OF THE STUDY AND SCOPE FOR FURTHER RESEARCH

There are still some limitations to this thesis which will create some openings for further investigation, for example: what would be a fair conversion value for the KD against the GCC currencies, especially since the KD holds the highest exchange rate value against most other currencies in the GCC region and the rest of the world? Since Kuwait holds a larger investment portfolio abroad, would it benefit from the investment activities of other sovereign wealth funds, especially one owned by GCC countries? How will Kuwait benefit politically from joining the GCC monetary union? What would be the effect on investments, the labour market and trade if Kuwait drops its commitment to join the GCC monetary union, as Oman and the United Arab Emirates have done?

This study has not provided answers to these questions, and there is scope for further research in these areas.

9.6 POLICY IMPLICATIONS AND CHALLENGES FOR KUWAIT

Joining the GCC economic and monetary integration has some important implications for Kuwaiti policy, for example:

- Kuwait will lose its monetary independence.

- GCC central authority will impose monetary and fiscal policies on all GCC members. This might cause some disturbance, especially when it comes to exchange rate policy. Kuwait has had the experience of a shift in exchange rate policy when it changed the currency to which the KD was pegged from a basket of currencies to the dollar alone, which resulted in an increase in the inflation rate.

- How will the government of Kuwait deal with its budget balance, since at the moment it passes all its budgets balances to parliament for approval, while other GCC countries are free to approve their budgets without having to pass them to any other authority?

- The State of Kuwait is like other GCC countries which have adopted a strategy of maintaining a more diversified economy, thus reducing its reliance on oil. Will Kuwait be able to achieve its privatization plans and create a more diversified economy when the country has to follow a central monetary and fiscal policy?

- The labour market in Kuwait is small compared to that of Saudi Arabia. Will the State of Kuwait, as the major player in the Kuwaiti local job market, be able to absorb more labour from other GCC countries when there are no restrictions on GCC nationals moving from country to country to find work?

9.7 CONCLUSION

In summary, we can conclude that the decision of Kuwait to join the GCC single monetary union will generate both costs and benefits, but that the benefits will outweigh the costs. Kuwait will gain from being part of a large economic and political bloc which controls a large reserve of oil and gas. Kuwait will also be in a good position to gain from a uniform GCC oil price. For if the GCC countries introduce a new single currency there is a chance that oil will be priced in the new GCC currency rather than in US dollars, which would reduce the risk of loss as a result of a fall in the price of the dollar on the foreign exchange.

The new single currency will create more capital and a liquid market for regional companies. Other financial instruments, such as the debt instruments, will be available

to all GCC companies when they all operate under single currency and market. These companies will also have more access to liquidity.

At the same time, adopting the new single currency may put Kuwait in a position to benefit from a floating exchange rate regime if the Gulf Central Bank decides to use it instead of having a fixed exchange rate regime as at present. The benefits of adopting a fixed exchange rate regime will, however, be lost.

The question has arisen in recent months whether the uprisings and demands for democratization associated with the so-called Arab spring will have any effect on the the launch of the GCC currency and economic integration. Many believe that they will have a positive impact on the process. One of the reasons for thinking this is that some GCC countries, namely Bahrain, Oman, and Saudi Arabia, have a higher level of unemployment than the others, and fearing this as a potential cause of unrest, are in favour of accelerating the launch of the union so as to access the privileges of labour mobility among member states. The economic benefits of the union are thus seen as an aid to political stability. Finally, the similarity of the GCC economies makes the process of moving towards a monetary union smoother. The lack of complexity in the economic structures of Kuwait and the rest of the GCC members will make the creation of a single monetary currency an example to be followed by other countries who likewise share a similar economic structure, culture, religion and language.

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APPENDIX

QUESTIONNAIRE

My study investigates how Kuwaitis view the costs and benefits of economic and monetary integration within the Gulf Co-operation Council, and whether they think Kuwait is ready to join an optimum currency area (OCA). The study will examine some of the possibilities in an attempt to suggest what may be in the best interests of Kuwait. I am surveying the steps Kuwait is taking to enter into a monetary union with other member states of the GCC and the possible consequences of its decision to join such a monetary union. I will be focusing on the following issues:

Monetary policy

Fiscal policy

Trade

Investment

Labour markets

Other general issues

Personal data

What is your name?

What is your job title?

What is your university degree?

How long is your working experience?

Monetary policy

Central banks or monetary authorities use monetary policy to manage the money supply, liquidity and the cost of money. Central banks and monetary authorities usually use monetary tools to protect the country's economy from economic crises and to control inflation. In the event of entering into a monetary union, the country will give up its own monetary policy and will follow the union's monetary convergence and policy.

Discussion questions (please outline your answer in 3 to 4 lines):

What would be the effect on monetary policy in general?

How would you view the effect of the monetary union on price stability?

Will the introduction of the new currency increase or decrease local prices?

What would be the cost to the state of Kuwait of returning to a fixed exchange rate with the US dollar like Saudi Arabia, Bahrain or Qatar rather than a basket as at present?

Fiscal policy

A country's macroeconomic policy tools are used by the government to control the total level of economic activities within the country. These will include setting the level of government expenditures and revenues. Fiscal policy refers to the overall consequences of the country's budget outcomes on economic activities. There are three types of possible stances of fiscal policy: contractionary, expansionary and neutral.

Discussion questions:

What would be the effect on fiscal policy in general?

What would be the effect on Kuwait of following a fiscal policy determined collectively with its partners in the monetary union?

How well would the union fiscal policy serve Kuwait's economy?

Trade

Is the commercial exchange of buying and selling on both domestic and international markets. Trade can be the exchange of goods, services or both between two parties or countries.

Discussion questions:

What would be the effect on trade in general of monetary union?

How would monetary union affect the state of Kuwait trade activities with both regional countries and internationally?

Would the introduction of a new single currency enhance Kuwait's competitive position?

Investment

Investment is the action of laying out money or capital to purchase financial instruments or other assets with the expectation of gaining profit in the form of interest, inflows, or a

value added to the asset. Investment policy is influenced by considerations of risk, management, finance and political stability.

Discussion questions:

What would be the effect of monetary union on investment in general?

Will the monetary union increase the level of investment in Kuwait?

How would the prices of assets in Kuwait respond to the introduction of the monetary union?

Labour

Labour is work conducted by human beings. It is usually contrasted with other factors such as production, capital and land.

Discussion questions:

What would be the effect of a monetary union on the labour market in general?

What would be the effect on the local Kuwaiti work force of the monetary union?

Will employment increase or decrease?

Other general issues

What would be the political risk for Kuwait of joining a monetary union to promote economic integration?

How would you view the decision taken by both Oman and United Arab Emirates to withdraw from the monetary union, and will it have an impact on the union?

When do you think the new currency will be introduced?

What will be the signal sent to the international market when the GCC monetary union is established?