

The Gulf Monetary Union

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Abstract

The aim of this paper is to evaluate the political economy of the Gulf Monetary Union (GMU). From a political perspective, I argue that if established, the GMU will increase bargaining power at the supranational level, but it will also raise tensions between and within members states. From an economics perspective, the Union will have a positive, yet limited, impact through an increase in intra-industry trade among members. Where the GMU process can have the biggest impact is in improving economic efficiency and enhancing the quality of institutions. A successful monetary union requires discipline, transparency, accountability, institutional independence, coordination, communication, sharing, expanded research capacities and improved statistical frameworks. If the process towards establishing the GMU encourages the candidates to expedite their work towards meeting these requirements, then the countries, through a strengthening in the quality of their institutions, will achieve long-term growth, low inflation, and macroeconomic stability. Most importantly, these benefits will come with or without the GMU being established at the end.

Keywords: Monetary Union, Persian Gulf, Optimum Currency Areas

I. Introduction

January 2010 was the targeted date for countries of the Gulf Cooperation Council (GCC) to launch the Gulf Monetary Union (GMU). The move by the six oil-rich Gulf countries to adopt a single currency would be the final and most far-reaching aim of the Unified Economic Agreement that was signed by the GCC countries about thirty years ago. It would also be an unprecedented event. GCC countries account for 45% of the world's proven oil reserves and 17% of the proven natural gas reservesⁱⁱ. The stability of the global economy depends on the ability of these countries to maintain a smooth supply of oil at a fair price. At the same time, any decision of the countries to move away from the US dollar peg can exacerbate global imbalances by adversely affecting the value of the US dollar.

Had these countries succeeded, the GMU would have been the biggest monetary union outside Europe with an economy as big as Germany's and an area almost half the size of the Eurozone.

As I write this chapter it is obvious that the launch of the GMU has been postponed. The impact of the global financial crisis, the slow progress that the member states have made towards fulfilling some of the accession criteria and harmonizing their economies, and the decision of Oman and the United Arab Emirates to drop out of the negotiations in 2006 and 2009, respectively, are some of the factors that contributed to the delay. Whether the union will be established later - albeit with a delay - or not, remains unclear. It is also unclear whether the Gulf countries are closer now to establishing the GMU than they were five years ago; I doubt they are.

The decision to establish the Gulf Monetary Union is a political one, driven by a single goal: to maintain and enhance political stability in the Gulf through the added political and economic unity that a successful monetary union can bring. By establishing a bigger political constituency, the GCC countries as a block, increase their bargaining power and they can overcome external threats, especially from Iran and Iraq. Moreover, moving to a single currency makes the

expectation of a move away from the US dollar more credible, and gives the block more leverage at the negotiating table.

Since the GMU is driven by political considerations, we must recognize that the decision to postpone or even abandon the launch will not depend on the economic advantages and disadvantages. Rather, it will reflect the political environment within the GCC countries and the political will of the rulers.

However, the key political cost of the GMU, if it comes to pass, will be the surrendering of policy autonomy at the national level. How big the cost is for the member states depends on their ability to maintain national unity and avoid internal conflicts while pursuing a common external policy at the block level. In 2003, Saudi Arabia did not openly support the US war on Iraq in order to maintain national unity, while the other GCC states endorsed the US efforts. Had the Gulf Monetary Union been in place, it would have been more difficult for the Saudis to deviate from the consensus, for such an act would damage the credibility of the GMU. At the same time, Saudi Arabia would have faced the risk of internal conflictⁱⁱⁱ.

The magnitude of the political cost associated with the surrendering of policy autonomy at the national level also depends on whether decisions are dictated by Saudi Arabia or taken by consensus in a democratic environment among the GCC states. That is not to say that Saudi should not have more voting power. After all, Saudi Arabia accounts for 67% of the national population and 83% of the total territory of the GCC. Nonetheless, the decision makers must ensure that the views of all member states are taken into consideration and that the policies promote the interest and well-being of the GMU as a whole, and not the interests of individual countries. The timing of United Arab Emirate's exit from the GMU is not random. It came after it was announced that the regional Central Bank would be located in Riyadh and not in Abu Dhabi. Clearly, if the interests of other member states are not taken into account, the political costs may outweigh the political gains.

As for the economic impact, the GMU will have a positive, yet limited effect in the short-run. Getting rid of the local currencies in favor of a single currency lowers transaction costs, eliminates nominal exchange rate risk, and increases trade among the GMU members. How big will the increase in trade be? Evidence suggests it will not be significant. In the case of the European Monetary Union (EMU), trade at the bilateral level within the EMU increased by 5% to 15%, although not all of the increase can be attributed purely to the EMU. In the case of the GMU, the increase in trade will be smaller since there is less bilateral trade among the GCC countries than there is among the EMU countries.

Nevertheless, the two main economic disadvantages of monetary unions – loss of monetary autonomy and loss of the ability to use exchange rates as an automatic stabilizer – are not a major concern for the GMU countries. For all intents and purposes, the countries gave up monetary autonomy and the ability to use exchange rates as automatic stabilizers when they pegged their currencies to the US dollar^{iv}. Actually, moving to a single currency could eventually help them gain back some monetary autonomy and control over their currency.

The biggest gains from the GMU will be neither political, nor economic. They will be institutional. Thus, a successful monetary union requires discipline, transparency, accountability, institutional independence, well-developed analytical capabilities, coordination and communication. It also requires that each country expands its research capacity and improves the quantity and quality of data that it produces.

So whether and when the GMU is established are not that important. What is most significant is the progress the countries make on the *technical* requirements along the transition path. If they succeed in fulfilling those requirements, the quality of institutions in each country will be much improved and a stronger institutional framework will bring long-term growth, improved welfare and enhanced stability with or without the GMU. Only then would the countries participating in the Gulf Monetary Union fully benefit from the provisions of a monetary union.

I elaborate on all these points in the following sections. In Section 2, I provide a historical timeline on the establishment of the GCC and the GMU process. In Sections 3, 4, and 5, I describe the political, economic, and institutional aspects of the GMU, respectively. I conclude with a summary of the main points and some final thoughts.

II. The Timeline

The first shot at a Gulf monetary union was in 1975-1978 by Bahrain, Kuwait, UAE, and Qatar. An attempt was made to reach monetary coordination and issue a single currency – the Gulf Dinar – but it failed. Without Saudi Arabia's involvement, the effort did not gain much momentum. Furthermore, border disputes strained the negotiations^v.

In 1979 the former Soviet Union invaded Afghanistan. The same year, Iran became an Islamic Republic after Ayatollah Ruhollah Khomeini led a movement that toppled the Shah of Iran. A year later Iraq invaded Iran and the Iraq-Iran war broke out. The war lasted until 1988.

The Persian Gulf states found themselves in the midst of conflict. They realized that they have become, metaphorically speaking, a battle ground for the Cold War fought between the US and the former Soviet Union and they feared that the conflict would hit home. While providing security for their borders was a concern, it was not the biggest. What was more worrisome was the fear that communism or the ideology of the Iranian Revolution would spread home and fill the political vacuum that was created by the British withdrawal in 1971^{vi}. Faced with the military and ideological tensions, the states in the Persian Gulf recognized the need to unite and establish their own identity. This time, Saudi Arabia and Oman were on board.

On May 25 1981, the Persian Gulf states of Qatar, Bahrain, Oman, United Arab Emirates, Saudi Arabia, and Kuwait formed the Cooperation Council for the Arab States of the Gulf, commonly known as the Gulf Cooperation Council (GCC). The

Charter, signed in Abu Dhabi by the leaders of these countries, encourages policy coordination, integration, and unity among its members.

A few months later, on November 11 1981, the 2nd Supreme Council meeting of the GCC took place in Riyadh. There, the Unified Economic Agreement (UEA) was ratified. The UEA encourages coordination and standardization of economic, financial, and monetary policies and sets the stage for full economic integration among its members. Article 22 of the UEA specifies the need for economic convergence criteria:

Member States shall seek to coordinate their financial, monetary, and banking policies and enhance cooperation between monetary agencies and Central Banks, including the endeavor to establish a joint currency in order to further their desired economic integration.

To be implemented in three stages, the UEA called for the sequential establishment of a free trade area, a customs union, and a common market and economic union^{vii}.

Consequently, the Central Bank Governors and Monetary Agencies Committee and The Committee on Financial and Economic Cooperation of the GCC were founded. These two bodies later joined to form the GCC Technical Committee for Monetary Union. Its mission was to provide a blueprint for the implementation of Article 22 of the UEA, on issues such as inflation, interest rates, exchange rates, and fiscal coordination. In 2009, the Committee concluded its work and passed on the recommendations to the newly established Monetary Council, a body that includes the Governors of the regional Central Bank. His Excellency, Muhammad Al Jasser, the Governor of the Saudi's Central Bank, was elected as the first Chair of the Council. The position runs for a year.

The free trade area was established in 1983 and the customs union in 2003. The common market that provides the GCC residents with equal treatment and equal rights was launched on January 1st 2008. However, it has not yet been fully

implemented. A review and update of national laws and regulations are required. The process is under way, but progress has been slow^{viii}.

The final and most far-reaching part of the UEA is the establishment of an economic union, GMU. To form the union, the GCC countries have to get rid of their local currencies and adopt a single currency. In addition, monetary sovereignty will be transferred to the regional Central Bank and a single monetary policy will exist across the GCC countries.

A very important milestone to the process towards the monetary union was reached in the Muscat Summit. Named after the capital of Oman, the city that hosted the summit in December of 2001, the Supreme Council ordered all members to adopt the US dollar as the common peg no later than January 2003^{ix}. The Council also set January 2010 as the deadline for the introduction of a single GCC currency. In a 2005 report, the IMF welcomed and supported the decision through a Press Release by the then Managing Director Rodrigo de Rato. Furthermore, the IMF considered the 2010 deadline reasonable^x.

A major setback to the establishment of the GMU was the withdrawal of Oman and the United Arab Emirates. In 2006, Oman announced that it was officially out of the GMU because it found the 2010 launch target to be too optimistic^{xi}. The country expressed its willingness to reconsider joining after the GMU is established. In 2009, the United Arab Emirates, a front-runner for hosting the Gulf Central Bank, exited a few days after a decision was taken to locate the Gulf Central Bank in Riyadh, Saudi Arabia.

III. The Politics

In establishing the Gulf Monetary Union, the leaders of the GCC states saw a clear political advantage. By forming a common market and adopting a single currency, the GCC countries achieve a greater degree of integration, which sends a stronger message of unity and enhances political stability.

At the block level, the states gain bargaining power by creating an overwhelming political constituency. The direct benefit is that any policy communicated at the supranational level carries more weight than policies communicated at the national level.

There is also an indirect benefit. Managing a single currency gives the GCC countries extra leverage at the negotiating table. The GCC countries have been contemplating for a long time a possible move away from the US dollar peg. For various political, economic, and institutional reasons, with the exception of Kuwait, the countries have chosen to maintain the dollar peg. The introduction of a single currency, however, will be combined with a discussion on the exchange rate regime for the new currency, and this time a move away from the US dollar will be more credible. A possible move away from the US dollar peg will have an adverse impact on the value of the US dollar, will raise exchange rate volatility globally, and most certainly will exacerbate global imbalances^{xii}. This is bad news for the US, Europe and China. Therefore, how and when the GMU chooses to alter the exchange rate regime of the new currency becomes a policy instrument that provides the block with added leverage.

However, the increase in bargaining power at the supranational level comes at a cost. The countries will have to give up policy autonomy at the national level. That is, while each country will have the right to vote on every decision and policy, financial and economic integration requires that a large number of decisions be taken at the supranational, and not the national level. That is not to say that all decisions need to be taken collectively. But the greater the degree of national sovereignty the countries are willing to surrender, the higher will be the gains at the block level.

The loss of policy autonomy at the national level will be costly, as it will raise tensions internally for some countries. It will also increase conflicts across the GCC states. To see why, we must recognize that the GCC world is not flat. At the macro level, there seems to be a lot of homogeneity. The countries share borders, their people speak the same language, share the same culture and

ethnic background, and observe the same religion. But at the micro-level, there are substantial differences across the GCC countries. There are variations in the levels of income, modernization, conservatism, secretarial sensitivities, radicalism, and in expectations about the future path of the Gulf. These differences make some constituencies less prone to change than others. They also make some people less willing to accept policies derived at the supranational level, for they fear that such policies do not reflect the best interests of the people, but are driven by the interests of specific member states. As a result, maintaining national unity and avoiding internal conflicts while pursuing policies at the supranational level can be more challenging for some countries than others. And for these countries, the cost of giving up policy autonomy will be higher.

The importance of maintaining national policy autonomy can be illustrated from the positions GCC states took with regards to the US War in Iraq in 2003. At the Sharm El Sheikh Arab League Summit, the UAE, under Sheik Zayed, called for Saddam's resignation, and supported the US effort to change the regime in Iraq by force if needed. Qatar, Kuwait, and Bahrain endorsed Sheik Zayed's call, while Saudi Arabia, the biggest U.S. ally in the region, retained an ambiguous front and did not openly back the U.S. effort, in order to minimize the risk of upsetting local groups. Saudi society remains very conservative and the state's battles with radicalism and terrorism are ongoing. Had the Saudis endorsed Sheik Zayed's call, they would have certainly faced rising tensions at home.

Furthermore, the cost of surrendering national autonomy is exacerbated by the dominance of Saudi Arabia. Saudi Arabia accounts for 83% of the total GCC land, 67% of the population, 49% of total market capitalization of listed companies, and 46% of the aggregate GDP (see Figure 1). The smallness of the other GCC states compared to Saudi is a challenge to ensuring that decisions at the block level reflect the interest and well-being of the GMU as a whole, and not the interests of Saudi. Failure of Saudi to gain the trust of the small states will bring tensions and result in a larger number of conflicts across the countries. While the EMU benefitted from the presence of two dual powers, France and Germany, that

helped prevent one country from dominating, the dynamics in the GMU are different, making it extremely difficult for the small states to ensure that their voices are heard. UAE's clear dissatisfaction with the decision to locate the Gulf Central Bank (GCB) in Riyadh, and subsequent withdrawal from the GMU negotiations is a lesson of what is to come if the Gulf states cannot strike a balance between Saudi's dominance and fairness of policy making at the block level^{xiii}.

Overall, the Gulf Monetary Union will be a political liability. The cost of surrendering policy autonomy at the national level will outweigh the benefit of increased bargaining power at the block level. Of-course, Saudi Arabia has every incentive to want the GMU to be implemented. Having a single voice representing the GCC on economic and foreign policy issues, serves Saudi better, especially when that one voice reflects Saudi's wishes.

But what do the small states gain? Kuwait is in for security reasons. Being part of the GMU enables Kuwait to rely more on the GCC states for support and protection, and less on the U.S. against an outside aggressor. Bahrain is in for economic reasons. The GMU enables its nationals to seek employment opportunities in other oil-and-gas rich GCC countries. Furthermore, not being part of the GMU will have a devastating effect on Bahrain's financial sector, as many firms would exit Bahrain and relocate within the GMU.

For Qatar, the benefits of a potential GMU for the country are less obvious. Since 1995, Qatar has taken a more active role on foreign policy issues, and it has become a regional mediator of peace to the surprise, and perhaps irritation, of its neighbor, Saudi. In 2008, Qatar initiated and led a mediation to solve the Lebanese conflict behind closed doors, which prevented a new civil war in the country. Currently, Qatar is mediating for a peaceful resolution to the Darfur issue, and to resolve the border disputes between Eritrea and Djibouti. By entering the GMU, Qatar may have to scale back its role as a regional mediator and the country will have to work with Saudi and the rest of its neighbors to promote policies that reflect the consensus of all GMU members. Whether Qatar

will benefit politically or not from the GMU depends on GMU's will to help Qatar have a stronger voice as a regional mediator for peace, stability, and prosperity.

IV. The Economics

If the Gulf Monetary Union is established, the union members will be getting rid of their local currencies in favor of a single, common currency. The move to a single currency will promote trade as transaction costs will fall, nominal exchange rate volatility will disappear, and price transparency will increase^{xiv}.

The gains from trade will be positive, but not substantial. In a highly referenced paper, Andy Rose estimates that currency unions triple trade among their members^{xv}. However, subsequent research showed the estimate to be too optimistic. Empirical studies on the Eurozone find that the introduction of the Euro contributed to about 5% to 15% increase in trade within the Eurozone^{xvi}. But these studies also argue that not all gains can be attributed to the euro, as trade with non-Eurozone members, such as the United Kingdom, Sweden, and Denmark, increased by roughly the same amount. Taking into account the lessons from the Eurozone, and the fact that there is less intra-industry trade within the GCC than within the Eurozone, the increase in trade will be limited. And the potential gains will not come entirely from trade creation, but rather from trade diversion. The single currency will encourage GMU members to trade more with each other and less with other, non-GMU partners.

The key disadvantages of monetary unions are that by giving up the local currencies, the countries lose monetary autonomy and the ability to use exchange rates as automatic stabilizers. Monetary autonomy enables the Central Banks to pursue expansionary policies when output is low and contractionary policies when the economy is overheating and expected inflation rises beyond a tolerable level. Exchange rates can also help stabilize the economy. Under floating exchange rates, an adverse demand shock that lowers output will also cause a depreciation of the local currency. The depreciation makes domestic goods cheaper abroad and foreign demand for the goods rises. An export-led recovery then takes place as domestic firms increase their exports. Similarly, an

increase in inflation, which can occur if there is strong domestic growth, will cause an appreciation of the exchange rate. The appreciation makes it harder for the domestic firms to export, as the goods now become more expensive abroad. The resulting drop in exports slows down the economy and the inflationary pressure subsides.

By entering a monetary union, the country has to give up its local currency. Without a local currency, the country no longer has the ability to use monetary policy or the exchange rate to stabilize the economy. Thus, entering the union and adopting a single currency comes at a high cost.

In a series of influential papers published before the EMU was launched, Martin Feldstein a prominent Harvard economist and one of the biggest opponents of the euro, argued that because the cost of giving up the local currencies would be too high for some European economies, especially the small ones, the EMU would be an economic liability. For Feldstein, the EMU made political, but not economic sense^{xvii}.

In the case of the GMU, however, getting rid of the local currencies entails no such costs. Since 2003, the GCC countries, with the exception of Kuwait, pegged their currencies to the US dollar. With the currencies pegged, the exchange rates no longer act as automatic stabilizers.

Furthermore, the countries also gave up monetary autonomy. Under the fixed exchange rate regime, and with the relatively free flow of capital across the GCC, the real mandate of the GCC Central Banks is to maintain exchange rate stability by shadowing the policies of the Federal Reserve, and not to pursue price stability or high output. For example, if the Fed implements an expansionary monetary policy through lower interest rates because of a slow-down in the US economy, the Gulf countries have to lower interest rates as well, regardless of whether the GCC economies are also experiencing a slowdown or not. Similarly, if the Fed raises interest rates in order to prevent inflation from building up in

the US economy, interest rates in the GCC will also need to rise in lockstep in order to maintain the peg.

Because the GMU members do not have monetary autonomy, and cannot use the exchange rate as automatic stabilizer, they will not need to worry about the cost of giving up the local currencies once the GMU is established. Therefore, they will not have to incur the typical and important costs associated with the introduction of a single currency.

Several studies conducted on the GMU miss this very important point. Many papers on the subject ask whether the GCC is an Optimum Currency Area (OCA)^{xviii}. An OCA is characterized by low inflation, free movement of labor, capital, and all other factors of productions, as well as economic convergence through business cycles synchronization. Using a range of methodologies, some scholars conclude that the GMU will be an economic liability because the OCA criteria are not met^{xix}. Others emphasize the economic advantage of the GMU as they find that the OCA criteria are met^{xx}. Is it important, however, to know whether the countries satisfy the OCA criteria or not for the purpose of evaluating the economic impact of the GMU? The answer is no. I will explain why.

The economic evaluation of monetary unions is a simple, straight-forward cost-benefit analysis. The benefits come from the increase in trade between the union members, and the costs come from the loss of monetary autonomy and the ability to use exchange rates as automatic stabilizers. Having identified the gains and the losses, we must then measure them. To assess the benefits we must estimate how big the increase in trade will be. To assess the costs, we must estimate how painful it will be for a country to give up its local currency.

The OCA analysis is used to measure the pain. If the OCA criteria are not met and the economies of the union members do not converge, giving up the local currency will be painful. On the other hand, if the OCA criteria are met and the economies converge, giving up the local currency will be less painful and it will

lead to a smooth transition because policies at the block level will closely match the preferred policies at the national level.

If countries have to bear a cost for giving up their local currencies – and I emphasize the *if* statement – then the OCA and convergence analysis reveals how big the associated cost is. But in the case of the GMU, union members do not have to incur this cost for the reasons explained above. Therefore, measuring how big the cost would be, if it existed, is not very informative for assessing the economic impact of a potential GMU.

That is not to say that establishing whether the GCC countries form an OCA and analyzing whether the economies converge or not is unimportant. The answer to both questions is central to understanding the dynamics of the GMU. But we must first make sure that we ask the right question. If the choice presented to the GMU potential member states were to either maintain their local currencies and move to a flexible exchange rate regime or adopt a single currency and a common monetary policy, then we would like to know whether the potential members of the GMU satisfy the OCA criteria^{xxi}.

But even if we ask the right question, we must be very cautious when performing cross-country comparisons in the GCC. The methodologies used to calculate the data in each country differ substantially. Take inflation for example. To compare inflation measures across the GCC countries, it is essential that the methodologies used to calculate inflation in each country are harmonized. Furthermore, we would like to ensure that this common methodology is the most appropriate. We are nowhere near this point in the Gulf. First, there is absolute lack of transparency on the methodologies used by each of the GCC countries. Second, these methodologies do not measure inflation accurately because the formulas used are based on fixed baskets of goods that do not change dynamically over time. This is a problem because the rate at which new products are introduced in the market is massive. Recent empirical evidence reveal that on average 40% of the retail items available today were not available two years ago, and 30% of the items that existed two years ago disappeared^{xxii}.

Simply put, pick a basket of goods in 2006 and try to measure how the price of that basket changes over time. If you look at the basket in 2010 it will seem as if there was a big hole in the basket, for now the basket is half-empty. So, we end up measuring the price of the remaining goods, re-adjusting the weights, and ignoring all the new goods that appear in the economy. Currently, the Gulf countries are taking substantial steps to improve the quality of their data. While their hard work and commitment will have an impact on the quality of the data in the future, nothing can be done to improve the quality of the historical data. Therefore, in the absence of harmonized methodologies and quality data, we must not attribute too much weight on cross-country comparisons.

Most central, however, is the fact that these cross-country comparisons reveal nothing about the future. The countries are changing. Great efforts are taken at huge costs in order to diversify the economies away from the hydrocarbon sector. Every country invests heavily in education, in research, in technology, and in promoting industries that are not linked to the oil and gas sectors. Under the corresponding National Visions, all countries have set their own roadmaps and set of strategies for how to become advanced economies in the next ten to twenty years. While some countries will be more successful than others, the sure thing is that the future structure of the economies will be different. There is absolutely nothing we can learn from historical data today about how the countries may look like ten years from now. Even today, the UAE and Qatar look nothing close to what they looked like ten years ago. Can many GCC residents, especially in Dubai and Doha, recognize their cities in photos taken a decade ago?

I conclude this section with a brief discussion of two ingredients that are extremely important for a functioning and successful monetary union: price stability mandate and fiscal coordination mechanisms. Price-stability results in high levels of output, low unemployment, financial stability, exchange rate stability, and low inflation. Economists and policy-makers alike agree that the most important, if not the only, mandate of a Central Bank should be price stability. Most of the macroeconomic gains associated with the EMU are attributed to the European Central Bank's commitment to fight inflation, a

credible commitment inherited from the Bundesbank. In the case of the GMU, setting price stability as the mandate of the Gulf Central Bank is purely symbolic as long as the single currency is pegged to the dollar. With a pegged currency, maintaining exchange rate stability will be, by default, the only true mandate.

A future change in the exchange rate regime that will see the single currency float will enable the Gulf Central Bank to adopt price stability as its mandate. When this happens, developing a mechanism for fiscal coordination in the GMU will be critical. Strong fiscal coordination ensures that the burden of country-specific shocks is not borne entirely by a single country. Without fiscal coordination and restrictions on borrowing, independent national fiscal policies that are favorable to bailouts raise the risk of moral hazard. Furthermore, in the absence of coordination, high pro-cyclical fiscal spending that is linked to the substantial oil revenues will undermine the goal of price-stability set forward by the Gulf Central Bank.

V. Institutional Building

A monetary union is not simply formed when a group of countries adopt a single currency and common monetary policy. This definition is missing the essential institutional building blocks of a monetary union, which are the most vital factors that participating countries benefit from. Identifying and understanding these factors, which we often neglect to talk about, is to me the most important element in discussing the potential benefits that the process of developing the Gulf Monetary Union may bring to the candidates.

Much of the GMU doctrine is based on the paradigm of the EMU. Well, we can copy the institutional structure of the EMU, we can adopt its legal and regulatory framework, but will the GMU run like an EMU? No. The DNA will still be different.

A true monetary union requires discipline, collaboration, communication, transparency, accountability, Central Banks' independence, expanded research capabilities, and broader availability of data to guide policy-making. While in the

EMU discourse we do not talk much about these ingredients since their existence is for the most part taken for granted, it is wrong to assume the same in the Gulf.

As I mentioned earlier, there is still a lot of work to be done in strengthening the statistical framework of each GMU member. The countries must work on the quality, timeliness, dissemination, and coverage of macroeconomic and financial statistics. Furthermore, the methodologies must be harmonized. Better data will improve the quantity and quality of research, and enhance policy making. The discussions for the establishment of the GMU helped some countries recognize earlier the need to strengthening the statistical framework. Recently, Bahrain and Qatar joined the IMF's General Data Dissemination System, and Saudi Arabia asked the Fund for technical assistance to improve its statistical framework.

Another requirement for a successful Union is that the regional Central Banks and the Gulf Central Bank become truly independent. Independence will help the countries maintain inflation at low levels. In the 70s and 80s, several countries faced high inflation rates, because the Central Banks had set high employment targets above the natural level. Why did they set the targets too high? They did it because the Central Banks were prone to political influence that looked at the short-term political gains associated with lower unemployment, and ignored the long-term economic costs of high inflation. Central Bank independence helps resolve this time-inconsistency problem. For the rapidly expanding Gulf countries, especially Qatar, maintaining low inflation is a challenge. Failure to control inflation can have devastating effects.

Independence of the Gulf Central Bank is a necessary, but not sufficient condition for successful monetary policies by the Gulf Central Bank. The GCB, as well as the regional Central Banks, must be accountable for their actions so that independence is used appropriately. They also have to be transparent on the economic, procedural, policy, and operational aspects of their operations^{xxiii}. Accountability and transparency will boost the GCB's credibility, they will protect its independence, and they will enhance the understanding and effectiveness of monetary policy. The importance of these three pillars of central

bank governance – independence, accountability, and transparency – is well understood and implemented in Europe and in other advanced economies, but not so much in the Gulf.

Another challenge that the Gulf countries face is how to improve communication and collaboration. Currently, there is little collaboration across countries, across departments, and even within departments. Whether this happens because individuals are concerned that intellectual property rights are weak in the Gulf and that their work can be copied by others if they try to share their work or collaborate, or whether they are afraid that they will be held accountable for their ideas, the end result is that there is very little sharing and collaboration. But how can the Gulf Monetary Union succeed if policy makers and academics do not learn how to collaborate, communicate, and share?

While for Europe the ingredients I described above, which we can also call technical requirements, to a certain level have been in place before the creation of the EMU, for the Gulf countries the absence of these ingredients should worry the Union enthusiasts. Too much focus is paid on evaluating the OCA criteria, on testing the convergence of the economies, and on examining whether the candidates satisfy the accession criteria that were set in Maastricht for the EMU candidates. This analysis is misplaced. First, we should care about fulfilling the technical requirements, and then we should focus on the rest. After all, the former will benefit each country with or without the GMU in place. The latter will matter only after the GMU is established and after the former requirements are met.

To the extent that the process of establishing the Gulf Monetary Union will raise awareness on the importance of these requirements and motivate the potential GMU members, both individually and jointly, to work hard towards meeting them, then the trip will be a very successful one, regardless of whether or not the GMU is established. By achieving these goals, the countries will be guaranteed long-term growth, for then the quality of institutions will be stronger. This is the true contribution of the Gulf Monetary Union to its members. The GMU process,

with the attention placed properly, aligns the incentives for a successful monetary union at the regional level, with the incentives for macroeconomic stability, long-term growth, and low inflation at the state level, and provides the guidelines on how all these can be achieved simultaneously.

VI. Conclusion

For the past three decades, the six countries of the Persian Gulf, namely Qatar, Bahrain, Kuwait, Oman, United Arab Emirates, and Saudi Arabia have been contemplating the establishment of the Gulf Monetary Union.

The establishment and early success of the European Monetary Union, along with the strong growth of the Gulf economies, accelerated the GMU discussions. By 2003 all Gulf States pegged their currencies to the US dollar, and 2010 was set as the target date for the launch of a single currency.

In the second half of the decade, however, the process was derailed and the launch of the single currency has been postponed. The withdrawal of Oman and United Arab Emirates, the impact of the global financial crisis on the Gulf economies, the slow progress that the member states have made, and perhaps second-thoughts by a member or two on the actual benefits that GMU will bring to their countries are all factors that contributed to the delay, and possible postponement of the GMU.

Politically, I think the GMU will be a liability. While it will increase bargaining power at the supranational level, it will also bring tensions both across and within countries. Economically, the GMU will bring some gains to the GMU through an increase in trade, but the gains will be small.

The true benefits will be institutional. The GMU process, if implemented correctly, will expedite the speed at which the Central Banks can achieve true independence, transparency, and accountability. Furthermore, the process will require the countries to expand their research capabilities and strengthen their statistical frameworks. Finally, it will demand more discipline, collaboration,

coordination, and sharing among the policy-makers and academics across countries and also within.

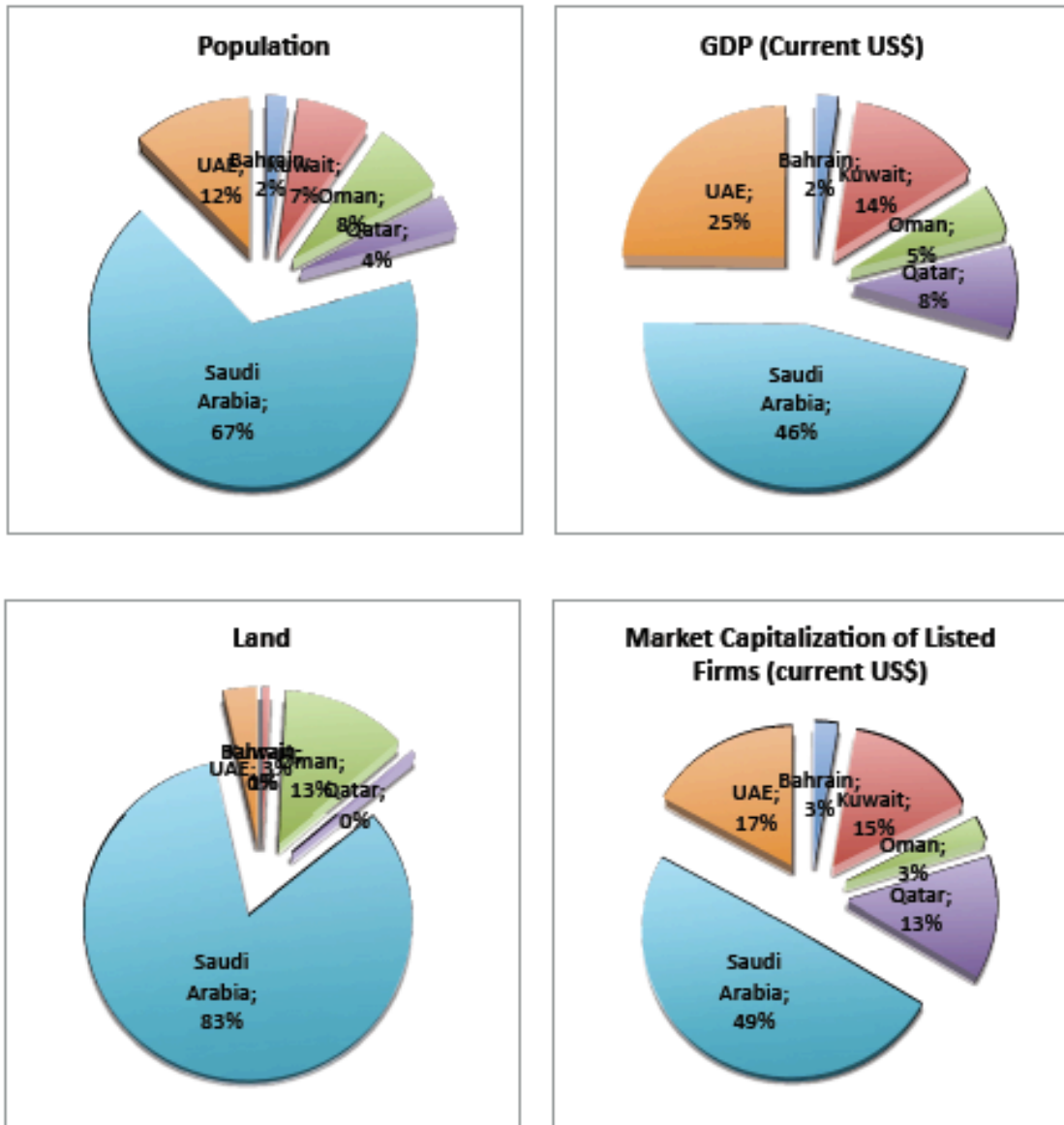
By meeting these requirements for the benefit of the Union, the Gulf States will increase economic efficiency in their countries that will lead to macroeconomic stability, enhanced policy-making, low inflation, and long-term growth. And these gains will be realized, even if the GMU is eventually not established.

A successfully established monetary union will have two additional and substantial benefits. First, the introduction of the single currency will act as a precursor to a possible change in the exchange rate regime, and a move away from the US dollar peg. Moving away from a fixed exchange rate regime and closer to a floating one will give back monetary autonomy to the Gulf and the ability to use the exchange rate as an automatic stabilizer.

Second, it will encourage other Middle East, non-GCC countries to aspire towards becoming a part of the GMU by achieving political and economic stability. A real benefit of the EMU is not what it has achieved directly for the participating members, but what it has achieved indirectly by encouraging non-EMU countries to improve their socioeconomic and political environments and streamline their legal and regulatory frameworks to that of the EMU so that they can be considered for participation during the enlargement rounds. By giving non-GCC countries an identity to seek, a strong GMU has the potential to export stability in the Middle East and lower the external threats the GCC countries face.

To conclude, the delay to launch the single currency appears to be a prudent course of action. First, the countries must move further along in their diversification efforts, and second, Oman and UAE must come back to the negotiating table before the GMU is established. But the discussions and preparations should continue. Only this time, the committees must recognize that there are additional and more fundamental requirements for establishing a successful monetary union, so that they can work hard towards meeting them.

Figure 1 - Population, GDP, Land, and Market Capitalization across the GCC



Source: World Development Indicators, 2009*

* 2007 data used for GDP

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ⁱⁱ IMF data and author's calculations

ⁱⁱⁱ Many Saudis cite internal conflict as the cause for the demise of the first and second Saudi states in the 19th century - a history they would rather not repeat.

^{iv} Kuwait is an exception. The country chose to move away from the dollar peg in May of 2007. It now pegs the Kuwaiti dinar to a basket of currencies, although it is widely believed that the US

dollar dominates the basket. As a result, the currency does not fluctuate much with respect to the US dollar.

^v Beatrice Maalouf, "The GCC: A Union to Be Reckoned With," Presented at the Congress of the Czech Political Science Society (2009)

^{vi} *ibid*

^{vii} A free trade area calls for the elimination of all tariffs and not-tariff-barriers (NTBs) in most traded goods and services between the participating countries. A customs union calls for a common external tariff between the free-trade area and its trading partner. Finally, a common market calls for freedom of movement of labor and capital, and the elimination of all physical, technical, and fiscal barriers across the member countries.

^{viii} See IMF's "GCC Monetary Union – Choice of Exchange Rate Regime" (2008)

^{ix} Khalid Al-Bassam, "The Gulf Cooperation Council Monetary Union: a Bahraini Perspective," BIS Papers no 17 (2003): 105-107

^x see International Monetary Fund, Roberto De Rato, Press Release No 05/231 (Oct 2005)

^{xi} Willem H. Buiter, "Economic, Political, and Institutional Prerequisites for Monetary Union Among the Members of the Gulf Cooperation Council," *Open Economies Review*, Spring, vol. 19(5) (2005), 579-612

^{xii} The US dollar will be negatively affect by a potential move of the GCC countries away from the peg because the markets may perceive the de-peg as the first step of a process that will lead to a non-dollar pricing of oil and oil derivatives.

^{xiii} The GMU countries must recognize that where the GCB is located and who gets to run it are two separate issues. Kuwait, Qatar, and Bahrain can argue that since the GCB is in Riyadh, the governor should be a national of their countries in order to maintain a balance. In Europe, tensions were created when both France and Germany fought over the location of the ECB. The tensions subsided when Germany got the location, and France the presidency.

^{xiv} Exchange rate volatility is not a major concern for intra-industry trade in the Gulf, as all currencies, with the exception of the Kuwaiti dinar, are pegged to the US dollar.

^{xv} Rose, A "One Money, One Market: The Effect of Common Currencies on Trade," *Economic Policy*, no 30, pp 9-45 (2000)

^{xvi} For evidence on the effect that the euro had on trade in Europe, see Frankel, J "The Estimated Effects of the Euro on Trade: Why are they Below Historical Evidence of the Effects of Monetary Unions Among Smaller Countries?" in *Europe and the Euro*, edited by Alberto Alesina & Francesco Giavazzi (University of Chicago Press) (2009), Baldwin, R. and D. Taglioni "Trade Effects of the Euro: A Comparison of Estimates," *Journal of Economic Integration*, vol 22(4) (2007), and Micco, A., E. Stein, and G. Ordonez "The Currency Union Effect on Trade: Early Evidence from EMU," *Economic Policy*, vol 18(37), pp 315-356 (2003)

^{xvii} See Martin Feldstein "The Case Against EMU," *The Economist*, June 13, pp 12 -19 (1992), *Ibid* "Why Maastricht Will (Still) Fail," *The National Interest*, no 32, pp 19-22 (2003), *Ibid* "The Political Economy of the European Economic and Monetary Union: Political Sources of an Economic Liability," *The Journal of Economic Perspectives*, no 4, pp 23-42 (1997a), and *Ibid* "EMU and International Conflict," *Foreign Affairs*, vol 76(4), pp 60-73 (1997b)

^{xviii} For the original discussion on Optimum Currency Areas see Mundel, R. A. "A Theory of Optimum Currency Areas" reprinted in Blejer, Mario et. Al. (1997) "Optimum Currency Areas: New Analytical and Policy Developments" IMF (1961)

^{xix} See for example Laabas, B., and I. Limam "Are GCC Countries Ready for Currency Union?," Arab Planning Institute, Kuwait (2005) and Shotar, M. and K. Shams "Economic Policies and the Possibilities of Unified GCC Currency", Qatar University (2005)

^{xx} See for example Khalid AlKhater ""The GCC Monetary Union and the Potential Strategic Gains: Aspirations and Challenges" Working Paper submitted at a seminar held at the GCC General Secretariat, March 6th, 2010, Riyadh, Saudi Arabia, Jadresic, E "On a Common Currency for the GCC Countries", IMF Policy Discussion Paper 02/12, Washington: International Monetary Fund (2002), Darrat, A., and F. Al-Shamsi "On the Path to Integration in the Gulf Region: Are the Gulf Economies Sufficiently Compatible?" (2003), AlKholifey A. and A. Alreshan "GCC Monetary Union", Saudi Arabian Monetary Agency (2009)

^{xxi} We would also need to be able to evaluate whether monetary autonomy and a flexible exchange rate would be a blessing or a curse. Independence of the Central Bank, transparency, accountability and credible commitment to fight inflation are some of the attributes required for the former to happen.

^{xxii} The evidence, which is part of ongoing work by the author, is based on monthly or bi-monthly scanner level retail data for each of the GCC countries going back five years.

^{xxiii} Economic transparency by the Central Bank is reached when all the information used to make assessments is made available to the public. Procedural is when the information on the process used (such as publication of minutes) is made available. Policy is when there is an immediate and timely announcement of monetary policy decisions, and operations is when the Central Bank provides information of the implementation of monetary policy, as well as evaluations of past policies. A recent book edited by Segalotto, Arnone, and Laurens (Segalotto, J-F, Arnone M. and L. Bernard (2009) "Central Bank Independence, Accountability, and Transparency: A Global Perspective," Palgrave) is an excellent reference on central banks governance.