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On the Monetary Union of the Gulf States

by

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On The Monetary Union of the Gulf States

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Abstract

This paper attempts to highlight the main characteristics of the economies of the Gulf Cooperation Council (GCC) and their plan to form a monetary union by 2010. Several aspects are considered such as the pattern of trade, the monetary side, and the fiscal side. The main conclusion is that the large similarities among the GCC members reduce the costs of introducing a single currency while the small intra-trade volume reduces the benefits. Furthermore, in general the GCC states have achieved a noteworthy degree of convergence taking the European convergence criteria as a reference.

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1. Introduction

The experience of the European integration and the successful introduction of the Euro motivated other countries to strengthen regional economic integration in general and monetary integration in particular. Since its establishment in 1981, the Gulf Cooperation Council (GCC) aims at supporting the economic integration among its six members Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates (UAE). Several major steps towards this goal have already been taken. The GCC states formed a customs union in 2003 and plan to enter the stage of a common market in the beginning of 2007. At the Muscat summit in December 2001, the GCC members agreed on launching a common currency by 2010. If this happens, it will be the first monetary union to follow the European monetary union. The International Monetary Fund (IMF) welcomed this decision by the GCC and offered policy advice and technical assistance.[1]

Joining a monetary union is associated with benefits such as lowering transaction costs, boosting trade, and reducing risk. In contrast, the main cost of a member country is the loss of its ability to purse a national monetary policy. In the case of the GCC states, similar economic structures, combined with other factors like culture similarities and a common language, support economic integration and the formation of the GCC monetary union. However, the GCC states are facing challenges concerning the choice of the future exchange rate regime, the agreement on convergence criteria, and the need for diversifying their economies. The main object of this paper is to provide an up to date brief overview on the issue. Previous papers that addressed the regional integration of the GCC states are, for instance, Fasano et al. (2003) and Sturm and Siegfried (2005).

The paper is organised as follows: Section 2 presents the main features of the GCC economies. Section 3 examines the pattern of trade in the region. Section 4 considers the monetary side while section 5 focuses on the fiscal side and further issues. Section 6 concludes.

2. Characteristics of the GCC economies

2.1 Main economic indicators

Table 1 displays the main economic indicators of the GCC states. The GDP (based on purchasing power parity PPP) for the GCC members as a whole is about 572 billion US dollar in 2005. This constitutes roughly one third of the GDP of France. The biggest economy among the six members is Saudi Arabia with a GDP of 337 billion US dollar in 2005, which is about 59 percent of the GDP of the whole block. The second biggest economy is the UAE with a 19 percent share in the total GDP for all members, while the smallest economy is Bahrain (2.7 percent). The region is characterised by relatively high real growth rates, for example 7 and 6 percent in the case of Bahrain and Saudi Arabia respectively (table 1). In 2004, the GCC area had about 35 million

[1] See for example IMF Press Release (2005) by the Managing Director Rodrigo De Rato.

inhabitants. With 24 million inhabitants Saudi Arabia has the largest share of the GCC population (68 percent). All GCC states are oil-dependent economies. This can be illustrated by looking at the share of the petroleum activities sector, including oil and natural gas, in nominal GDP. The share is the highest in Qatar (62.2 percent) followed by Saudi Arabia and Kuwait (47.8 percent and 47.6 respectively) and the lowest in Bahrain (23.2 percent).

The weighted average GDP per capita in 2005 for the GCC states is 17,374 US dollar. Qatar has the highest level among the members with 29,606 US dollar, which indeed exceeds the average GDP per capita for the Euro area that is 28,702 US dollar.[2] Saudi Arabia has the lowest level among the members with 14,592 US dollar. Thus, the difference between the highest and the lowest GDP per capita level among the GCC states is about 15,000. This difference is relatively small compared to the difference of 47,500 US Dollar in the Euro area between the highest GDP per capita level (Luxembourg) and the lowest one (Portugal).

Table 1: Main economic indicators in the GCC states in 2005

Country	**GDP (US$ Bill)**	**GDP share in the GCC GDP (percent)**	**GDP annual growth (percent)**	**GDP per capita (US$)**	**Petroleum activities[a]/ nominal GDP**	**Inhabitants[b] (Mill)**
Bahrain	15,796	2.76	7.1	19748	23.2	0.72
Kuwait	44,675	7.81	3.2	16297.2	47.6	2.61
Oman	39,559	6.92	3.8	16299.6	42	2.53
Qatar	23,584	4.12	5.5	29606.6	62.2	0.78
Saudi Arabia	337,268	58.97	6	14592	47.8	23.95
UAE	111,027	19.41	5.6	23722.8	32.6	4.28
GCC	571,909	100	5.56 [c]	17374.6 [c]	44.34 [c]	34.87

[a] Including the gas sector.

[b] Figures on inhabitants are in 2004.

[c] Weighted average based on the GDP share.

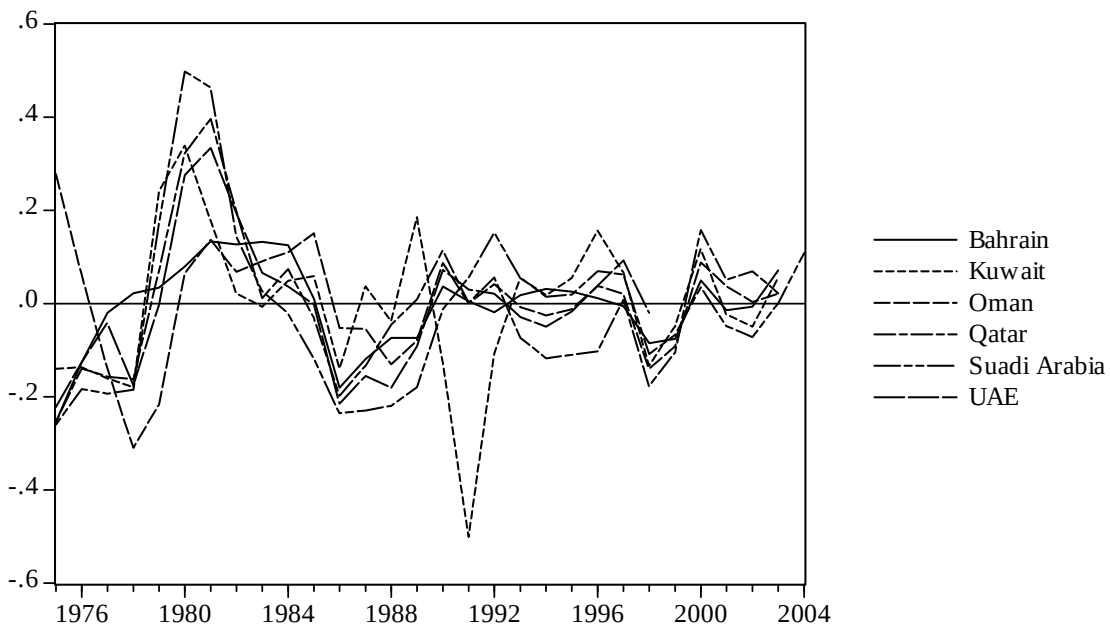
Source for data: IMF, International Financial Statistics (2004), World Economic Outlook (September 2005), and the national central banks.

[2] Unweighted average; Euro area refers to the 12 members in the European Monetary Union: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain.

2.2 Business cycle

The fact that all GCC economies are dependent on oil and oil activities suggests that the business cycles of these countries are highly correlated. Figure 2 draws the output gap for the GCC members calculated as the deviation of the GDP from the Hodrick-Prescott trend. Excluding Kuwait in 1990-91, the Gulf War period, a high correlation between the business cycles of all GCC members can be observed. Monetary unification means that a member state can no longer use national monetary policies. Instead, monetary policy is conducted by a union-level central bank. Based on the analysis of the theory of the Optimum Currency Areas, this is particularly costly for a member country in the case of asymmetric shocks when exchange rate policy might be needed at the national level.[3] For the GCC states with symmetric business cycles, the likelihood of asymmetric shocks to occur is rather small. Consequently, according to the theory of the Optimum Currency Areas, it is less costly to relinquish the ability to pursue a national monetary policy when forming the GCC monetary union. It should be mentioned that in the long run, when the GCC states decrease the dependency on oil activities and become more diversified, the correlation between their business cycles could be reduced.

Figure 1: Business cycles in the GCC states[a]



[a] Deviation from the Hodrick-Prescott trend.

Source for data: IMF, International Financial Statistics, 2004.

[3] See De Grauwe (2005) for a comprehensive theoretical analysis.

3. Trade

The GCC economies are open to international trade. This is indicated by the degree of openness defined as the ratio of exports plus imports to GDP. As listed in table 2, the ratio ranges between 73.6 percent (Saudi Arabia) to 147 percent (Bahrain). According to the World Trade Organization (WTO), Saudi Arabia is ranked number 19 in the list of the world exporters in 2004. All GCC members primarily export oil and oil products (including natural gas). The share of oil products and gas in total exports reaches 92 and 90 percent for Kuwait and Qatar[4] respectively in 2004 (table 2). The share is smallest for the UAE (35.8 percent). All GCC states are currently members in the WTO (table 2).

The main export destination for all GCC members is Asia; in particular the Far East and Japan. This is demonstrated in table 3. For example, 52.1 percent of Kuwait's exports go to Asia. If one adds Japan this share reaches 72.5 percent. A similar pattern of exports can be obtained from table 3 for the other GCC members. On the imports side, in general the EU and Asia are the main partners for the GCC members. As it is shown in table 4, the EU is the main source of imports to Kuwait, Oman, Qatar, and Saudi Arabia, while in the case of the UAE Asia is the major source of imports while the EU is the second major partner. Over the last decade the current accounts of all members show surpluses indicating that savings exceed investments in the GCC states.

Table 2: Trade indicators in the GCC states

Country	**Openness** [a]	**Petroleum activities** [b]**/ exports**	**WTO membership**
Bahrain	146.9	76.5	1995
Kuwait	92.5	92.8	1995
Oman	93.6	68	2000
Qatar	84.7	90	1996
Saudi Arabia	73.6	88.36	2005
UAE	132.8	35.8	1996

[a] Average 2001-2003, and 2004 for UAE and Qatar.

[b] Including gas; figures in 2004 except for Saudi Arabia in 2003.

Source for data: World Trade Organization and national central banks.

[4] Gas plays an important role in the case of Qatar.

Table 3: Destination of the GCC exports in 2004

	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	UAE
Asia	11.1	16.1	12.4	12.3	18.9	37.6
EU	27.5	37.2	29	45.5	31.1	33.1
Japan	7.3	12.8	16.7	5.1	9.7	1.4
USA	5.6	7.9	4.7	9.5	15.2	6
GCC	37.7	10.1	27.6	17.4	4.8	3.7
Others	10.8	15.9	9.6	10.2	20.3	18.2

Source for data: IMF International Trade Direction.

It is widely maintained that the benefits from a monetary union, especially by lowering transactions costs, depend positively on the degree of trade intensity among its members. Also, several studies claim that introducing a currency union has a considerable positive effect on bilateral trade.[5] Although the GCC is a free trade area since 1983, trade between the GCC members is rather small. This is obvious from tables 3 and 4. The share of exports to the GCC states to total exports is only 1.7 percent for Kuwait, and about 5 percent for Qatar, the UAE, and Saudi Arabia. This share is the highest for Oman with 9.1 percent (table 3). Concerning the import share, similar small figures are shown in table 4. Bahrain is an exception with a share of imports from the GCC to total imports reaching 37.7 percent. However, the small intra-trade volume is not surprising because the GCC states are similar especially in terms of their endowments. Considering the ratio of exports from one to the other GCC members to the non-oil exports provides somehow larger figures. This is indicated in table 5.

In fact, over the last two decades intra-trade in the GCC area has risen. For example, as it can be seen in figure 2, Saudi Arabia's exports to the GCC states in 2003 is 25 millions riyal (approximately 6 billions US dollar) compared to only 5 millions riyal (1.3 billions US dollar) in 1984. Notably, this trade is concentrated on Bahrain and the UAE. Furthermore, the increase in Saudi Arabia's trade is mainly due to the increase in trade with the UAE that had a very small trade share with Saudi Arabia in 1984 as compared to 2004. The same pattern occurs on the imports side.

[5] For example Rose (2000) and Glick and Rose (2002).

To boost trade in the GCC area, the member states entered the stage of a customs union in the beginning of 2003 with a standard common tariff of 5 percent on all commodities imported from outside the area.[6] This step broadly presented a decrease in the average tariff rates for the individual members compared to the prior situation. Referring to 1997 for example, the average tariff rate was highest in Saudi Arabia (12.3 percent), followed by Bahrain and UAE (8 percent), Qatar (7 percent), and Kuwait (6 percent), while Oman had the lowest rate of 4.8 percent.[7] Additional attempts to enhance economic integration among the member states are reflected by the GCC plan to form a common market in the beginning of 2007.[8]

Table 4: The source of the GCC Imports in 2004

	Bahrain	**Kuwait**	**Oman**	**Qatar**	**Saudi Arabia**	**UAE**
Asia	11.1	16.1	12.4	12.3	18.9	37.6
EU	27.5	37.2	29	45.5	31.1	33.1
Japan	7.3	12.8	16.7	5.1	9.7	1.4
USA	5.6	7.9	4.7	9.5	15.2	6
GCC	37.7	10.1	27.6	17.4	4.8	3.7
Others	10.8	15.9	9.6	10.2	20.3	18.2

Source for data: IMF International Trade Direction.

[6] Exceptions are related to alcoholic and tobacco products.

[7] Source: IMF Country Report (2005).

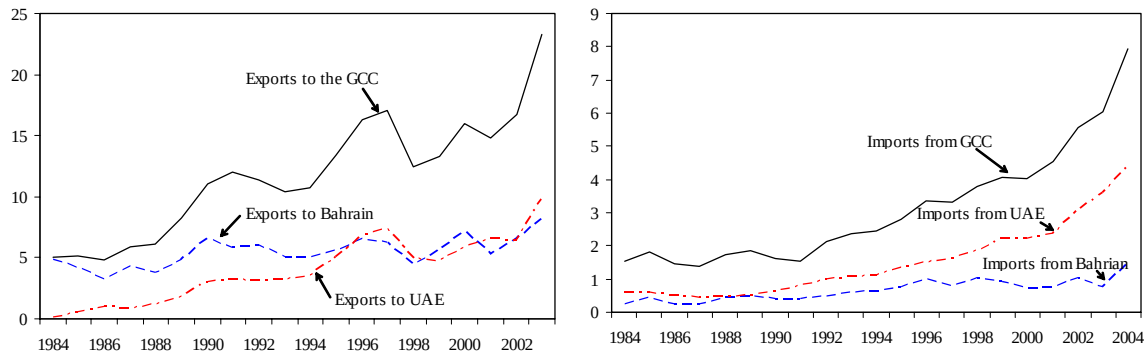
[8] As far as trade in the region is concerned, it should be mentioned that in May 2003 the Bush administration proposed establishing a US Middle East Free Trade Area (MEFTA) by 2013. Thus far, out of the six GCC members only Bahrain attained a free trade agreement with the US in 2004. Currently Oman and UAE negotiate, on bilateral bases, for the establishment of free trade agreements with the US. Strikingly, these negotiations are made individually and not by the block as a whole.

Table 5: Non-oil exports within the GCC states 2004

	Exports to GCC/Non-oil exports
Bahrain	37.4%
Kuwait	-
Oman	50.2%
Qatar	26.5%
Saudi Arabia	28.6%
UAE	13.1%

Source for data: The national central banks.

Figure 2: Exports and imports of Saudi Arabia to and from the GCC members[a]



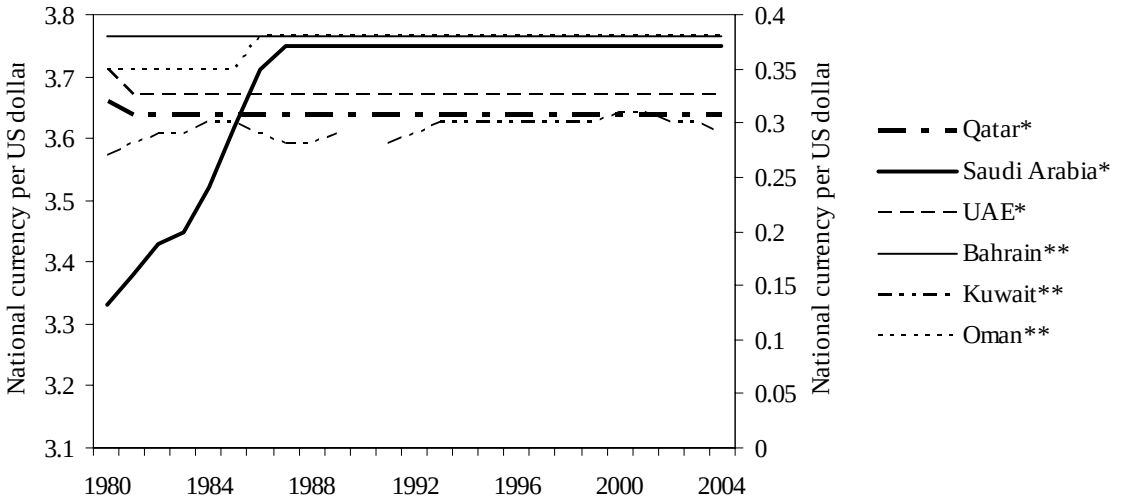
[a] Figures on the vertical axis are in billions of Saudi Arabia riyal.
Source for data: Central bank of Saudi Arabia.

4. Monetary side

4.1 Exchange rate

According to the IMF, until 2001, four out of the six GCC currencies, namely, the Bahraini dinar, the Qatar riyal, the Saudi Arabian riyal, and the UAE dirham, fluctuated around the value of the special drawing rights (SDR). Concerning the remaining two currencies, the Omani rial is officially pegged to the US dollar since 1973 and the Kuwaiti dinar is determined according to a weighted basket of currencies. However, in practise, as it is shown in figure 3, all currencies except for the Kuwaiti dinar have a de facto fixed exchange rate vis-à-vis the US dollar for the last two decades. Since 1980 the Bahraini dinar and the Qatar riyal have been pegged to US dollar at the rate of 0.37 per $ and 3.64 per $, respectively. Likewise, since the 1980s the Saudi riyal (1986) and UAE

Figure 3: Exchange rates in the GCC states; national currency per US dollar



* Left-hand scale.
** Right-hand scale.
Source for data: IMF, International Financial Statistics, 2004.

dirham (1981) are fixed at a rate of 3.75 per $ and 3.67 per $, respectively. Additionally, the Kuwaiti dinar showed a stable exchange rate against the US dollar especially since the gulf war in 1991. As a step towards a complete monetary union, the GCC introduced a de-jure peg in 2001. The formal agreement states that a fixed exchange rate of all GCC currencies vis-à-vis the US dollar must be maintained. Given the already existing stability of GCC states' exchange rates and the de facto peg to the US dollar, the agreement in practise did not require major modifications by the national authorities.

An important point must be emphasised with this regard. Recalling that the GCC states are open to international capital flows and given the fixed peg, essentially, by forming a monetary union, the GCC states are *not* relinquishing a policy instrument. This token follows from the principle of the impossible trinity according to which the following three conditions cannot be maintained simultaneously: a fixed exchange rate, full capital mobility, and monetary policy independence.

Thus far, it is not formally stated whether the future common currency will be pegged to an external anchor, the US dollar or a basket of currencies for instance, or whether it will operate under a floating exchange rate system. In choosing the future exchange rate regime, the GCC must take into consideration two important aspects. On the one hand, the fixed exchange rate with the US dollar worked well against high volatility in oil prices and keeping inflation[9] in track. One must recall in this context that oil products, the key exports of the GCC states, are usually priced in US dollar and not in local currencies. On the other hand, a more flexible exchange rate regime might

[9] See next section on inflation in the GCC states.

be more beneficial to the non-oil sector in terms of competitiveness of the non-oil exports. This especially arises since all GCC economies are aiming at a higher degree of diversification, and consequently, a potential increase in the relative importance of the non-oil sector. This aspect is particularly relevant for those countries with declining reserves of oil and gas (Oman and Bahrain).

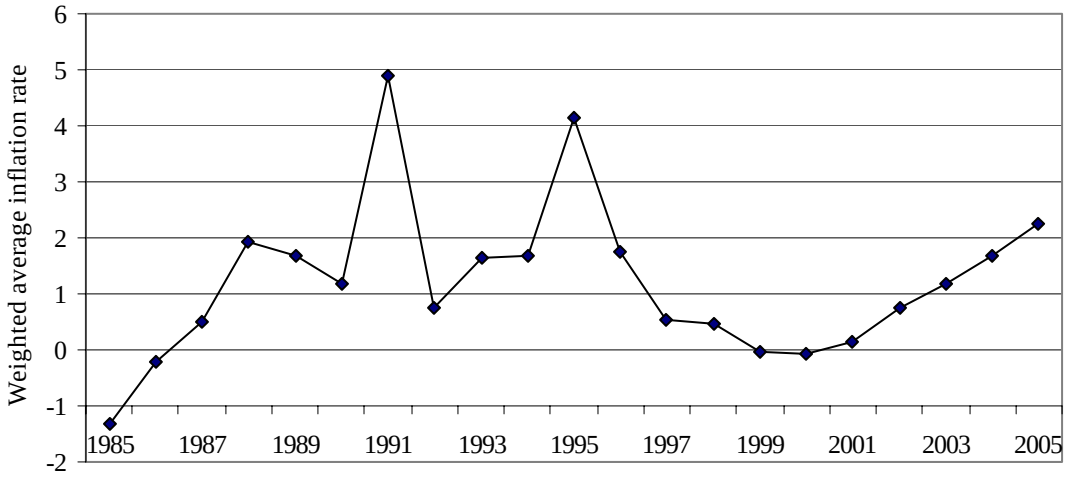
Abed et al. (2003) compare a peg of the future common currency to a basket consisting of the US dollar and the euro with the peg to the US dollar. They conclude that at the current conditions there is no significant gain from selecting the euro-dollar basket instead of the dollar peg. Abed et al. put forward a basket of currencies consisting of at least the US dollar and the euro with a larger weight of the dollar to serve as a conservative transitional step in the direction of a more flexible exchange rate regime. The discussion about the choice of the exchange rate system is best summarised by Frankel (1999): “no single currency regime is right for all countries or at all times”. For the time being, several grounds, perhaps, drive the preference of the GCC towards a hard peg in the sense of a fixed exchange rate of the incipient common currency. First, as mentioned above, it is a policy that has been applied for years and performed well and that the GCC central bankers are familiar with. Second, in the region of the Middle East that is subject to some political instability, a hard peg to an external anchor might be important at least within the step of bringing in the new currency so it can gain confidence and insulate itself from probable external shocks. Third, a soft peg is easier said than done. This is indicated by the hypothesis of vanishing intermediate regime (Frankel 1999, Fischer 2001); that is, countries tend to move towards one of two extremes, either hard peg or floating. Hence, given the current conditions the key issue is the choice between a peg to the US dollar or a basket that contains the US dollar and the euro rather than a choices between a fixed or floating exchange rate system. It should be added, however, that such a consensus stands in contrast to the choice of other main oil exporting countries such as Norway and Venezuela that have independently floating exchange-rate arrangements; or Iran that switched in March 2002 to a market-based managed floating exchange rate system.

4.2 Inflation

Although inflation experiences vary among the member states, the average inflation rate of the GCC area as a whole was relatively low in the last decade. In fact, figure 4 illustrates that the weighted average inflation is below 2 percent since 1996 but with an upward trend reaching 2.25 percent in 2005. Exceptionally high inflation rates were recorded in 1991 and 1995. The fixed exchange rates played an important role in keeping inflation in check in the GCC area.

Looking at the individual country experience in the last 20 years, in principle, inflation rates tend to be volatile. As can be seen from figure 5, the GCC members witnessed *temporarily* high inflation rates due to country-specific events, but succeeded in controlling inflation after periods of upward pressure. An obvious case is Kuwait in 1991 when the inflation rate reached 9.8 percent directly

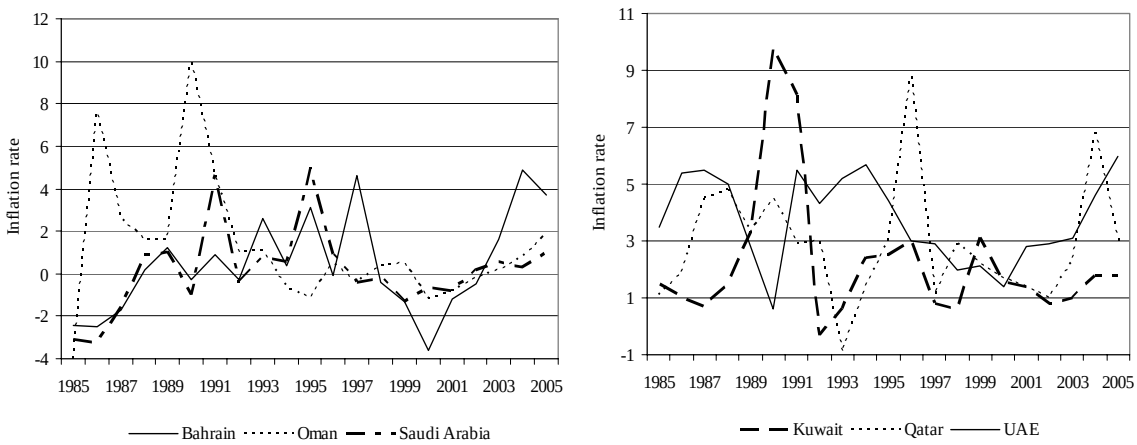
Figure 4: Weighted average inflation rate for the GCC union



Source for data: IMF, World Economic Outlook, September 2005.

after the Gulf War. In subsequent years inflation has significantly declined in Kuwait. Another case for inflationary experience is for instance Qatar in 2004 when the highest inflation rate among the GCC members was recorded (6.8 percent). Qatar's central bank reported that inflationary pressure in the country was due to the boom in the reconstruction sector; a significant increase in rents due to pulling down many buildings for modernisation and rebuilding purposes. In 2005 Qatar's inflation rate dropped to 3 percent. In the same year, high inflation occurred in the UAE (6 percent). Saudi Arabia, the biggest economy in the GCC, has had fairly low inflation rates, even negative rates sometimes, over the last 15 years; exceptions are the years 1991 and 1995.

Figure 5: Inflation rates of the GCC states



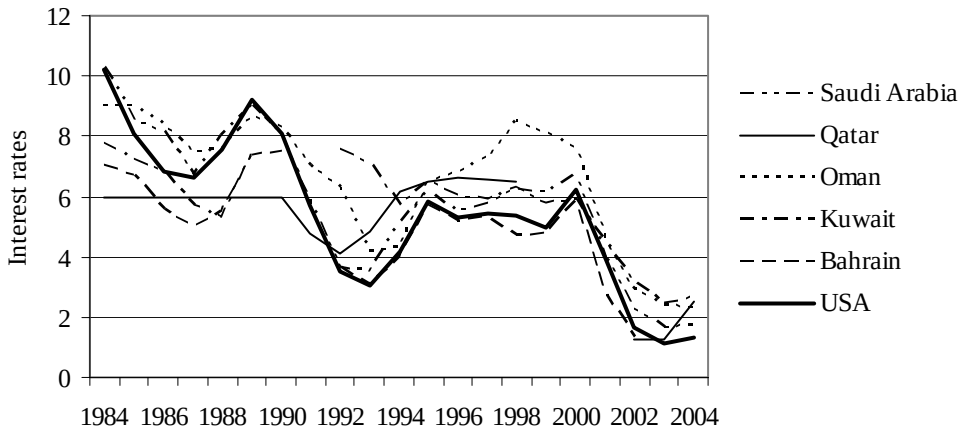
Source for data: IMF, World Economic Outlook, September 2005.

Obviously, the attitude to price stability leads to the question: Who is in charge on pursuing the monetary policy in the future GCC monetary union? The ideal answer is a common independent central bank. In essence, the establishment of the central bank at the union level as an independent body should be obtainable. The national central banks of the GCC states have a sort of independence. For instance, in Saudi Arabia the law prohibits the financing of the government deficit by the central bank. In other GCC states it is allowed but only temporarily advances not to exceed 10 percent of the budget revenue of the preceding year, and to be repaid within three months. Yet, it is not fully clear if the GCC members will agree on establishing this union-level institution or will chose a form of coordination between the national central banks instead.

4.3 Interest rate

Figure 6 plots the interest rates on three months deposit in the GCC states and the US Federal funds rate. Figure 6 shows that, in the last two decades, the interest rates in the GCC states co-moved. Qatar had a fixed interest rate until 1990. Afterwards, the interest rate fluctuated in line with other GCC interest rates. Additionally, figure 6 emphasises the fact that the GCC interest rates closely follow the US interest rate; in the case of Bahrain and Saudi Arabia; the interest rates of both countries almost coincide with that of the US. This is not surprising given the fixed peg to the US dollar. As a consequence, the difference between the highest and the lowest interest rate in the GCC area is quite small, making no need for massive convergence steps, in this context, ahead of introducing a single currency.

Figure 6: Interest rates in the GCC states



Source for data: IMF, International Financial Statistics, 2004, and national central banks.

5. Fiscal side

5.1 Deficit

The discussion on the budgetary issues in the GCC states presented here draws attentions to three important aspects. First, for all GCC states the major source for government revenues is the revenues of the oil and oil activities sector (table 6). Government expenditures tend to move pro-cyclically with total revenues and consequently with oil sector revenues. Figure 7 demonstrates this fact over time. For each country, the dashed line, presenting the oil sector revenues, is clearly the chief source of the total government revenues (thick line), as is reflected by the small distance between the two curves. Additionally, a co-movement between the government expenditures curve and the oil sector revenues curve is easily observed.

Second, all members witnessed budget deficits in the 90s and succeeded in achieving surpluses at 4least from 2002 on. In the case of the UAE, a balanced budget was accomplished in 2004. This is also shown in figure 7.

The third point to be highlighted is that revenues from oil activities are exhaustible. This means, in the long run the GCC governments must rely on alternative sources for revenue. The projected depletion of oil reserves is: 2011 Bahrain, 2022 Oman, 2049 Qatar, 2077 Saudi Arabia, 2110 UAE, and 2121 Kuwait.[10] Gas reserves depletion is projected as follow: 2012 Bahrain, 2060 Oman, 2112 Saudi Arabia, 2139 UAE, 2191 Kuwait, and 2840 Qatar. Thus, the issue of finding substitutions for oil activities revenue is predominantly relevant for Bahrain and Oman.

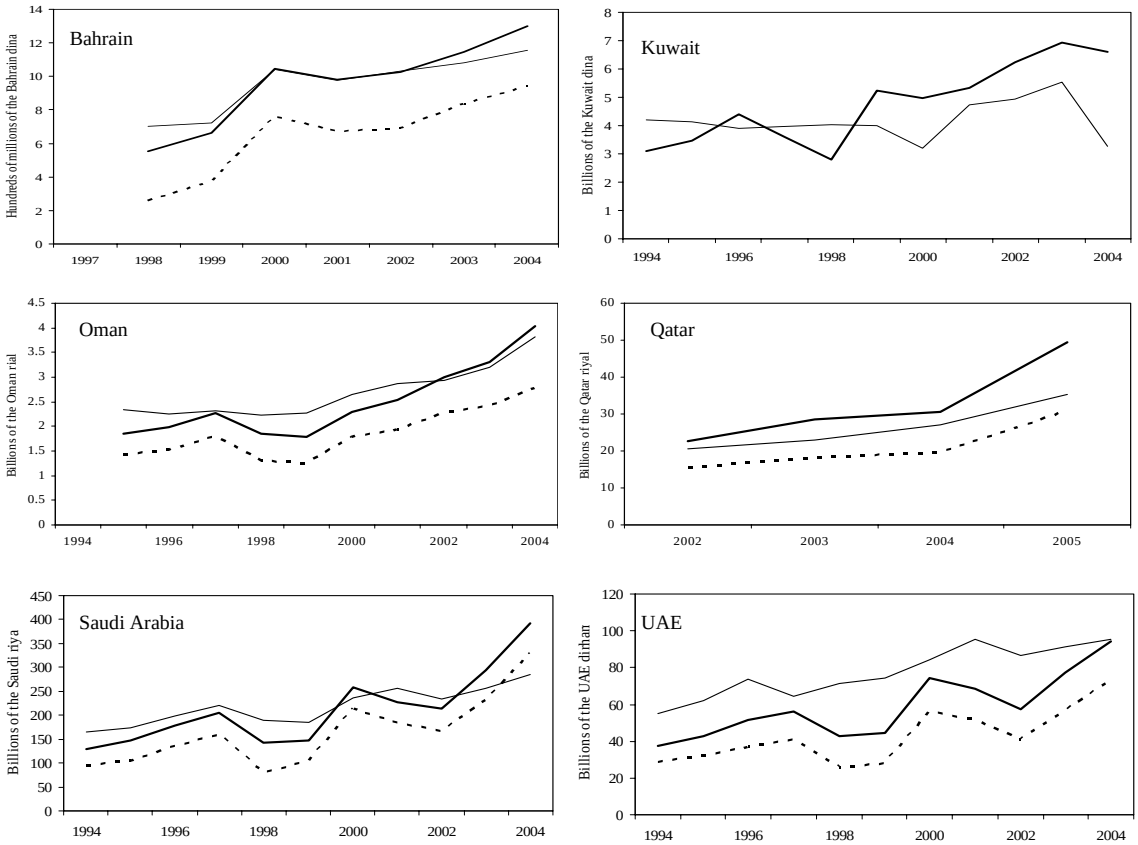
Table 6: The share of oil revenue in total government revenues in 2004

Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	UAE
72.6	88.5	68.9	64.3	84.1	77.6

Source for data: The national central banks.

[10] Source: BP Review of World Energy.

Figure 7: Public finance in the GCC states[a]



Source for data: The national central banks.

5.2 Debt

The GCC states have relatively low debt-to-GDP ratios as indicated in table 7. Comparing the figures in 2005 with 1998-2002 averages, the member states succeeded in reducing the debt ratios remarkably, and it is projected to have lower debt ratios in 2006. The UAE is characterised by the lowest debt ratio in the GCC states while Saudi Arabia has the highest one. Striking, in this context, is the substantial decrease in the Saudi Arabia debt ratio, from 82 percent in 2003 to 27.3 percent in 2006, as a result of embarking on policies supported by the recent boom in oil prices to reduce the public debt (table 7).

5.3 Convergence

In 2005, the members of the GCC agreed on applying convergence criteria that are in line with the EU convergence criteria: 1) Budget deficit lower than 3 percent of the GDP. 2) Public debt-to-GDP ratio lower than 60 percent. 3) Currency reserves in excess of at least four months' imports. 4) The interest rate should not exceed the average of the lowest three countries' rate by more than 2

Table 7: Debt-to-GDP ratios in the GCC states

	1998-2002	2003	2004	2005	2006
Bahrain	29	37.1	28.6	24.8	23.5
Kuwait	43.6	27.6	20.4	14	11.9
Oman	27.4	16.4	15.4	11.1	9.5
Qatar	76.1	54.3	42.2	30.2	24.4
Saudi Arabia	96.7	82	65	42.7	27.3
UAE	5.5	6.6	8.4	6.6	2.8

Source for data: IMF Regional Report, September 2005.

percent. 5) Inflation rate that is not more than 1.5 percent higher than the average of the six states' rate. The final version of the GCC criteria is not clearly announced yet and the European Central bank is asked to provide support.[11] Of course, there are no theoretical reasons to apply exactly the same criteria as the EU. Additionally, it is important to note that the GCC convergence criteria are unlikely to be selection criteria for entering the union because the decision has already been made to include all GCC members. Consequently, the criteria will serve as a policy guide.

With respect to public finance, currently all members satisfy the budget deficit norm. Indeed, as demonstrated above, the GCC states succeeded in achieving budget surpluses. Nonetheless, one caveat must be made here. Because of the high dependency of government spending on revenues from the oil activities sector, fiscal expansion within periods of high oil revenue is perhaps not reflected by a higher deficit ratio. The reason for this is that higher oil prices cause a higher GDP value and higher revenues. Therefore, the ratio of budget deficit to GDP might give a misleading picture of the fiscal policy stance. Based on this token, some argue in favour of incorporating the ratio of non-oil balance to non-oil GDP as an indicator for fiscal policy in oil-dependent countries.[12] Regarding the debt ratio, based on the figures in 2004, Saudi Arabia is the only country that does not satisfy the debt criterion. Nevertheless, as mentioned before, recently Saudi Arabia successfully reduced its public debt ratio and therefore satisfies the condition starting from 2005.

The GCC states retain relatively high foreign reserves. Table 8 shows that in 2004 all states, except Bahrain, held reserves that cover the imports of 4 months. It should be noted that increasing the period to cover imports of 6 months, for example, will cause Bahrain and UAE violate the reserves requirement.

[11] Based on statements by the GCC officials; see for example Financial Times Deutschland (2005).

[12] The non-oil fiscal balance as an indicator for fiscal stance in oil-producing countries is examined by Barnett and Ossowski (2002).

Table 8: Foreign reserves and 4-Months imports in the GCC states

	Bahrain	**Kuwait**	**Oman**	**Qatar**	**Saudi Arabia**	**UAE**
Reserves[a]	1.94	8.25	3.6	3.4	27.3	18.5
4-Months Imports[b]	2	3.64	2.65	1.8	13.6	18

[a] Total reserves minus gold.

[b] Calculated as: annual imports*(1/3).

Source for data: IMF, international Financial Statistics, 2004, and the national central banks.

With reference to the monetary criteria, no major convergence steps are needed. The already existing fixed peg to the US dollar makes no need to introduce bilateral parities as the European Monetary System did prior to the introduction of the euro. Concerning the interest rate, as a result of following the US interest rate the interest rate criterion is satisfied by all members. Careful attention however is needed regarding inflation volatility in the individual member states. In 2004, inflation rates in Bahrain (4.9 percent), Qatar (6.8 percent), and the UAE (4.6 percent) exceeded the weighted average of the block that is 1.68 percent by more than 2 percent. In fact, in the case of Qatar the difference reached 4.5 percent. Based on the figures in 2005, only the UAE, with 6 percent inflation rate compared to 2.25 weighted average GCC rate, violates the criterion. This gives rise to the importance of a clearly specified reference period for all convergence criteria; i.e. the entry year or a period average.

Which country meets or violates what criterion? Table 9 summarises the answer this question taking 2004 as a reference year. Overall, table 9 can be interpreted such that the GCC states have achieved a noteworthy degree of convergence though inflation tends to be an exception.

Table 9 Convergence in the GCC states, 2004 as a reference year

	Bahrain	**Kuwait**	**Oman**	**Qatar**	**Saudi Arabia**	**UAE**
Deficit	Yes	Yes	Yes	Yes	Yes	Yes
Debt	Yes	Yes	Yes	Yes	No	Yes
Reserves	No	Yes	Yes	Yes	Yes	Yes
Interest rate	Yes	Yes	Yes	Yes	Yes	Yes
Inflation	No	Yes	Yes	No	Yes	No

Source: Own construction.

5.4 Diversification and further issues

Diversification

Without a doubt, the principal challenge facing all GCC members is to diversify their economies and maintain a stronger non-oil sector. Actions are in directions of supporting foreign direct investment, the tourism sector, privatisation, infrastructure development, and establishing financial centres.[13] The two countries with lower oil-dependency ratio are the UAE and Bahrain. The UAE leaded by Dubai is a straightforward example. Massive projects are implemented to invest in the tourism sector and to found the leading business centre in the region. Also, Bahrain is finding its way by supporting tourism and establishing a centre for Islamic banking. Other members such as Saudi Arabia attempt to support the manufacturing base. Diversification and enhancing non-oil activities are linked to another challenge, namely labour market reforms and the creation of new jobs. The region is characterised by a very high population growth. The GCC region had 35 million inhabitants in 2004 compared to 13.76 million in 1980.[14] All GCC economies have a large public sector and heavily rely on foreign human capital. The public sector cannot absorb the increase in the labour supply. Especially, nationals have strong preferences to work in the public sector. Free movement of labour within the block does not add much to this issue. First, it is expected to be low, and second in general GCC nationals have similar educational bases. In brief, diversification is not only relevant in the long run or only for those states with declining reserves but it is also an immediate need.

Enlargement

At this stage a potential enlargement for the GCC future common market and the monetary union is not on the agenda. Scenarios that one might think of is to expand the block to include the whole Arabian peninsular, that is to say Yemen join the union. Certainly, including Yemen with GDP per capita that is only about 500 US dollar generates larger differences among members. However, Chami et al. (2004) estimate a positive effect of such an enlargement. Other scenarios such as the inclusion of other Arabic countries is by large a political process that is not planned yet. Furthermore, the fairly small trade volume between the GCC states and their neighbour countries retard the domino effect as a driving force of an enlargement. The domino theory (Baldwin 1995) emphasises that discriminatory effects resulting from deepening a free trade area creates, through affecting the relative competitiveness, political economy forces that lead to speeding up the enlargement.

[13] See for example Fasano, U. and Iqbal, Z. (2003).

[14] Source: IMF, International Financial Statistics, 2004.

6. Conclusion

The GCC states are open and highly oil-dependent economies that operate at a fixed exchange rate regime pegged to the US dollar. Starting from the establishment of the free trade area in 1983, the member states agreed on several steps to deepen the economic integration: the establishment of a customs union in 2003, the planned establishment of the common market in 2007, and the agreement to introduce a single currency by 2010. Due to considerable similarities among the GCC economies the formation of the monetary union is associated with low costs. Given the already existing fixed exchange rate system, introducing a single currency cannot be considered as a massive change. Furthermore, the review presented in this paper suggests that the GCC states achieved a remarkable degree of convergence in terms of criteria similar to the European convergence criteria. Since the theoretical trade integration of the GCC states is not yet reflected by a large intra-GCC trade volume, the expected economic benefits associated with introducing a common currency might be lowered. Reducing oil-dependency is the key issue facing the GCC to maintain stronger economies and pick up the benefits of a deeper integration.

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