

Journal of Economics Bibliography

www.kspjournals.org

Volume 5

June 2018

Issue 2

Feasibility study on the implementation of a Unified Currency in the Gulf Cooperation Council

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Abstract. The paper discusses the feasibility of a unified currency among the Gulf Cooperation Council (GCC) countries and suggests policies to be used should it be implemented. Several other currency unions are examined as inspiration for policies and strategies to apply to the GCC's prospective currency union.

Keywords. Gulf Cooperation Council, Central bank, Currency board, Currency union, Monetary union.

JEL. E52, E58.

1. Introduction

The Gulf Cooperation Council (GCC) is an alliance between six Middle Eastern member states: The Kingdom of Saudi Arabia, Kuwait, the United Arab Emirates (UAE), Bahrain, Qatar, and Oman. The council was established in May 1981 in Riyadh, Saudi Arabia with the goals of political and economic unification. A "Supreme Council" is the joint decision-making tool of the GCC and is made up of heads of state from the respective member states. An appointed president oversees the council. The presidency rotates annually among the six heads of state.ⁱ

Since inception, the GCC has held the goal of creating a unified currency. The Council sees widespread opportunity for mutual benefit across member states. A unified currency would see the abolition of exchange rates between national currencies, breaking down a barrier to trade between the countries and expanding trade opportunities. This would make the members of the GCC more competitive, in addition to effectively unifying markets across the six nations. A unification of markets would also result in a unification of monetary and economic policy that would strengthen ties between member states and ultimately assist in reaching the wider political goals of the council.ⁱⁱ

As the next section outlines in detail, the GCC has failed to implement a currency union so far. The subsequent sections of this paper analyze the strategies of existing major currency unions and one past currency union in the hopes of applying them to a potential currency union in the GCC. The main aspects studied are the governance structures and the profit sharing schemes of each of the respective currency unions. The Eastern Caribbean Currency Union offers an interesting potential solution to the GCC's unique political problem in the form of offering each member of its governing body an equal vote. The now defunct Malayan Currency Board implemented a profit sharing scheme that could be applicable to the GCC. The European Central Bank uses an unbalanced voting right rotation system, but has a streamlined and efficient organizational structure that could be used to the benefit of the GCC. The CFA franc zone, which is actually two currency unions in Africa, is also discussed, but is found to be less

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Journal of Economics Bibliography

relevant to the GCC. This is due to the oversight of the French central bank and France's support for the pegged exchange rate of the CFA francs to the French franc and later the euro.

2. The GCC's failure to implement a Unified Currency

One condition for the success of any monetary union is a degree of political cooperation, although, as we will see, the level of cooperation has varied widely across currency unions. There are also significant economic factors that play into the politics of forming a unified currency. In recent history, the GCC nations have not exhibited the prerequisite cooperative attitudes for the establishment of a unified currency (Kholifey, & AlReshan, n.d.). Oman pulled out of the unified currency agreement in 2006 due to concerns about its ability to meet the criteria set forth for the unified currency. These concerns were mainly related to maintaining a specific level of debt as a portion of GDP. Similar concerns for the UAE caused the country's withdrawal from discussions in 2009. Oman's concerns point to a larger issue with the economic compatibility of the GCC when it comes to the sizes of their respective economies. Figure 1 shows the GDP of the countries of the GCC. There is a great disparity in size between the economies. Saudi Arabia is far and away the largest economy, with a GDP of \$678 billion. The UAE is the second-largest economy, with a GDP of \$378 billion. Saudi Arabia has a greater GDP than most of the other GCC countries combined. This massive gap in economic size is another contributing factor to situations like the one that transpired with Oman. There must be monetary policy set in place when forming the unified currency that levels the playing field between the member nations. Saudi Arabia may be economically ready for a unified currency, but if the other nations in the council are not prepared, the unified currency is bound to fail. As a result, this paper will focus on suggesting monetary policies and institutional arrangements that could help mitigate the issues that arise from this economic disparity, using successful monetary unions as inspiration for solutions.

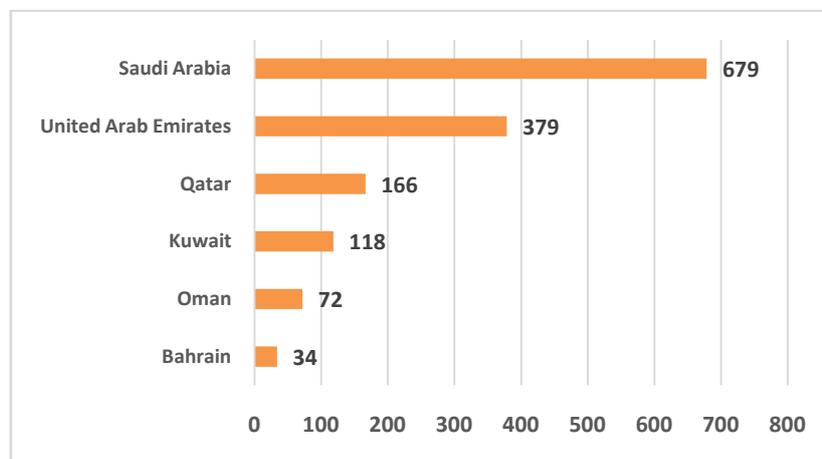


Figure 1. GDP of GCC Member States in Billions of USD, 2017
Source: IMF World Economic Outlook Data Mapper, 2017.

3. An Overview of Some Successful Monetary Unions

The monetary unions that will be examined in this paper are the Eastern Caribbean Currency Union, Malayan Currency Board, European Monetary Union, and CFA franc zone. All are currency unions founded since World War II and each comprises or has comprised three or more independent countries. The latter criteria was chosen to exclude currency unions between only two countries, which would not provide an applicable analogue for the GCC since it is made up of several countries. A currency union between two countries lacks the political and governing complexity that is found in currency unions between more countries.

Journal of Economics Bibliography

This paper will use a specific framework to analyze the previously mentioned currency unions and then offer suggestions as to how to apply previously successful policies to the GCC and its potential currency union. The first step of the process is to outline the details of each of the currency unions, how they operate, and how they were formed. This will give insight as to how the GCC could establish its own currency union in the future. Details include the members of the union, whether the currency is linked to another currency, the size of the central bank assets by the end of 2016, and any allegiance to a political union.

The second step is to outline the legal framework and governance of the currency union. This is mainly encompassed by how the currency union was adopted, and, most importantly, how the governance of the currency board is implemented. The manner in which the currency union distribute profits generated from central banking activities among its constituents is the third step in the analysis. Finally, any changes to governance as a result of historical controversy will be noted.

4. Eastern Caribbean Currency Union (ECCU)

4.1. Basic Facts

The Eastern Caribbean Currency Union (ECCU) is made up of six former British colonies - Antigua and Barbuda, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, Dominica, and Grenada - plus two British overseas territories, Anguilla and Montserrat. It was formed in 1983 and is governed by the Eastern Caribbean Central Bank (ECCB), headquartered in Basseterre, Saint Kitts. The members of the ECCU use a common currency called the Eastern Caribbean dollar, which is pegged to the U.S. dollar at 2.70 ECD to 1 USD (Van Beek, *et. al.*, 2000). At the end of 2016, the ECCU held net assets (foreign and domestic) worth 15.782 billion ECD (IMF, 2017).

The ECCB is the successor to the British Caribbean Currency Board and the East Caribbean Currency Authority. The currency board was established in 1951 as an economic component of the stillborn West Indies Federation. By 1965 the two largest members of the currency board, Guyana and Trinidad and Tobago, had left to establish their own central banks. The remaining members converted the currency board into the currency authority, which had greater discretionary powers but not all those typical of a full-fledged central bank. Barbados left to establish its own central bank in 1972. In 1976 the remaining members switched the anchor currency from the pound sterling to the U.S. dollar at the existing cross rate, and in 1983 they converted the currency authority into a full-fledged central bank. The members of the ECCU are also part of a political union called the Organization of Eastern Caribbean States (OECS). The organization was established in 1981 by the signing of the Treaty of Basseterre, with the aim of creating economic unity and protecting human and legal rights. In 2010, the treaty was revised to create an economic union similar to that of the European Union. It established a unified financial and economic space in which goods can move freely and monetary policy was made uniform.ⁱⁱⁱ

4.2. Legal Matters and Governance

The ECCB Agreement Act of 1983^{iv} specified the legal framework and governance of the new central bank. Aside from establishing the bank as an independent legal entity, Part II of the agreement also outlined the main objectives of the central bank. They are: (1) “to regulate the availability of money and credit”; (2) “to promote and maintain monetary stability”; (3) “to promote credit and exchange conditions and a sound financial structure conducive to the balanced growth and development of the economies of the territories of the Participating Governments”; and (4) “to actively promote through means consistent with its other objectives the economic development of the territories of the Participating Governments.”

Journal of Economics Bibliography

The agreement also establishes in Part IIA the central bank's powers in times of special emergency. Emergencies, in this case, are times in which the bank perceives the interests of the people to be endangered, or a financial institution is in imminent danger of failing to meet its obligations. This section gives the central bank the ability to investigate, seize control of, and even restructure the capital base of a financial institution, among other powers, during times of emergency.

As for governance, the agreement outlines in Part IV how the central bank will be managed. The central bank's governing body is divided into two main groups, the Monetary Council and the Board of Directors. Monetary and credit policy is determined by the Monetary Council as described in Article 7 of the agreement. Each member country appoints one minister to the council, who has the right to a single vote. The ministers elect a Chairman of the council, who has the right to a single vote, in addition to the ability to break a tie with a casting vote. Decisions are made with a simple majority of present ministers, with a required quorum of five of the six member countries. General administration of the central bank and policy decisions are entrusted to the Board of Directors. Directors are selected by member nations just like the Monetary Council. The Governor and Deputy Governor of the Board of Directors are appointed by the Monetary Council and serves for terms of up to five consecutive years. The Governor (or in his place the Deputy Governor) has no vote except in the event of a tie. In essence, the Board of Directors acts as the embodiment of the bank, and the Governor has the power to take action on behalf of the central bank such as signing documents. The Monetary Council, on the other hand, is responsible for making the broad monetary and credit policies that the central bank will implement.

The ECCB Agreement does not specify a particular exchange rate or exchange rate policy for the Eastern Caribbean dollar. It does however specify that external reserves must equal at least 60 percent of the ECCB's currency in circulation and demand liabilities—in other words, the monetary base. In addition, the agreement outlines a policy for the establishment and maintenance of a general reserve. At the end of every fiscal year, the ECCB's general reserve holdings must be equal to no less than 5 percent of the bank's demand liabilities. Should the reserve fall below 5 percent, any net profits generated by the bank's activities are used to replenish the general reserve up to 10 percent of demand liabilities. The Agreement does not specify capital contributions, which could eventually threaten the currency union should tensions arise over uneven contribution. Recent publications by the IMF and World Bank have called on the ECCB to amend their policies to set a minimum capital contribution for admittance into the ECCU (IMF, 2017).

4.3. Applying the ECCB's Legal Structure to the GCC

By inspecting the governance structure of the ECCB, we can identify many potentially useful ideas for the GCC. One important thing to note is the simplicity of the structure of the bank's governing bodies. Although the member nations making up the ECCB are similar in size, giving each country the ability to appoint a minister and director of its choice, each with equal voting power, equalizes power differences between the nations. When considering the nations of the GCC, a massive hurdle in the path of establishing a unified currency is that the Kingdom of Saudi Arabia is so much larger than the other countries. By giving each country equal voting rights on both boards, the political weight of each ECCB member country is not determined by the size of its economy. Doing likewise in the GCC would encourage the smaller countries to join the currency union, as they would have decision power disproportionate to their economic size.

A second useful idea is the ability of the ECCB Monetary Council to appoint the Governor of the Board of Directors. In the GCC, Saudi Arabia has historically dominated political discussions due to its sheer size. Allowing Saudi Arabia only one vote and the other five, smaller nations one vote each would give the other nations the ability to appoint a Governor who is not from Saudi Arabia. This would give them the opportunity to have more control over the currency union than if

Journal of Economics Bibliography

Saudi Arabia were to have representatives in locked into position of power on both governing bodies.

That being said, there are some aspects of the ECCB model that likely would not be successful when applied to the GCC currency union. The existence of two separate governing bodies that appear to have similar, nearly overlapping sets of responsibilities could prove to be detrimental to the GCC union. The Middle East is already riddled by bureaucracy, and adding additional layers of complexity would only slow decision-making. The countries of the GCC have tried repeatedly to implement a currency union, with little success. They have already demonstrated an ability to defer decisions and delay implementation, so putting in place two separate governing bodies would only hinder the central bank's ability to operate efficiently. That is especially the case considering the political volatility of the member nations and their interactions. Hence, using one committee, the Board of Directors, to administer the central bank would likely be more efficient in the GCC union's case.

4.4. Profit Sharing

A central bank, like other types of banks, performs activities that generate revenue. Revenue comes from interest on loans to commercial banks or other entities as well as from interest and capital gains on domestic government securities and foreign securities. As the profits of a central bank are normally kept by its respective country, in the case of monetary unions one of the key monetary policy decisions is how to distribute profits among member nations. Here again the ECCB offers an interesting model.

The Eastern Caribbean Central Bank Act specifies that net profits generated by the end of the fiscal year be dispersed among member nations in proportion to the amount of currency in circulation in the respective country.³⁶ The ECCU's longevity indicates that this redistribution policy has not caused significant strife between the member nations. However, this may be because the members of the ECCU are all relatively similar in size.

Figure 2 below shows the GDP in billions of USD for each member of the ECCU. The largest country in the currency union – Saint Lucia – has a GDP of 1.72 billion USD. The smallest country in the currency union – Dominica – has a GDP of 0.61 billion USD. This represents a spread of 1.1 billion USD, with Dominica having an economy³⁶ percent the size of Saint Lucia. Now let us consider the nations that make up the GCC. Saudi Arabia has a GDP of 679 billion USD, whereas the smallest country in the GCC – Bahrain – has a GDP of 34 billion USD. This represents a spread of 645 billion USD, with Bahrain having an economy close to only 5 percent the size of Saudi Arabia.

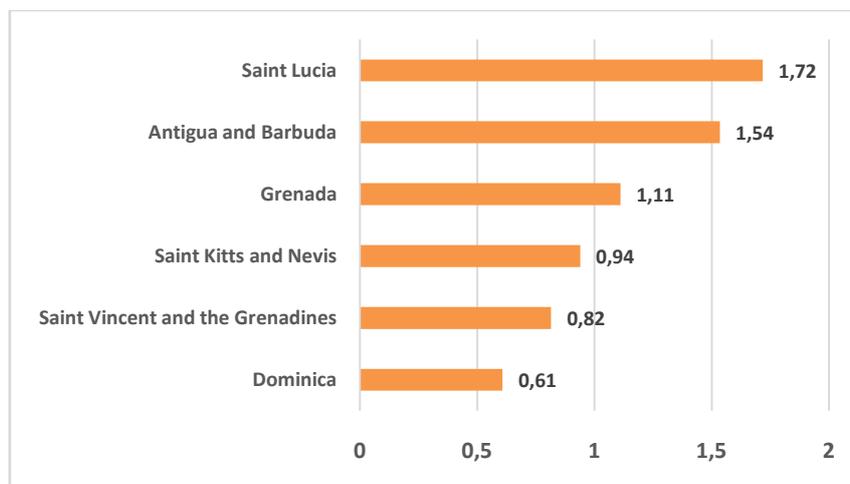


Figure 2. GDP of Eastern Caribbean Central Bank Member States in Billions of USD, 2017

Journal of Economics Bibliography

Although GDP size is not a direct indicator of the amount of money in circulation, it gives a general idea of proportion. A large economy tends to have more money in circulation than a smaller economy. While it is difficult to compare the exact sizes of money supplies in the GCC countries due to the different compositions of their money supplies, Saudi Arabia did in fact have the largest money supply in 2013 as well as the fastest growth rate (Pratap, 2013).

The large difference in money supply between the GCC countries makes this profit redistribution scheme unsuitable for a potential currency union in the GCC. It provides little incentive for smaller GCC countries like Oman and Bahrain to participate in a monetary union.

Alessandra Casella of Colombia University found that “a small economy will not take part in the [monetary union] agreement unless it can secure influence that is more than proportional to its size and a transfer of seignior age revenues in its favor” (Casella, 1990).

When considering a political make up like that of the GCC, with countries of extremely varied sizes, profit sharing is an essential piece of the currency union that will draw in the smaller countries. In the case of the ECCU, all the member nations are relatively close in size. This is not the case for the GCC. Therefore, a profit redistribution scheme based on money supply is unlikely to incentivize smaller countries in the GCC to join a monetary union. A reworked profit sharing formula must be proposed that disproportionately rewards the smaller nations in order to guarantee their participation.

5. Malayan Currency Board (MCB)

5.1. Basic Facts

Unlike the other currency unions discussed, the Malayan Currency Board is no longer in existence. This currency board is considered because it was fairly durable, surviving the independence of its most populous member. The currency board also had unique features, which differed from that of other currency boards due to the Malayan currency board’s more limited powers.

The British protectorates of the Malayan States and the British-ruled Straits Settlements formed the Malayan Currency Board (MCB) in 1938. The Malayan States had been using Straits Settlements currency without a share in the profits the Straits Settlements generated from issuing the currency. The MCB permitted them to share in the profits. The MCB used the former exchange rate of the Straits Settlement dollar, \$1 Malayan to 2 shillings and 4 pence sterling, or \$50 Malayan to £7 (George, 2016). This rate was specified in the agreement establishing the MCB, as was a reserve ratio of 100 to 110 percent, to be held in British securities, British Empire securities other than those of the participating governments, or other assets approved by the British Secretary of State for the Colonies.

The Malayan Currency Board was first headquartered in Singapore, where the Straits Settlements currency board had been, but moved to Kuala Lumpur in 1962, keeping an office in Singapore.

During World War II the territories of the MCB were under Japanese occupation, but the MCB held its assets in London, out of reach for the Japanese, and resumed operations after the war. In 1946 the separate protected states of the Malayan peninsula united to form the Malayan Union. In 1952 Brunei, Sarawak, and British North Borneo joined the MCB, occasioning a revision of the MCB agreement. Malaya became independent in 1957 and there was another revision of the agreement in 1960 to remove certain powers formerly exercised by British colonial officials. In 1963, Malaya, Sarawak, North Borneo, and Singapore united to form Malaysia. Friction within the federation led to Singapore’s expulsion from it in 1965. The currency board ceased operation in 1967.

Journal of Economics Bibliography

5.2. Legal Matters and Governance

The 1938 constitution of the Malayan Currency Board established the Board of Commissioners of Currency Malaya, which was made up of a maximum of five members. The members were appointed by the Governor of the Straits Settlements and the High Commission of the Malay States. The Commissioners of Currency were endowed with the sole ability to issue currency notes in the territories of the member states. The 1938 agreement did not specify any geographical distribution of the board of commissioners. The 1951 revision of the constitution specified one member each from Malaya, Singapore, and the combined territories of Brunei, Sarawak, and North Borneo, plus two persons agreed upon by the member governments and not representing any particular territory. The 1960 revision of the constitution gave Malaysia two members; Singapore, Brunei, Sarawak, and North Borneo one member each; plus one person agreed upon by all the member governments, with recognized banking or financial experience, and not representing any particular territory.

The MCB was not a central bank, and accordingly it had no power to act as a lender of last resort to commercial banks. Until the revision of its constitution in 1960, the MCB was expected to refrain from holding securities issued by member governments, and even after 1960, in practice it did not take advantage of its potential ability to hold domestic securities.

5.3. Profit Sharing

The MCB's 1938 constitution implemented the Currency Fund Income Account, which tracked all of the revenue generated by the Malayan dollar. At the end of the fiscal year, expenses were deducted from this account and the surplus was funneled into the All Malaya (Currency Surplus) Fund. Each government in the union was entitled to a share of the fund as listed in Figure 3. The shares were determined by an expert committee, which based them on the expected circulation of Malayan currency in each jurisdiction, itself largely a function of the jurisdiction's economic size.

	<i>Per Cent.</i>	
Government of the Straits Settlements ...	37.00	
.. .. Perak ...	16.75	
.. .. Selangor ...	12.75	
.. .. Negri Sembilan ...	4.50	
.. .. Pahang ...	3.00	
Total Federated Malay States ...	37.00	
	<i>Per Cent.</i>	
Government of Johore ...	9.25	
.. .. Kedah ...	7.00	
.. .. Kelantan ...	5.25	
.. .. Trengganu ...	3.00	
.. .. Perlis ...	0.75	
.. .. Brunei ...	0.75	
Total Unfederated Malay States ...	26.00	

Figure 3. *Distribution of Profits, Malayan Currency Board*

Source: Malayan Currency Board constitution, *Singapore Government Gazette*, October 14, 1938, p. 2849.

The agreement set the initial shares assigned to each government. Every five years, a new scale could be voted on and if agreed upon by governments with cumulative shares of over 75 percent, the new scale would take effect. If no new scale was agreed upon, the existing scale would stay in effect for the next five

Journal of Economics Bibliography

years. In addition, any shortage in the Currency Fund Income Account had to be recouped by the governments in the union proportional to their outstanding shares.^{vi} The MCB had no paid-in capital, so this provision was inserted in case of the unlikely event that the MCB's high level of external assets turned out to be insufficient to meet demands for liquidation.

5.4. Applying the MCB's Profit Sharing Procedure to the GCC

The MCB's method of allocating profit shares could be better suited to the needs of the GCC than assigning shares based on capital. By assigning shares more flexibly, the GCC could have more control over how potential members are rewarded. For example, smaller countries such as Oman and Bahrain could be assigned larger shares of the surplus fund to induce them to join the currency union. In addition, the restructuring mechanism would work to the GCC's benefit. Should the smaller countries start to catch up to the larger economies in the future, the shares could be rebalanced every five years to adapt to current conditions without having to adjust the capital contributions (George, 2016).

6. European Union (EU) and European Central Bank (ECB)

6.1. Basic Facts

The European Union (EU), established in 1993 by the Maastricht Treaty, is a political and economic union that now extends to 27 European countries (Wilde, 2017). The EU is also in part a currency union: 19 member nations use the common currency, the euro, and the expectation is that the rest will join eventually, except Britain, which is negotiating to leave the EU. The monetary policy of the currency union is governed by the European Central Bank (ECB), headquartered in Frankfurt, Germany.

The euro was launched as a unit of account in 1999, but not issued as cash until January 1, 2002. At inception, the cash was introduced at fixed conversion rates in the countries that adopted it. Between 1999 and 2002, the euro was an "invisible currency."

Today, the euro, like most mature economies' currencies, is a floating currency. This means that its exchange rates are determined by market forces. However, the ECB still plays a major role in monitoring and maintaining the stability of the currency in the exchange markets (Smaghi, 2009). As for the assets held by the ECB at the end of 2016, €349 billion worth of assets were reported in its 2016 annual accounts.^{vii}

6.2. Legal Matters and Governance

The main governing body of the ECB is the Governing Council. Members of the Governing Council include the Executive Board of the ECB and the governors of the respective national central banks. All members of the Executive Board receive a vote, but only 15 governors receive a vote. Once there are more than 22 governors, article 10.2 of the ECB statute outlines a method through which voting rights are determined. In short, governors are ranked and placed in groups that receive a different number of voting rights per group, often fewer than the number of governors in said group. The rankings are determined by the relative share of the national central bank of the respective governor in the aggregate GDP of the European Union. The higher the share of a country's GDP in the EU, the better its governor ranks and the higher the likelihood of him receiving voting rights. Governors within a grouping rotate voting rights.^{viii}

The responsibilities of this Governing Council are described in Article 10. The Governing Council is responsible for making decisions regarding the actions the ECB is mandated to conduct, establishing monetary policy, and intermediate monetary policy. The latter could include setting key interest rates and decisions relating to supplying ECB reserves. The Executive Board essentially implements

Journal of Economics Bibliography

decisions made by the Governing Board and relays information to the national central banks.

The ECB has some organizational features that should be considered by the GCC union, and others that should be avoided. Placing governors on a voting rotation established by their countries' share of the aggregate GDP could be entirely destructive to the goals of the currency union. If implemented in the GCC, the Kingdom of Saudi Arabia would have a great advantage over the remaining, relatively smaller countries of the GCC. Saudi Arabia represents 47 percent of the aggregate GDP of the GCC.^{ix} Should Saudi Arabia always have a governor, or at least more often than others, with voting rights on the Governing Board, it would have a bigger influence on decision making than other members of the union. This would be politically unsustainable and unrealistic considering historic resistance from other GCC countries towards a currency union for this very reason. (Note that in the euro area, Germany, the largest economy, only has 29 percent of the total GDP.^x)

One feature of the ECB that is applicable to the GCC union is the use of the Executive Board as an implementation tool. The Executive Board serves to "execute" decisions made by the Governing Board, instead of being an additional decision-making hurdle. This could serve as a model for the GCC union as it offers a tool for carrying out decisions. Having a central body that coordinates among the national central banks would offer a streamlined and efficient method of carrying out policy decisions.

6.3. Profit Sharing

In the ECB statute, Article 28 states that the capital holdings of the ECB shall be €5 billion as of the establishment of the ECB. Currently, the capital holdings of the ECB stand at €10.8 billion.^{xi} Article 29 details the Key for Capital Subscription, in which the shares of the capital holdings are distributed among the member nations. This is calculated as the sum of: (1) 50 percent of the share of its respective Member State in the population of the Community in the penultimate year preceding the establishment of the European System of Central Banks (ESCB) and (2) 50 percent of the share of its respective Member State in the gross domestic product at market prices of the Community as recorded in the last five years preceding the penultimate year before the establishment of the ESCB. Later, Article 33 states that all "Monetary Income" – income generated by the execution of monetary policy – shall be redistributed to the member states in proportion to their paid-up shares.

6.4. Applying the ECB Model to the GCC

Let us use the format dictated by Article 29 to see how these numbers would play out in the GCC. First, each country's share of the total GCC population using the most recently collected census data from the Gulf Labour Markets and Migration Programme are as follows:

Table 1. Population Shares of GCC States^{xii}

Country	Date/Period	Total Population	Share of Total Pop.
Bahrain	mid-2016	1,423,726	2.68%
Kuwait	31 Dec 2016	4,411,124	8.31%
Oman	7 April 2017	4,599,051	8.66%
Qatar	Feb 2017	2,673,022	5.03%
Saudi Arabia	May 2016	31,742,308	59.76%
United Arab Emirates	mid-2010	8,264,070	15.56%
Total		53,113,301	100%

Next, we calculate each country's 2017 GDP as a share of the whole GCC's aggregate GDP using the IMF Data Mapper as a source:

Journal of Economics Bibliography

Table 2. *GDP Shares of GCC States*

Country	GDP (bn USD)	Share of Total GDP
Bahrain	33.873	2.34%
Kuwait	118.271	8.17%
Oman	71.931	4.97%
Qatar	166.346	11.49%
Saudi Arabia	678.541	46.87%
United Arab Emirates	378.656	26.16%
Total	1447.618	100%

Source: IMF, World Economic Outlook (2017)

Finally, we average the two percentages to get the capital key percentages for each country:

Table 3. *Capital Shares of Prospective GCC Central Bank, Calculated Like ECB Shares*

Country	Share of Total Pop.	Share of Total GDP	Capital Key %
Bahrain	2.68%	2.34%	2.51%
Kuwait	8.31%	8.17%	8.24%
Oman	8.66%	4.97%	6.81%
Qatar	5.03%	11.49%	8.26%
Saudi Arabia	59.76%	46.87%	53.32%
United Arab Emirates	15.56%	26.16%	20.86%
Total	100%	100%	100.00%

Source: Author's calculations.

This model employed by the EU has its advantages. The first is the uneven distribution of capital contribution. It is an advantage because the member nations must also contribute capital to the central bank in proportion to their shares. In our above example Saudi Arabia, the largest economy in the GCC and Middle East, would contribute 53.32 percent of the capital holdings of the central bank. If Saudi Arabia were to continue using the EU as an analogue, a capital of €10.8 billion would result in a Saudi contribution of €5.8 billion. The largest economy in the union would be putting up the largest upfront capital. Smaller countries in the union like Oman and Bahrain would be incentivized by this structure, as they would not have to put as much capital at risk. Saudi Arabia might be getting the most of the redistributed profits, but it would also be taking on the biggest financial burden.

The second advantage of this model is its dynamic nature. By using GDP and population as the determining factors for capital contribution, a country's share of the central bank's capital holdings can grow if its economy grows relative to other union members. This factor will incentivize countries in the union to grow their economies to obtain a higher share of their central bank's capital holdings and the profits associated with it.

That being said, this model also comes with disadvantages. Since the capital being contributed to the currency union's central bank is coming from the member nations' existing capital holdings at their own central banks, the capital contribution could be seen as a simple repositioning of funds. Assuming that each country had enough capital holdings currently to fulfill its contributions to the central fund, no new capital would need to be generated. If this perspective is taken, there would be zero risk in transferring existing funds to another bank that is under the country's purview. Not only that, but each country would still have legal ownership of the capital it contributed, represented by its share in the joint central bank. As a result, the differing capital contributions could be seen as inconsequential and not seen as a motivating factor for smaller countries.

The risk here lies in the collective management of the joint central bank. If poorly managed, the contributed capital could be lost. Since the money would not be managed by the national central banks, distrust could sow doubt. In addition, countries like Saudi Arabia and the UAE, which would contribute the most capital, might feel a greater sense of investment in the union and attempt to control it. We have seen examples in the past of the larger countries of the GCC strong-arming

the smaller ones. The recent tensions between Qatar and the rest of the GCC resulted in the expulsion of Qatari nationals from Saudi Arabia and the UAE. This disproportionate contribution effectively equalizes the economic strain placed on the member nations, but does little to alleviate political tension.

7. CFA Franc Zone

7.1. Basic Facts

The CFA Franc Zone is a combination of two currency unions: the Central African Economic and Monetary Community (CEMAC), whose central bank is the Banque des Etats de l’Afrique Centrale (BEAC) and the West African Economic and Monetary Union (WAEMU), whose central bank is the Banque Centrale des Etas de l’Afrique de l’Ouest (BCEAO). Figure 4 is a map of the members of both unions.

Both unions trace back to the Banque de l’AfriqueOccidentale, a Paris bank that issued notes throughout French colonies in Sub-Saharan Africa. During World War II French Equatorial Africa aligned with the Free French government in exile and issued a currency distinct from that issued by the Banque de l’AfriqueOccidentale in French West Africa, which remained aligned with the French wartime regime in Vichy. The division persisted after the war and the independence of most of French colonies in 1960. Guinea and Mauritania left the currency unions and established their own central banks, but the former Spanish colony of Equatorial Guinea and the former Portuguese colony of Guinea-Bissau later joined the unions.

Each union has its own central bank, issuing currencies that are distinct but both called the CFA franc. Each union has a separate treaty with France with similar features and policies. The CFA franc is pegged at 655.957 CFA francs per euro. The rate was previously pegged at 100 CFA francs per French franc, and the rate with the euro is the cross rate that existed when France joined the euro area.

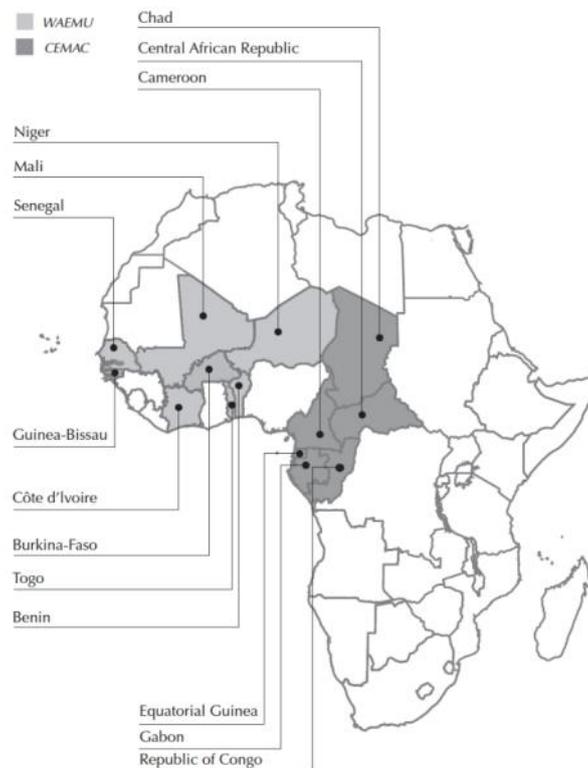


Figure 4. Map of the CFA Franc Zone and Its Two Central Banks

Source: IMF – “The CFA Franc Zone: Common Currency, Uncommon Challenges,” Anne Marie Gulde, 2 April 2008.

Journal of Economics Bibliography

7.2. Legal Matters and Governance

Initially France had half the votes on the boards of directors of BEAC and BCEAO. In 1972 and 1973 revisions of the central bank constitutions reduced France to a single vote, like the African member countries. Arguably the most notable part of the agreements between the two currency unions and France today is that France guarantees the conversion rate of the two currencies. The French Treasury holds a special operations account for the central banks, which serve as a source of overdraft capacity should a reserve shortage occur (Gulde, & Tsangarides, 2008).

However, this deal comes with three caveats. The first is a requirement for 20 percent of the central banks' sight liabilities to be held in foreign exchange reserves. The second is a requirement for 50 percent of those foreign exchange reserves to be held in the French Treasury's operations account. The third is an interest rate hike should an overdraft occur.

What this deal accomplishes for the currency unions is increased stability. Della Corte *et al.*, (2015) found that exchange rates depreciate when there are sovereign risk shocks. By offering WAEMU and CEMAC a pegged exchange rate, it insulates the two unions' currencies from sovereign risk. This provides much needed stability in the region, especially when considering that several member nations are exporters of oil, which is subject to volatile swings in prices.

Despite the provisions to safeguard the exchange rate of the CFA franc, it was devalued in 1994 from 50 per French franc to 100 per French franc. The central banks were not sufficiently vigorous in following the rules. They lent excessively to government enterprises and depleted their foreign reserves. France refused a bailout without a devaluation and a promise to tighten oversight. The CEMAC and WAEMU economic unions are intended to help keep that promise.

The extensive French involvement in the CFA franc zone since its beginning and continuing through today has no potential analogue for the GCC countries. Despite its long history and relatively successful record of maintaining a pegged exchange rate with its anchor currency, it does not seem to be a good example from which to draw lessons for a GCC monetary union.

8. Conclusions

8.1. Type of Monetary Authority

Whatever the potential merits of a currency board, it does not seem to be in the cards politically for the GCC. Excluding Saudi Arabia, all the GCC members once had currency boards, which they have since replaced with central banks. All now have people with the managerial capacity to operate central banks and all seem to want the degree of discretionary monetary policy that central banking offers, in particular the ability to serve as a lender of last resort to commercial banks. Accordingly, the analysis here has focused on a joint central bank.

8.2. Legal Matters and Governance

Perhaps the most applicable voting model of the central banks and currency board mentioned in this paper is that of the Eastern Caribbean Central Bank. One member is appointed from each member country and each member has an equal vote. A simple majority is required to pass decisions. This can serve to be a great equalizer between the political powerhouses of the GCC. Countries with more political power like Saudi Arabia or the UAE threaten to dominate the smaller countries of the GCC in the decision-making arena. Although the countries' economic sizes are nowhere near proportional, giving them equal votes in the currency union would incentivize the smaller members to join. In the Eastern Caribbean Currency Union, the member nations were relatively similar in size, so giving them equal votes was less of an issue. However, implementing an equal-vote arrangement in the GCC could prove to be a powerful motivator for political unity and success. Perhaps it would be desirable to combine equally weighted

Journal of Economics Bibliography

voting with a supermajority provision so that certain decisions could only be made by agreement of more than half of the member countries' representatives on the governing board. (Since the GCC has six members, a six-member board could not take action unless at least four countries agreed on a measure; a 3-3 tie would result in no action.) That being said, it is worth noting that the legal structure of the ECCB could prove to be a hindrance to the GCC union's overall progress. Having two layers of governance within the central bank – a Board of Directors and a Monetary Council – allows redundancies and inefficiencies to arise. Given the historical evidence of the GCC's ability to quickly make decisions, adding extra layers of bureaucracy will inhibit the central bank's agility in response to economic developments. Here, adopting a similar approach to that of the ECB might be more beneficial. Having an Executive Board carry out the decisions made by the Governing Council offers an attractive solution to the efficiency problem. Centralizing decision-making to a single body of members to then be carried out by another group would streamline the roles of each governing body.

8.3. Profit Sharing

The capital contribution model implemented in the ECB is of particular interest when considering the best option for the GCC. As discussed in a previous section, using this model in the GCC would result in Saudi Arabia putting up the most capital. This is an attractive aspect of the currency union to the smaller economies of the GCC, as they would be taking a smaller share of the risk. However, the profit payback scheme employed by the ECB might not be the most appealing to them. That being said, it is reasonable for the country taking the most risk to be reaping the most rewards. In addition, the beauty of this model is its adaptability. As countries continue to grow, should the economic composition of the GCC shift in the favor of some country other than Saudi Arabia, they would be compensated as such. Profit sharing need not be tightly linked to capital contributions. The profit sharing scheme used in the Malayan Currency Board is enticing as it offers a degree of flexibility and agency that is not present in the ECB. The members of the currency union can decide the share of capital that each country must contribute and consequently how much they are compensated for doing so. Using a more arbitrary system for determining profit sharing could incentivize smaller countries like Oman by giving them a disproportionate share of the profits. The advantage of this system as the MCB used it is that it can be changed on a five-year basis, so the profit sharing can be used as a short to medium term tool to incentivize greater political will for joining the union by offering economic compensation.

8.4. Choice of Exchange Rate

As with any kind of union, there are many aspects that all contributing parties must agree on, one of which being the choice of exchange rate. As we have discussed above, in the case of the GCC there are many political tensions surrounding these decisions and they must be made carefully to ensure political unity. When it comes to exchange rate, not rocking the boat may be the best option.

Most countries in the GCC are currently pegged to the dollar, the exception being Kuwait. It would be far more difficult to convince six governments to agree on a new exchange rate rather than to convince only Kuwait to adopt a pegged currency. Not only is it possibly the easiest political solution, but it is also a sound exchange rate choice regardless. Other options such as pegging to the price of oil or a basket of currencies can be more volatile. If the GCC countries were to decide later that it would be better for their currency to float, they could do so. Malaysia and Singapore both moved from currency boards to pegged exchange rates under central banking and eventually to floating rates. The ECB is the only currency union among those surveyed here that was floating from the start.

Journal of Economics Bibliography

8.5. Choice of Headquarters

While perhaps a less critical choice, the choice of the location for the central bank headquarters serves as a political symbol. In previous discussions, Saudi Arabia insisted that the central bank be headquartered in Riyadh. Though this might make the most sense as Saudi Arabia would be the largest contributor to the currency union, there are already tensions from the smaller nations regarding Saudi Arabia's tendency to use its size to dominate negotiations. A concession from the Saudis on the headquarter location could serve as an olive branch to the other nations and a symbol of its willingness to cooperate. A headquarters would work just as well in any of the other nations, but special consideration should go toward the UAE and Kuwait as they are more established as international financial hubs. As was the case with the Malayan Currency Board, it would be possible to establish one or more branch offices in addition to the headquarters, both for business and political reasons.

Notes

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