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The GCC Monetary Union: Choice of Exchange Rate Regime

Mohsin S. Khan

Abstract

The creation of a monetary union has been the primary objective of the Gulf Cooperation Council (GCC) members since the early 1980s. Significant progress has already been made in regional economic integration: The GCC countries have unrestricted intraregional mobility of goods, labor, and capital; regulation of the banking sectors is being harmonized; and in 2008 the countries established a common market. Further, most of the convergence criteria for entry into the monetary union have already been achieved. In establishing a monetary union, however, the GCC countries must decide on the exchange rate regime for the single currency. The countries' use of a US dollar peg as an external anchor for monetary policy has so far served them well, but rising inflation and differing economic cycles from the United States in recent years have raised the question of whether the dollar peg remains the best policy.

Mohsin Khan considers the costs and benefits of alternative exchange rate regimes for the GCC. These include continued use of a dollar peg, a peg to a basket of currencies such as the special drawing rights (SDR) or simply the dollar and euro, a peg to the export price of oil, and a managed floating exchange rate. In light of the structural characteristics of the GCC countries, Khan considers the dollar peg the best option following the establishment of a GCC monetary union. The peg has proved credible and is easy to administer. If further international integration in trade, services, and asset markets makes a higher degree of exchange rate flexibility desirable in the future, implementing a basket peg could provide this flexibility. Regardless, the choice of exchange rate regime for the GCC countries need not be permanent: The countries could initially peg the single GCC currency to the US dollar and then move to a more flexible regime as their policy needs and institutions develop.

Keywords: Exchange rate regimes, monetary unions, Gulf Cooperation Council
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Mohsin S. Khan has been a senior fellow at the Peterson Institute for International Economics since March 2009. Before joining the Institute, he was the director of the Middle East and Central Asia department at the International Monetary Fund from 2004 to 2008.

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Peterson Institute for International Economics
1750 Massachusetts Avenue, NW Washington, DC 20036-1903
Tel: (202) 328-9000 Fax: (202) 659-3225 www.piie.com

INTRODUCTION

The creation of a monetary union has been an overriding objective of the regional economic integration process among Gulf Cooperation Council (GCC) members since the early 1980s.[1] Since then, the GCC member countries have come a long way on the road to economic integration. When established, the GCC monetary union would be the second most important supranational monetary union in the world in GDP terms, second only to the European Monetary Union.[2]

The experience of monetary unions elsewhere in the world can provide useful insights into the challenges that the planned GCC monetary union faces. Presently there are five monetary unions in the world. Three of these unions are in Africa, one in the Caribbean, and one in Europe. In all of them, a new common currency was created, except in the Southern African Common Monetary Area (CMA), in which the South African rand is the common currency in circulation. The GCC countries are probably the most homogeneous among the unions, sharing a common history, language, and culture.[3] They are mainly oil exporters (with the exception of Bahrain), are very open to trade and imported labor, have very flexible labor markets in which even nominal wages can adjust, and have complete factor mobility within the group. Further, they all have full convertibility. One could argue that the GCC countries have already fulfilled many of the preconditions for a currency union. Overall the GCC meets the generally accepted criteria for a single currency among its members, namely proximity, size, fluctuations of output, trade structure, and inflation performance (Berengaut and Elborgh-Woytek 2006). Much progress has been made toward achieving the goal of a full-fledged GCC monetary union. GCC countries have achieved virtually unrestricted intraregional mobility of goods, national labor, and capital, and prudential regulations and supervision of the banking sector are being gradually harmonized. All members except Kuwait have pegged their currencies to the US dollar since 2003, a common external tariff was introduced in 2003, and the common market was launched on January 1, 2008. Although the GCC currencies have been de facto pegged to the US dollar for decades,[4] a single GCC currency is expected to encourage trade and financial integration, and facilitate foreign direct investment, although there are questions as to whether the GCC can be considered an "optimum currency area" (Rose 2000; Frankel and Rose 1998 and 2000; Buiter 2008).

The European Central Bank (ECB) has provided the GCC with a draft Monetary Union Agreement

1. The GCC includes Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates (UAE). A useful description of the GCC is contained in a recent study by the European Central Bank; see Sturm et al. (2008).

2. In 2008 total GDP of the GCC was over $1 trillion, and the average per capita income was about $25,000.

3. Edmund O'Sullivan (2008) has a very interesting and detailed account of the history of the Gulf states.

4. During 1980–2002 Bahrain, Qatar, Saudi Arabia, and the UAE were formally pegged to the IMF's special drawing rights (SDR) basket but were effectively pegged to the US dollar. Oman was formally pegged to the US dollar and Kuwait to an undisclosed basket of currencies.

(MUA) and statutes on the Gulf Monetary Council (GMC) and the Gulf Central Bank (GCB). GCC members states have decided that a monetary council will be established by the end of 2009 to serve as a transition body in preparation for the single currency and the GCC Central Bank. A set of five convergence criteria (on inflation, interest rates, reserves, fiscal balance, and public debt), similar to those used in the run-up to the European Monetary Union, has been agreed in principle (table 1). Although they are not preconditions for entry, by the end of 2008 the GCC countries had met almost all of the convergence criteria. The exception is inflation, reflecting the recent higher inflation rates in Qatar and the UAE. But even in these countries, inflation is not expected to persist. In fact, the high inflation in these two fast-growing economies is due to supply constraints arising from the rapid pace of implementing large investment and construction projects, and these pressures are expected to ease soon.

But there have also been some unanticipated setbacks to achieving the monetary union. In October 2006 Oman announced that it would not join the union by 2010, and in May 2007 Kuwait declared that it was moving from the dollar peg to an undisclosed currency basket, although it reaffirmed its commitment to join the union. There have also been delays in establishing harmonized systems and in institution building. In terms of preparedness for the common currency and the creation of a common, independent central bank, the monetary policy frameworks, payment and settlement systems, regulatory and supervisory structures, macroeconomic statistics, and other specific central bank functions have yet to be fully harmonized. The management of international reserves and nonreserve foreign assets has also not yet been agreed. In addition, on the fiscal side, setting up a common accounting framework and adequate budgetary procedures are a high priority in the period leading up to the introduction of a common currency. Finally, the countries facing high inflation rates need to reduce them to the GCC average. The remaining agenda is certainly challenging, and as a result, the 2010 deadline for the single GCC currency appears increasingly unachievable, a fact that is now acknowledged by the member countries as well as by the GCC Secretariat.

Looking ahead, one very important decision in the formation of a monetary union is the choice of an appropriate exchange rate regime. The countries' choice of a US dollar peg as the external anchor for monetary policy has obviously been credible and has served them well so far. In fact, one can argue that the generally low inflation rate in the GCC until recently has been due to the pegging of their currencies to the US dollar. At the same time, rising inflationary pressures in the last couple of years, increasing integration with global markets, and differing economic cycles and policy needs from that of the anchor country, the United States, have raised questions about whether the peg to the dollar remains appropriate.

The choice of the exchange rate regime has to be seen in the context of the structural characteristics of the GCC economies, in particular the importance of the oil sector in GDP, exports, and government revenue. At present, oil and gas production contributes about half of GDP and three-quarters of exports

Table 1 GCC countries: Compliance with the convergence criteria, end-2006

Country	Budget deficit lower than 3 percent of GDP, or 5 percent when oil prices are weak	Public debt to GDP ratio lower than 60 percent	Foreign exchange reserves in excess of four months' imports	Interest rates not higher than two percentage points above the average of the lowest three countries' rates	Inflation not higher than 2 percent above the average rate of the six states[a]
Bahrain	✔	✔	—	✔	✔
Kuwait	✔	✔	✔	✔	✔
Oman	✔	✔	✔	✔	✔
Qatar	✔	✔	✔	✔	—
Saudi Arabia	✔	✔	✔	✔	✔
UAE	✔	✔	✔	✔	—

✔ = criterion has been met
— = criterion has not been met

a. A weighted average based on US dollar nominal GDP of the six states.

Source: Country authorities and IMF.

and government revenues. The primary challenge for them is to diversify their economies and further develop the non-oil private sector in order to create employment opportunities for the rapidly growing national labor force. The issue then is which exchange rate regime would be most suitable in achieving this goal.

The objective of this paper is to outline the main alternative exchange rate regimes for the unified GCC currency and to discuss their respective advantages and disadvantages. To start with, this paper will discuss general considerations in determining exchange rate regimes. It will then consider GCC-specific issues.

GENERAL CONSIDERATIONS IN DETERMINING THE EXCHANGE RATE REGIME

The most common criterion suggested by the theoretical literature for determining the optimal exchange rate regime is macroeconomic and financial stability in the face of transitory real or nominal shocks. The conventional view on the choice of exchange rate regime has been that exchange rate flexibility allows for macroeconomic and financial stability in the face of real domestic shocks or foreign nominal shocks. Fixed exchange rates are more effective in achieving macroeconomic and financial stability in reaction to domestic monetary shocks. However, the insulating properites of alternative exchange rate regimes are strongly affected by the structural characteristicis of the economy, such as openness to international trade, capital mobility, and labor market flexibility. In practice, it is difficult to evaluate the effect of these characteristics on the functioning of the exchange rate regime, because they may have ambiguous

effects, and domestic and external shocks can occur simultaneously. Therefore, in choosing the exchange rate arrangement, one has to look to a number of criteria. Ideally, the exchange rate regime chosen should yield external stability, internal stability (low inflation), balance sheet stability, international competitiveness, credibility of monetary policy, and low transaction costs (Husain 2006).

External stability is defined as a balance of payments position that is not likely to give rise to disruptive adjustments in exchange rates. A balance of payments position consistent with external stability is one in which both the underlying current account is broadly in line with its equilibrium level and the capital and financial account position does not create risks of abrupt shifts in capital flows.[5] Balance sheet stability deals with the impact of exchange rate volatility on the net open position of the financial and public sectors. International competitiveness of the non-oil tradable goods sector is related to how well the real exchange rate supports external trade, and changes (actual and expected) in the nominal exchange rate can be an important indicator of the credibility of the domestic monetary policy stance. Similarly, exchange rate volatility can raise transaction costs in international trade and finance by increasing uncertainty and information needs. In applying these criteria, trade offs are usually necessary and political-economy considerations in the choice of regime may become relevant. Also, policy management considerations may dictate keeping an existing regime if no substantial gain is to be achieved by switching from one arrangement to another, and if the change would involve significant political or adjustment costs.

GCC member countries officially pegged their national currencies to the US dollar on January 1, 2003, as an explicit step toward monetary integration. Although at that time the countries (except Kuwait) were already pegged to the US dollar, the decision was based on the expectation that the dollar peg would maintain stability and strengthen confidence in the economies, and therefore the countries would go into the monetary union at those parities. As such, GCC countries have pursued economic policies consistent with exchange rate pegs. For instance, they have implemented appropriate fiscal policies and have flexible labor and product markets.[6] GCC members have also accumulated significant foreign exchange reserves, underpinning the credibility of the peg and discouraging speculation against their currencies. All in all, from the standpoint of macroeconomic stability, the dollar peg has worked well in these countries, keeping inflation relatively low and strengthening confidence in the currencies and in the economies more generally.

GCC governments (other than Kuwait) have stated that there would be no change in the current pegged regime until the monetary union, but that they remain open to the choice of the exchange rate arrangement under the planned GCC currency union. Ultimately, the choice of a specific exchange rate

5. This concept is comprehensively discussed in IMF (2007).

6. Fiscal policy becomes the main instrument used to promote domestic and external stability under the pegged regime.

regime will depend on the preferences of the GCC member countries, and will presumably be based on both economic and political considerations. The next section examines the arguments for and against the following alternative exchange rate regimes: a single currency (US dollar) peg, managed floating, pegging to a basket of currencies, and pegging to the export price of oil.

ALTERNATIVE EXCHANGE RATE REGIMES FOR THE GCC MONETARY UNION

Two main arguments have been offered by those who are in favor of alternative exchange rate regimes to the dollar peg for the GCC countries (for example, Setser 2007). The first is that GCC countries can pursue domestic goals of inflation and output better if they had monetary policy independence. The second argument is that imported inflation, owing to a sustained depreciation of the US dollar, could be avoided by abandoning the peg. The question is whether these arguments have sufficient merit. For example, distortions in the monetary transmission mechanism would constrain the effectiveness and efficiency of an independent monetary policy. Further, imported inflation is limited by low pass-through effects and administrative price controls. Thus, despite a significant depreciation of the US dollar, inflation in most GCC countries has been subdued until recently.

Exchange rate arrangements other than the dollar peg could be considered in light of emerging changes in trade and investment patterns, as well as in the economic structure across the GCC countries. One major factor is economic diversification. As countries diversify in the future, the differences in the economic structures of GCC countries will increase, leading to higher shares of manufacturing and service exports in total trade. This may increase intra-GCC trade, but will also highlight the importance of price flexibility in factor and product markets. In particular, the efforts at nationalizing the GCC countries' labor force, by increasing the number of nationals in the private non-oil sector on the one hand, and raising the costs of employing expatriate workers on the other, will inevitably reduce the flexibility of the GCC countries' labor markets. This will make it more difficult to ensure international competitiveness and adjust to terms-of-trade shocks while maintaining a currency peg.

External financial assets, now mainly dollar-denominated, may also become progressively more diversified as a consequence of globalization, growth prospects in emerging economies, and the rise of the euro as a reserve currency. With increased capital mobility, trade openness, and foreign direct investment, the requirements for sustaining an exchange rate peg become more demanding. Indeed, maintaining a tight peg to the dollar forces the GCC countries to rely almost exclusively on fiscal policy to manage oil-related volatility, and a more flexible exchange rate regime could give these countries another tool for adjusting to oil shocks.

Consequently, reasonable arguments can be made for adopting a more flexible exchange rate policy in the future after the monetary union is established. However, as argued later, there are equally

important and valid arguments in favor of maintaining the current peg to the US dollar after the introduction of the single currency.

Before examining closer the alternative options, one may legitimately ask whether the current level of the exchange rate in each country is appropriate. An argument that is made often is that the equilibrium real exchange rate has appreciated in GCC countries because the oil price increases since 2003 have resulted in a permanent improvement in the terms of trade. In theory, this would mean that the current actual real exchange rate is undervalued and should appreciate either through nominal appreciation or inflation. If inflation is due to overheating or dollar depreciation vis-à-vis the euro, then a nominal appreciation would be preferable. But, the current spike in inflation has been predominantly a supply-side phenomenon, driven by capacity constraints, and is expected to decrease as supply constraints ease, particularly in the area of housing. It is also the case that revaluation of the currency will only impact headline inflation in the short term, as it will have only a one-off effect on the domestic price level. Further, the associated costs of revaluation have to be balanced against the short-term beneficial effects that revaluation can have on inflation. In particular, a revaluation would impose significant valuation losses on the large official foreign assets of the GCC countries, and reduce international competitiveness for those countries that have embarked on economic diversification by developing tourism and the non-oil export sectors. There is also a risk that as soon as the signal is given that the exchange rate is a policy instrument available to tackle inflation, this could increase market expectations of further revaluations, and encourage speculation, even if fundamentals are unchanged, as was seen in the case of Kuwait when it went off the dollar peg in 2007.

For most countries it is extremely difficult in practice to determine the equilibrium real exchange rate and, hence, the appropriate level of the nominal exchange rate. It is even more problematic in the case of oil producers. Ideally, the exchange rate should be set at a level that would be consistent with sustaining the current account balance at some desired level (or "norm"). But the level of the equilibrium real exchange rate will depend on both the level and volatility of oil prices over the medium term. In fact, any change in current or future oil prices will change the equilibrium exchange rate and the current account norm, making the calculation of both extremely difficult as oil prices do change substantially almost on a day-to-day basis.

One particular argument that has been made is that because GCC countries are running large current account surpluses, their exchange rates must be undervalued. In that case, would the recommendation of a nominal (and therefore real) appreciation help to reduce the current account surpluses? The answer is not much. The problem here is that imports are highly inelastic in these countries, and the exchange rate changes that are generally advocated would have only a marginal, if any, effect on the current account. For example, empirical work in the IMF on the determinants of

GCC countries' current account positions shows that a 100 percent real appreciation would only reduce the current account surplus by about 4 percent of GDP. As a point of reference, the average current account surplus of the GCC countries in 2008 was 26 percent of GDP. A nominal appreciation may help somewhat on the inflation front, but inflation is expected to come down in these countries once supply bottlenecks and capacity constraints have eased. Current accounts in the GCC countries are mainly driven by the fiscal balance, so it will be the fiscal spending that is underway that will reduce current account surpluses over time.

What then are the alternative exchange rate regime options for the monetary union?

US Dollar Peg

A good case can be made for the monetary union to continue pegging to the dollar. Although the share of GCC trade with the United States is comparatively low, almost all exports (that is, primarily oil and gas) and a very high proportion of the external assets are US dollar-denominated. A dollar peg ensures stability of income flows from abroad and stabilizes fluctuations in financial wealth. Although fluctuations in the value of the dollar against other reserve currencies could generate volatility in cross-rates between these currencies and the GCC currencies, the share of GCC non-oil exports is still relatively small, minimizing the impact of such exchange rate changes on external trade. The peg to the US dollar has also helped the region avoid nominal shocks from geopolitical risks feeding into the economy. These risks are likely to continue, placing a premium on a credible US dollar peg.

The dollar peg provides a strong and easily understood anchor for monetary policy (Abed, Nuri, Erbas, and Guerami 2003). It is not possible to deviate too much from the US rate of inflation for an extended period of time. Yet, while inflation has been low in general, there have been significant differences between the GCC member states' inflation rates, which have led to diverging developments in their real effective exchange rates. One can argue that in this circumstance, price stability has to be supported by fiscal policy and by giving priority to implementing projects aimed at improving the economy's absorptive capacity.

International competitiveness can be maintained under a fixed exchange rate in the GCC countries because of labor market flexibility. In addition, fiscal policy has been the main instrument for avoiding the transmission of oil-sector volatility into the non-oil economy. Fiscal policy will obviously have to maintain its stabilizing role in the future, in particular as the GCC member countries agree on appropriate fiscal convergence criteria, diversify their revenue sources, and cast their fiscal policies in medium-term budgetary frameworks. However, GCC countries will not be able to assure international competitiveness by retaining the currently high degree of labor market flexibility in the long run. The share of nationals in the labor force in the private non-oil sector is increasing, the result of a fast-growing

national population and the fact that the public sector is no longer willing to act as employer of first and last resort.

The exchange rate peg also simplifies trade and financial transactions, accounting and business planning, as well as monetary coordination among the member countries. Exchange rate risk can be easily hedged, even without a domestic forward market, since it is possible to work through US dollar markets. This has been particularly advantageous to importers and investors as they have relied on the more developed international capital markets to hedge themselves.

Finally, the familiarity of GCC authorities and private economic agents with the US dollar peg, as well as the similar preferences the GCC countries have shown for a fixed exchange rate, speak in favor of maintaining the current arrangement after the implementation of the planned monetary union. Keeping the single currency peg to the dollar would leave the public and policymakers on already familiar grounds and facilitate the acceptance of a common currency.

Managed Floating

Letting the single GCC currency float against other currencies would have the advantage of allowing the GCC countries to use monetary policy to stabilize inflation and non-oil output and to promote the growth of the private non-oil economy. A more flexible exchange rate regime would also allow the countries to absorb large adverse real shocks more easily than a fixed exchange rate regime. As the GCC economies, their exports, and their international asset portfolios become more diversified, the flexibility of the labor market may decrease because of increased participation by nationals, the exposure to shocks (including to capital movements) may increase, and greater flexibility of the exchange rate would become more desirable.

In light of the current structural characteristics of the GCC economies, however, it is questionable whether active monetary and exchange rate policies would achieve external stability. This is because the interest rate channel of the monetary transmission mechanism is ineffective in an environment where economic agents' decisions are highly insensitive to changes in the interest rate. Corporate-sector investment and spending decisions (investment and consumption) in the GCC countries depend to a large extent on actual and projected government spending, limiting the role of financial markets and interest rates. Thus fiscal policy has to bear the burden of smoothing the effect of shocks on domestic activity. In addition, the exchange rate–current account channel is weak because of the insensitivity of exports and imports to changes in the exchange rate.

A further issue relates to the choice of the nominal anchor under a float. The two main alternatives would be inflation targeting and monetary targeting. Inflation targeting must be based on a good understanding of the inflationary process and its determinants, in addition to institutional and technical

requirements, such as sophisticated market-based monetary operations, central bank independence, and transparency of policy to build accountability and credibility. Monetary targeting would require a stable and predictable money demand function and the development of instruments and adequate forecasting ability to undertake efficient liquidity management. While none of these requirements is insurmountable, moving to an inflation targeting regime takes time, so monetary targeting would necessarily have to serve as the nominal anchor for price stability and would require the development of liquidity management instruments, which are currently lacking.

There are also risks associated with floating exchange rates. For example, there is the danger that large swings in oil prices could lead to volatile exchange rates and in the end to larger fluctuations in non-oil output and higher and more volatile inflation (Cashin and McDermott 2001). Especially given the thin foreign exchange markets that are dominated by a relatively small number of agents, it is likely that the central bank would have to intervene systematically to smooth the path of the exchange rate.

Furthermore, letting the exchange rate of the GCC currency float would also introduce a new and different type of uncertainty and risk into international transactions, as well as complicate budgetary accounting and business planning. At the same time, underdeveloped and incomplete financial markets would make hedging against exchange rate risk costly and probably impossible in the near term.

Basket Peg

A basket peg could serve as a cautious strategy toward a more flexible exchange rate policy. With a basket peg, the main anchor properties of an exchange rate peg could be retained, while at the same time gaining some adaptability to the adverse effects of swings among the value of the major reserve currencies. The volatility of the nominal effective exchange rate would be reduced, benefiting external trade and balance sheet stability. For example, a peg to the SDR would result in lower volatility of oil export receipts relative to the dollar peg.

Implementing a basket peg may be a useful way to introduce more flexibility of the exchange rate in a gradual manner, which would allow private market participants to learn to manage and live with foreign exchange risk. Compared with fixing to a single currency, pegging to a basket of currencies has the disadvantage that traders will have to bear the exchange rate risk. And in relatively underdeveloped financial markets hedging exchange rate risk would be difficult and costly. On the other hand, pegging to a single major currency allows market participants to take advantage of instruments available for that major currency. What probably matters most is the extent of the higher exchange rate risk versus the reduced cost from lower exchange rate volatility.

One disadvantage of basket pegs is that they may reduce the microeconomic and informational benefits of maintaining constant at least one bilateral exchange rate relevant for price comparisons and

economic transactions. Also, basket pegs tend to be less transparent and more difficult to explain to the public. The weights attached to the basket will have to be managed and lack of transparency could encourage speculative behavior, as the example of Kuwait shows.

One simple approach would be to peg to a transparent basket consisting only of the US dollar and the euro.[7] It would be simple to interpret, would reduce monetary dependence of the GCC on the US Federal Reserve, cover most transactions in goods, services, and financial instruments (now in the US dollar and the euro area), and allow for the use of both dollar and euro hedging instruments to efficiently manage financial risks given the considerable depth in euro financial instruments.

Pegging to the Export Price of Oil

Pegging the domestic currency to the export price of the main export product (PEP) has sometimes been suggested for small open economies that are relatively specialized in the production and export of a particular mineral or agricultural commodity.[8] The argument for PEP is that it simultaneously delivers automatic accommodation to terms-of-trade shocks, as floating exchange rates are supposed to do, while retaining the credibility-enhancing advantages of a nominal anchor, as dollar pegs are supposed to do (Frankel and Saiki 2002). A peg to the price of oil would allow the real exchange rate to move in line with the real price of the main export commodity. Essentially, it would decouple oil exporters' monetary policies from those of oil importers.

But there are several important qualifications and drawbacks attached to this type of exchange rate policy. First, the GCC countries taken together account for a sizeable part of total world output and exports. Therefore, the small economy assumption is not applicable in the case of the GCC, as the price of oil cannot be regarded as exogenous. Indeed oil can be seen as a major international currency in itself, and pegging their national (fiat) currencies to their own (commodity) currency would not anchor the GCC countries' currencies to something truly exogenous.

Second, it is questionable whether an automatic adjustment to terms-of-trade shocks would be effective under a PEP system. For example, an adverse terms-of-trade shock (a decline in oil prices) would, under the PEP, result in a real depreciation. However, with oil production in most GCC countries constrained by capacity and extraction limits, as well as by the OPEC quota system, all adjustment would have to come through expanding non-oil exports or cutting imports. However, in the GCC, non-oil exports depend on hydrocarbon production for inputs, and are therefore not independent from the level of oil and gas production.

Third, pegging to the price of oil would make import prices highly variable, as well as create

7. For a discussion of pegging to a dollar-euro basket, see Khan (2009).

8. A variant of this approach is pegging to a basket of commodities and currencies.

significant volatility for other sectors of the economy. For example, a consequence of high oil prices would be a real appreciation, which would raise the cost of other exports and dampen the diversification effort. In particular, the prices of non-pegged tradable goods would be destabilized in terms of domestic wages and nontraded goods, which could lead to adverse Dutch disease effects when oil prices rose. In the event of a decline in oil prices, it is unclear whether the oil peg would permit sufficient depreciation of the national currency to accommodate the adverse change in the terms of trade and stabilize export earnings. Further, it can be argued that a gradual adjustment in the real exchange rate may be preferable until the terms-of-trade shift appears permanent. In any event, with daily fixing of the exchange rate, PEP requires transparency and credibility that may take time to establish.

CONCLUSIONS

In summary, the dollar peg seems to be the best option in the short run after the establishment of the monetary union and the single currency. The longstanding de facto peg of the GCC currencies to the US dollar has served the economies well so far. The dollar peg has provided a credible nominal anchor for monetary policy, ensuring external stability, and since most exports are denominated in dollars, it has assured external stability. It is easy to administer and has simplified trade and financial transactions and accounting. It has allowed for greater monetary coordination among the GCC member countries and established the parities at which the GCC member countries will go into the monetary union, much like the Exchange Rate Mechanism (ERM) did for European Monetary Union. High labor market flexibility in the private sector has also helped international competitiveness and quick adjustment to shocks under the pegged regime.

During the run up to the monetary union, the main challenge would be to achieve the convergence criteria on inflation. Since rising inflation reflects mainly supply bottlenecks, the GCC countries should accelerate structural reforms to expand capacity and perhaps even rephase some of the large investment projects under implementation. The possibility of further continued depreciation of the dollar against other major currencies can also make inflation management more difficult. The authorities need to be mindful that a commitment to the peg in the transition to the monetary union requires them to implement policies that are consistent with a pegged regime.

Looking forward, the structural characteristics of the GCC economies will change and become more heterogeneous in the next couple of decades, as oil reserves will be depleted in some member countries, and the private non-oil sector will gain importance as the main source of new employment opportunities for the rapidly growing national labor force. GCC countries will be diversifying their economic structures, exports, and international assets. In these circumstances, a common monetary and exchange rate policy requires the setting of appropriate entry parities and compensating and/or incentive mechanisms (e.g.,

a fiscal transfer system) to balance differences among the economies. The establishment of the monetary union would also require a harmonization of the financial market infrastructure—including regulatory and supervisory frameworks, clearing and settlement systems, standardization of financial contracts—as well as taxation and tariff agreements and labor policies. With increasing integration in international trade, services, and asset markets, a higher degree of exchange rate flexibility may become more desirable in the prospective GCC monetary union to ensure external stability and international competitiveness.

To conclude, there are good arguments in favor of retaining the current fixed exchange rate regime in the near future, but keeping open the option of introducing more exchange rate flexibility in the medium term. On balance, however, the dollar peg seems to be the best option, both leading up to and at least in the short-run after the establishment of monetary union. A caveat to this position is that over the medium term, one does not expect to see a continuation of the depreciation of the dollar, or a diverging economic cycle relative to the United States. What is sure is that in a changing environment, a forward-looking monitoring framework will be essential for the monetary union. The decision for one or the other exchange rate regime depends ultimately on the policy objectives and common preferences of the authorities involved. It is important to also note that the choice of an exchange rate arrangement under the monetary union is not a permanent one. The GCC single currency could initially be pegged to the US dollar, but the exchange rate regime could be changed, say to a euro-dollar basket peg or even managed floating, in the future depending on how the economic and financial structures of the GCC economies evolve.

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