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REGIONAL MONETARY INTEGRATION IN THE MEMBER STATES OF THE GULF COOPERATION COUNCIL

by Michael Sturm
and Nikolaus Siegfried

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REGIONAL MONETARY INTEGRATION IN THE MEMBER STATES OF THE GULF COOPERATION COUNCIL[1]

by Michael Sturm[2]
and Nikolaus Siegfried[2]

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ABSTRACT

The Gulf Cooperation Council (GCC) plans to introduce a single currency by 2010 in its six member states, Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the UAE. This paper focuses on selected macroeconomic and institutional issues and key policy choices which are likely to arise during the process of monetary integration. The main findings are that (i) a supranational GCC monetary institution is required to conduct a single monetary and exchange rate policy geared to economic, monetary and financial conditions in the monetary union as a whole; (ii) GCC member states have already achieved a remarkable degree of monetary convergence, but fiscal convergence remains a challenge and needs to be supported by an appropriate fiscal policy framework; and (iii) there is currently a high degree of structural convergence, although this is expected to diminish in view of the process of diversification in GCC economies, which calls for adequate policy responses.

EXECUTIVE SUMMARY

The Gulf Cooperation Council (GCC) plans to introduce a single currency by 2010 in its six member states, namely Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates (UAE). This paper focuses on selected macroeconomic and institutional issues and key policy choices which are likely to arise in the GCC's process of monetary integration. It does not however assess the potential benefits and costs of a GCC monetary union, given that the political decision has been taken to introduce a single currency, and nor does it analyse options for monetary and exchange rate policy in the GCC after a single currency has been launched.

The main findings of the paper are that (i) a supranational GCC monetary institution is required to conduct a single monetary and exchange rate policy geared to economic, monetary and financial conditions in the monetary union as a whole; (ii) GCC member states have already achieved a remarkable degree of monetary convergence, but fiscal convergence remains a challenge and needs to be supported by an appropriate fiscal policy framework; and (iii) there is currently a high degree of structural convergence, although this is expected to diminish in view of the process of diversification in GCC economies, which calls for adequate policy responses.

The objective of monetary union in the GCC is embedded in a broader economic integration process, for which an ambitious, but consistent agenda has been set. Following the realisation of a free trade area and a customs union, the completion of a common market is scheduled for 2007, prior to the introduction of a single currency in 2010. A deepening of the so far relatively low degree of economic integration in the GCC would be helpful in order to reap the potential benefits of a monetary union, supporting the case for a comprehensive and timely implementation of the planned stages of integration. Furthermore, GCC institutions assisting the economic integration process, which so far has followed a mainly intergovernmental approach, might need to be strengthened in view of the stages of integration ahead.

A GCC monetary union will necessarily require a single and indivisible monetary and exchange rate policy. Given this principle of indivisibility, monetary union is more than just a particularly tight exchange rate arrangement, and the mere coordination of national monetary policies is not sufficient to sustain a single currency. A single monetary and exchange rate policy that is geared to the economic, monetary and financial conditions in the single monetary area as a whole can only be ensured if it is conducted by a supranational monetary institution. In particular, decision-making on monetary and exchange rate policy has to be centralised, while there are different options with regard to the centralisation or decentralisation of the analysis, implementation and communication of a single monetary and exchange rate policy.

The analysis of monetary and fiscal convergence in the GCC reveals a remarkable degree of monetary convergence, with generally low inflation rates in all member states and short-term interest rates co-moving in a narrow range. This is due to the GCC currencies' long-standing alignment with a common external anchor, the US dollar, which has led to a very high degree of intra-GCC exchange rate stability that is all the more noteworthy as it has prevailed in an environment of liberalised capital accounts. Fiscal convergence is less marked than monetary convergence and seems to constitute an important challenge for the GCC. As far as can be discerned from available data, the budget balance-to-GDP ratios as well as public debt levels vary significantly between member states.

While the current state of structural convergence of GCC member states does not seem to constitute an impediment to a functioning monetary union, the high degree of

structural homogeneity cannot simply be extrapolated into the future. Given the dominant role of oil and gas in the GCC economies, their economic structures, dynamics and trade patterns are broadly similar, thus reducing the likeliness of asymmetric shocks or the need to resort to nominal exchange rate adjustments. However, both the pace and direction of economic diversification will probably differ in the future between GCC member states, and will thus reduce the structural similarities between their economies. This process is likely to be reinforced by the very different time horizons over which the oil and gas reserves of GCC member states are expected to be exhausted, raising the possibility that a GCC monetary union might in the future comprise both major oil and gas producing countries and non-oil/gas producing countries. This stresses the importance of strengthening adjustment mechanisms other than the nominal exchange rate (such as factor mobility and price flexibility) in order to cushion asymmetric shocks, the likelihood of which may increase in the wake of ongoing diversification.

It would be helpful to monitor an appropriate set of monetary and fiscal convergence criteria in a framework of multilateral surveillance in order to entrench and further promote economic convergence. Key policy choices refer to the purpose, economic content and design of such criteria. The criteria could prove a useful information tool for assessing policies, and may serve as an anchor for expectations, although their role as a disciplining device for policies may remain limited due to the prevailing consensus in the GCC that they should not be selection criteria determining membership of the monetary union. It would be sufficient for monetary criteria to function as entry criteria, while fiscal criteria could play a useful role both as entry criteria and as permanent criteria, thereby serving as the foundation for a set of permanent fiscal rules. Ensuring sustainable fiscal convergence on the basis of sound public finances both in the run-up to monetary union and after its establishment is warranted, so as to avoid a situation in which undisciplined national fiscal policies undermine a stability-oriented monetary framework and lead to undesirable spillover effects between member states. While several options for appropriate fiscal criteria are conceivable, it is crucial that they take into account the specifics of fiscal policy in oil economies. For a meaningful monitoring and assessment of convergence criteria, and later on for the conduct of an area-wide monetary and exchange rate policy, the quality, availability and comparability of statistical data in GCC member states needs to be ensured.

Finally, a strong and informed political commitment to the objective of a GCC single currency and a basic consensus on the orientation of a single monetary and exchange rate policy are key prerequisites for establishing a sustainable monetary union in 2010, taking into account the fact that monetary union inevitably entails the transfer of monetary sovereignty from the national to the supranational level.

I INTRODUCTION

The European Union (EU) can look back on a history of more than 50 years of regional economic and monetary integration. Integration is far advanced, has been much discussed and analysed, and has often become a point of reference for other regions in the world, even though it is only one of many experiences regarding regional economic integration.[1] The debate about regional monetary integration and attempts to form regional currency blocs has particularly intensified since the successful introduction of the euro, which seems to have had a "demonstration effect" for other regions of the world.

The Gulf Cooperation Council (GCC), comprising six member states on the Arab peninsula (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates (UAE)) has recently made more definite plans for a regional monetary union, with the ultimate objective of introducing a single currency in GCC member states by 2010. Plans for monetary integration in the GCC date back to the GCC's Unified Economic Agreement, which was ratified in 1982, one year after the GCC was founded. However, concrete steps to approach this objective have only been taken over the last six years. In December 2000 the Supreme Council of the GCC (Heads of State) mandated the Committee of Monetary Agencies and Central Bank Governors and the Financial and Economic Cooperation Committee (Ministers of Finance) to draw up a working plan and a timetable to establish a single currency. In spring 2001 the GCC governors and finance ministers decided to establish a high-level technical working group in order to study the requirements for a monetary union. Initial results were presented at the GCC Supreme Council meeting in Muscat in December 2001, where Heads of State agreed on the following stages and timetable to establish a monetary union[2]:

- By the end of 2002, all national currencies of GCC countries shall be pegged to the US dollar.

- By the end of 2005, the Committee for Financial and Economic Cooperation (Ministers of Finance) and the Committee of Monetary Agencies and Central Bank Governors shall agree on economic convergence criteria, methods to calculate them, the required levels of these criteria, and the manner in which to fulfil them.[3]

- Between 2005 and 2010, GCC countries shall strive to fulfil the criteria.

- In January 2010, a single currency shall be introduced.

The GCC's planned monetary union is interesting for a number of reasons. It seems to be the most advanced initiative among various attempts to achieve monetary integration in many regions of the world, given the timetable and state of preparations. Moreover, the degree of economic convergence, in particular monetary convergence, that has already been achieved is high compared to other regions. If realised, the GCC monetary union would be the second most important supranational monetary union in the world in terms of GDP and population, after the euro area. Furthermore, it is worth noting that this integration initiative is taking place in a region, the Middle East, which has up till now been characterised by a very low degree of economic integration and failed attempts to foster regional economic interaction in an effective fashion, and whose

[1] See ECB (2004).

[2] The Muscat summit also concluded a new Economic Agreement replacing the 1982 agreement and forming the legal basis for a monetary union. The new Economic Agreement, Article 4, stipulates: "For the purpose of achieving a monetary and economic union between Member States, including currency unification, Member States shall undertake, according to a specified timetable, to achieve the requirements of this union. These include the achievement of a high level of harmonization between Member States in all economic policies, especially fiscal and monetary policies, banking legislation, setting criteria to approximate rates of economic performance related to fiscal and monetary stability, such as rates of budgetary deficit, indebtedness, and price levels."

[3] The criteria are not intended to be selection criteria. Rather, it is intended that all GCC countries shall introduce a single currency simultaneously.

economic performance has attracted considerable attention recently.[4] Finally, the GCC monetary union project has so far not been widely covered in the economic literature.[5]

Over the last few years the ECB has been in contact with monetary agencies and central banks in the region and with the GCC Secretariat General to discuss – as with other regional groupings – potential lessons from monetary integration in the EU to the extent that these are relevant to the region. This Occasional Paper is based on an ECB staff study on several aspects of the GCC's monetary integration process that was conducted in this context. While the paper has a clear focus on monetary integration in the GCC, some of the aspects covered, relating for example to convergence criteria and the establishment of a supranational monetary institution, are of broader interest for regional monetary integration processes in general and may be of relevance for other regions in the world that are currently considering monetary integration.

The paper is structured as follows: Chapters 2-4 review the characteristics of the GCC member states' economies; take stock of the economic and institutional integration achieved so far in the GCC; and analyse the economic convergence of GCC member states. Two key issues in the GCC's monetary integration process are discussed in the following chapters, namely policy choices with regard to convergence criteria (Chapter 5), and the establishment of a supranational GCC monetary institution (Chapter 6). Chapter 7 concludes with some final remarks.

[4] The low degree of economic integration is reflected in intra-regional trade, which accounts only for 8% of the total trade of Middle Eastern and Northern African countries. The economic performance of Arab countries compared to other emerging market economies over recent decades has been highlighted, for example, by the UNDP Arab Human Development Report (2002).

[5] So far, most publications have originated in the IMF. See for example IMF (2003).

2 CHARACTERISTICS OF THE GCC MEMBER STATES' ECONOMIES

The six GCC member states, Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates, envisage completing the process of economic integration by entering into a monetary union. This project is based on a shared economic background, as well as on a common language and history. Arabic is the official language across the entire Peninsula. Oil and gas remain the region's most important products, even though some countries have started to diversify their economies, focusing in particular on banking, trade and tourism. All economies are important employers of foreign labour, due to a shortage of human capital in the region.

This chapter reviews the key features of the six economies and the main economic challenges that lie ahead and that have a potential bearing on monetary integration. Section 2.1 looks at the GCC as a whole, putting it into perspective with other economic areas in the global economy. Section 2.2 focuses on the internal structure of the GCC from the perspective of major similarities and differences between the member states. Finally, Section 2.3 is dedicated to the major challenges facing the GCC countries, namely diversification, privatisation and labour market reform.

The main conclusions of the chapter are as follows: firstly, the six GCC member states are overall largely similar in terms of economic structures and face common challenges; secondly, most of their economies are largely based on oil and gas, and are rather open towards the rest of the world; thirdly, while exports of oil and gas mainly go to Asia, a considerable proportion of imports stem from the EU; fourthly, in general, financial markets in the region have not developed to a large extent, as regulation and the strong focus on oil and gas have led investors, also from within the GCC, to prefer investment outside the region; and fifthly, all the economies need to diversify away from oil and gas, to decrease the size of the government sector and to step up education efforts and labour market reform. At the heart of these challenges lies the need to generate sufficiently high growth in the private non-oil sector to promote employment opportunities for the young and rapidly growing population.

Notwithstanding these broad similarities, there are also some considerable differences. Oil and gas endowment differs greatly between countries, and reserves will soon be exhausted in some countries, and in the distant future in others. Financial markets are developed in a few member states, but less so in others. Pressure on the labour market is less acutely felt in some countries, and diversification efforts have not been equally successful everywhere. The effects of these differences will have to be taken into consideration when envisaging monetary union.

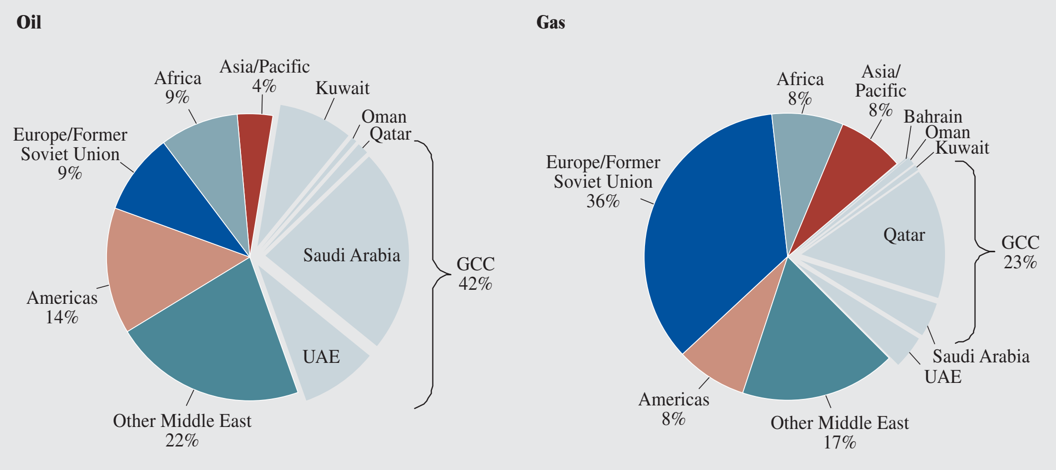
2.1 THE GCC IN THE GLOBAL ECONOMY

The GCC economy as a whole comprises 35 million inhabitants and produces an aggregate GDP of about €376 billion (2004 figures). It is therefore comparable in population to Canada, with which it also shares the distinction of being one of the least densely populated areas in the world. Total GDP is equivalent to roughly half the Canadian or half the aggregated Benelux output. The oil and gas sector contributes more than one-third of GDP in the GCC. Other contributing sectors, albeit much smaller, are construction, tourism and banking. Given the arid climate, agriculture is of negligible importance. Developments in nominal GDP and export values are closely related to energy prices, in accordance with the strong focus on oil and gas in the economy.

2.1.1 OIL AND GAS

The global importance of the GCC member states stems from the fact that the countries jointly account for 42% of global oil reserves, and 23% of global natural gas reserves (see Chart 1).

Chart 1 Geographical distribution of global oil and gas reserves



Source: BP Statistical Review of World Energy, 2004.

The GCC's strategic position in international energy markets will even increase over the next few decades, as it currently produces relatively little oil and gas per year in relation to the size of its currently proven reserves. At present output levels, which amount to 22% of global oil and 6.5% of global gas production, the GCC's reserves are being depleted two to three times more slowly than those of other regions of the world.[6] This suggests that at current production levels, the GCC will be among only a few remaining suppliers of fossil fuels in 2050.

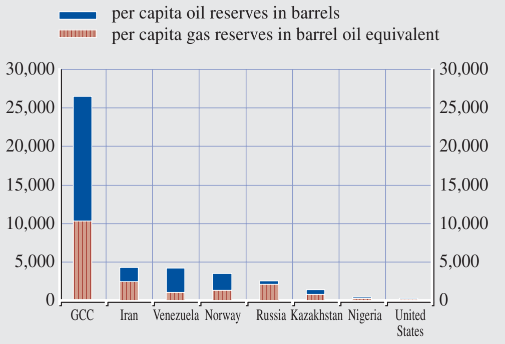
2.1.2 WEALTH

In per capita terms, GCC energy reserves are the highest globally, and comfortably exceed the ratios of the next countries on the list. Per capita oil reserves are more than five times higher than in Venezuela, over 30 times higher than in Russia, and over 150 times higher than in the United States (US). Per capita gas reserves in the GCC are moreover more than four times as high as in the country with the next highest ratio, Iran. Adding oil and gas reserves as energy equivalents yields an average of over 26,500 barrels of oil for each GCC national (see Chart 2), equivalent to a value of about €880,000 at year-end prices (2003).

Income from the export of fossil fuels makes the GCC the wealthiest region in the Middle East and comparable to some of the newly industrialised economies. Average income per capita in nominal terms amounts to some €11,000 per year, which puts the region almost on a par with South Korea, a high-income country by World Bank definitions. A significant part of this income, about €4,000

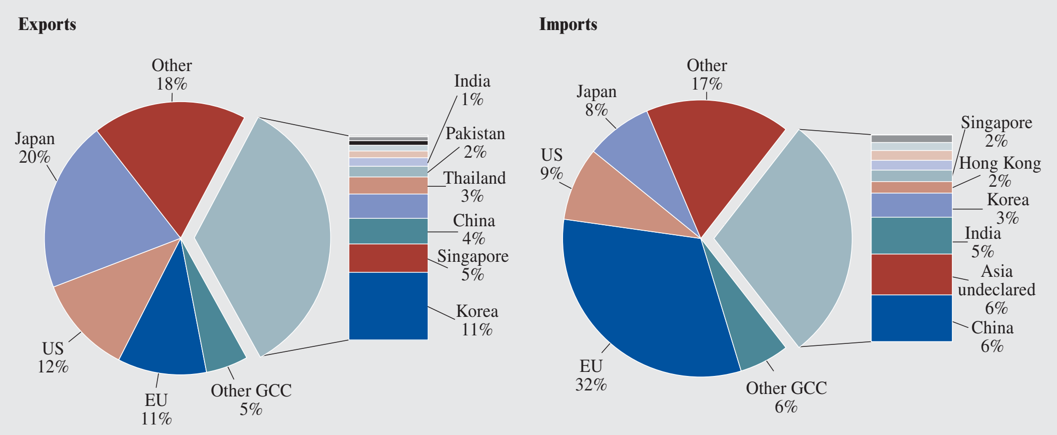
[6] Given that depletion projections depend on various factors that are difficult to predict, such as the future state of technology and prices, they should be regarded as highly tentative.

Chart 2 Per capita oil and gas reserves in barrels equivalent



Sources: BP Statistical Review of World Energy, 2004; CIA and United Nations Economic and Social Commission for Western Asia (ESCWA).

Chart 3 Export and import structures of the GCC



Source: International Monetary Fund (IMF) Direction of Trade Statistics (DOTS).
Note: Data are for 2003.

per capita, is directly generated from oil and gas revenues. The income distribution is more uneven than in most other high-income countries. This gap is most marked between nationals and non-nationals, because nationals receive higher wages than non-nationals. GCC citizens hold large financial assets outside the GCC financial system.[7]

2.1.3 TRADE

With regard to international trade, the GCC is a rather open economy, with the average of exports and imports reaching 48% of GDP. The trade balance has displayed a surplus of 20% of GDP on average over the last five years. While exporting mainly oil and gas, the GCC imports a high proportion of consumer and capital goods as a result of the arid climate conditions and the low share of manufacturing.

Roughly one-third of imports come from the EU and more than a third from Asia, while only 9% come from the US (see Chart 3). Exports are more concentrated and the main export markets for GCC oil are in Asia. Over 65% of total GCC exports are oil and oil products, and more than half of total exports are destined for Asia, principally to Japan, South Korea, Singapore and China. The EU and US account for 11% and 12% of exports respectively. Trade between GCC members is fairly low, accounting for just 5% of exports and 6% of imports. This is explained mainly by the similar factor endowment of the countries; however, trade barriers, which are to be eliminated as part of the integration process, may also have contributed to this low figure (see Chapter 3).

2.2 SIMILARITIES AMONG AND DIFFERENCES BETWEEN GCC ECONOMIES

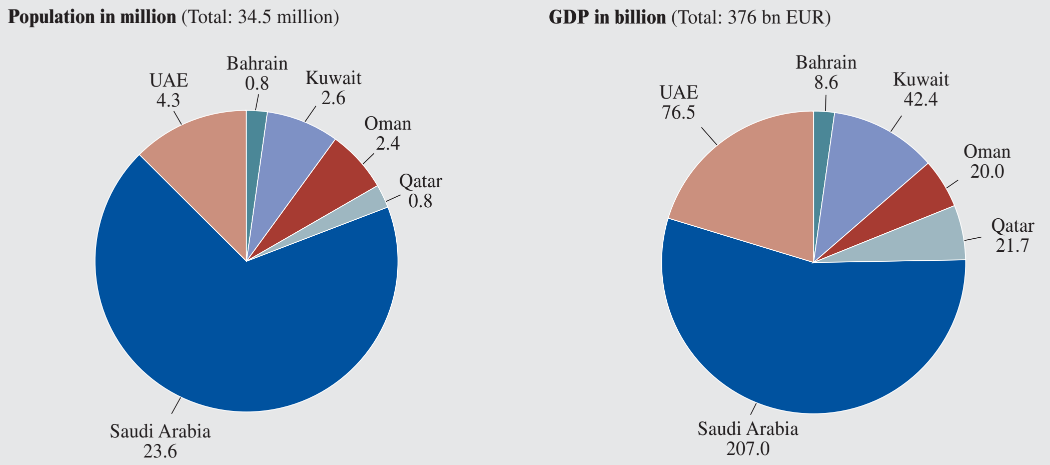
In terms of population and aggregate output, Saudi Arabia is the largest of the six countries, comprising about 24 million inhabitants (about 70% of the total GCC population) and accounting for more than half of total GCC GDP. The other five countries are considerably smaller: the second largest country, the UAE, is home to only 4.3 million people, or one-fifth of the Saudi population. The UAE produces roughly a fifth of total GCC GDP, less than half that of Saudi Arabia (see Chart 4).[8]

While Saudi Arabia has the largest overall weight in the GCC with regard to both population and total GDP, its income per capita

[7] Bourland (2001) estimates these assets at €870 billion, i.e. over 230% of GDP. However, such estimates are subject to great uncertainty.

[8] Similarities and differences between GCC economies with regard to economic developments (such as inflation and fiscal policies) will be discussed in Chapter 4.

Chart 4 GCC basic economic indicators

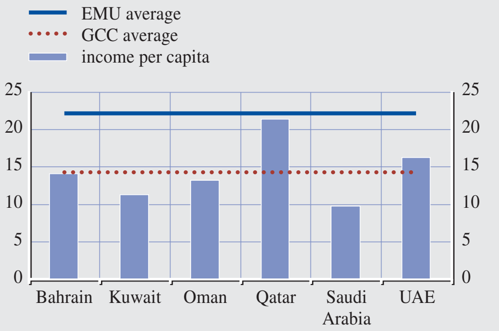


Sources: IMF, ECB staff calculations.
Note: Data are for 2004.

is lower than in most of the other countries. GDP per capita in Qatar is three times higher than in Saudi Arabia and even exceeds the euro area average by some 10% in nominal terms. With a GDP per capita (in 2004) in nominal terms of about €27,000 and €17,600 respectively, Qatar and the UAE are the wealthiest countries in the GCC. While the GDP per capita of Bahrain and Kuwait is lower, they are also high-income countries. Oman and Saudi Arabia (with a GDP per capita above €8,500) are upper middle-income countries, and are still far wealthier than the majority of the other Arab Middle Eastern countries. Converted to purchasing power parity (PPP) standards, the differences between GCC economies are less pronounced, although Qatar's GDP per capita remains more than twice as high as Saudi Arabia's, and almost equals the euro area average (see Chart 5).

Chart 5 Income per capita in individual GCC countries and GCC average

(GDP per capita in thousands, EUR, PPP)



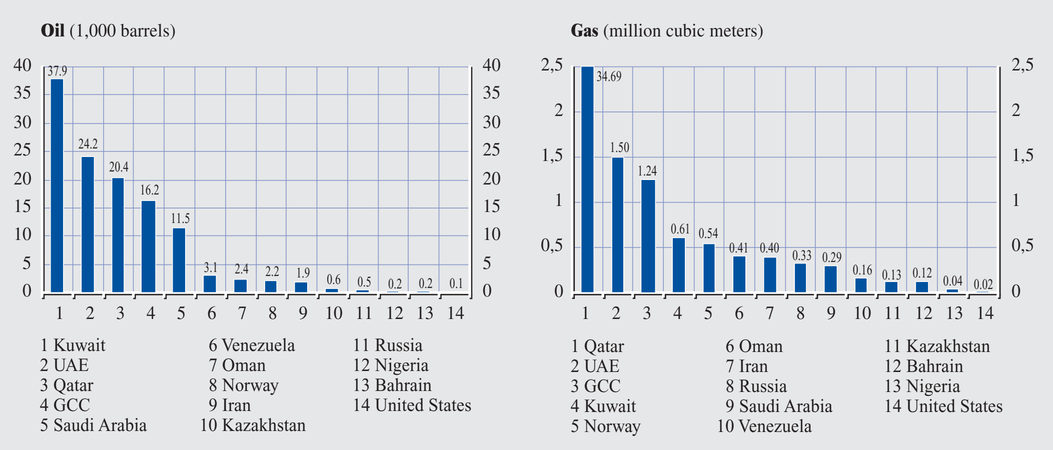
Sources: IMF, ECB staff calculations.
Note: Data are for 2004.

2.2.1 OIL AND GAS ENDOWMENT BY COUNTRY

Saudi Arabia accounts for more than half of all GCC oil reserves, while resources in the other GCC countries are considerably lower, with Bahrain in particular having only very limited natural resources. Although possessing relatively little oil, Qatar is home to the third largest natural gas reserves worldwide after Russia and Iran, and receives a considerable proportion of its income from gas. An examination of reserves in per capita terms reveals large differences in both oil and gas wealth per capita between countries (see Chart 6). Oil reserves per capita are relatively low in Oman and Bahrain, and considerably higher in the other countries. Similarly, gas reserves are relatively small in Oman, Saudi Arabia and Bahrain.

While these differences between countries are reflected in current production levels, resources are especially tight in Oman and Bahrain where, at current production levels, oil will run out

Chart 6 Per capita oil and gas reserves



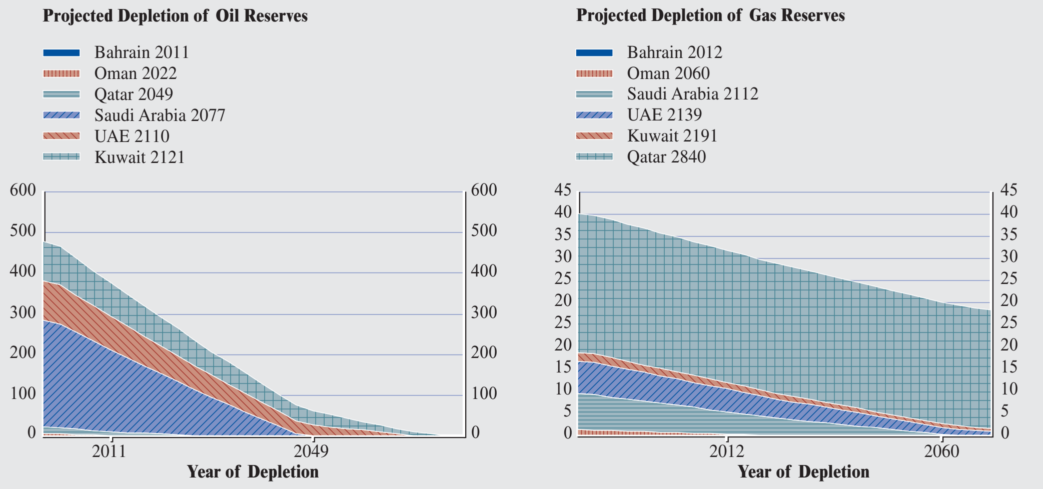
Source: BP Statistical Review of World Energy, June 2004. Oil reserves in barrels and gas reserves in cubic metres per capita.

during the next two decades. By contrast, oil reserves will last more than 100 years in Kuwait and the UAE, which means that these countries will be the only producers of oil in the GCC in 2100. Gas complements oil both in terms of drilling and revenues. With almost 15% of the world's natural gas reserves, Qatar's gas will not be exhausted within the next 800 years at current production levels. It is the only country that may be producing gas far into the next century at current output levels (see Chart 7). At the other extreme, Bahrain's reserves will run out soonest, with an estimated lifetime of less than ten years.

The pressure to diversify differs between GCC countries in line with the differences in energy reserves. GCC governments have started to aim at diversifying into other sectors, such as tourism and services. Approaches have varied widely, with the focus ranging from tourism to banking and manufacturing (see Section 2.3.1).

Chart 7 Projected depletion of reserves

(oil reserves in billion barrels; gas reserves in trillion cubic metres)



Source: BP Statistical Review of World Energy, June 2004.

Table 1 Source of GCC imports (2003)

	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	UAE	Total GCC
Imports-to-GDP ratio (%)	69.9	38.9	37.7	38.9	23.6	64.7	34.9
Source of Imports [1]							
Other GCC	35.8	9.6	27.8	14.9	2.5	2.7	5.9
EU	24.4	34.1	21.7	35.5	31.1	33.6	31.9
United States	11.4	14.5	6.2	12.2	9.3	6.5	8.6
Japan	7.8	10.1	17.1	10.5	7.6	6.7	8.0
Asia (excl. Japan)	10.7	17.8	15.6	17.2	26.9	36.4	28.8

Sources: IMF DOTS and World Economic Outlook (WEO).
1) As a % of total imports.

2.2.2 TRADE PATTERNS OF GCC MEMBER STATES

While the GCC is overall rather open, the openness of the individual economies varies widely, ranging from 77% and 72% in Bahrain and the UAE respectively, to 35% in Saudi Arabia.[9] For the GCC as a whole, the EU is the most important provider of imports, with a share of more than 30% of total imports. With the exception of the UAE, all countries receive the largest percentage of their extra-regional imports from the EU. By contrast, the share of imports from the US is less than 10% of total GCC imports, or below one-sixth of the total imports of each individual country (see Table 1).

On the export side, most of the prominent recipients of GCC exports are located in Asia, with the exception of Saudi Arabia, which also exports a large share to the US. Intra-regional trade is fairly limited. Except for Oman, no country exports more than 10% of its total exports to other GCC members (see Table 2). However, this picture changes somewhat if we look at non-oil trade instead of total trade. Kuwait and Qatar exhibit the highest share of intra-GCC non-oil exports among member states, exporting more than half of their total non-oil exports (mostly chemicals) to other GCC countries. Overall, non-oil trade accounts for roughly one-third of total trade within the region.[10]

On the import side, intra-regional trade is most important for Bahrain and Oman, which receive a considerable percentage of their imports from the other Gulf states (Oman imports machinery mainly from the UAE,

[9] Openess is defined here as the average of exports and imports per GDP.

[10] See Jadresic (2002).

Table 2 Destination of GCC exports (2003)

	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	UAE	Total GCC
Exports-to-GDP ratio (%)	83.9	54.8	56.2	72.0	45.9	79.1	55.8
Destination of Exports [1]							
Other GCC	5.9	1.5	10.6	4.8	4.8	5.1	4.9
EU	3.7	10.4	2.2	2.1	15.7	7.6	10.7
United States	3.6	11.9	3.3	1.7	20.7	2.2	11.7
Japan	1.3	22.0	16.2	46.0	15.4	26.1	20.3
Asia (excl. Japan)	8.1	49.2	59.4	36.6	32.1	31.4	34.2

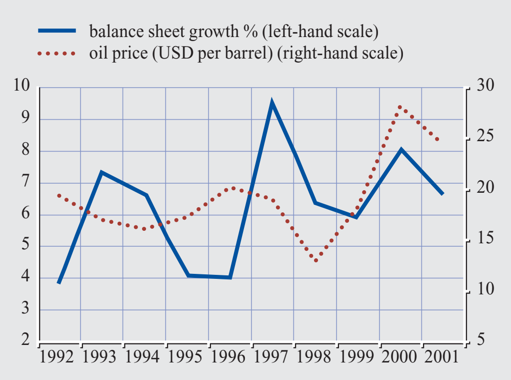
Sources: IMF DOTS and WEO.
1) As a % of total exports.

while Bahrain imports predominantly oil and fuel products from Saudi Arabia). The other countries receive less than 15% from the other GCC member states.

2.2.3 FINANCIAL MARKETS

The GCC financial systems are still relatively small in most countries, but have developed over recent years. They are largely bank-based, although stock markets have recently expanded. The banking sector is generally well developed, profitable and efficient, in particular compared with other Middle Eastern and North African countries.[11] Total GCC banking assets amount to about 122% of GDP (2003), with Bahrain, where bank assets exceed 800% of GDP, serving as a regional banking hub.[12] Due to interest rate ceilings in some countries in the past, bank lending has focused on the government sector rather than on the local private sector. Although cross-border lending within the GCC has been permitted for several years, a genuine intra-regional GCC banking market has not emerged (see Chapter 3). Besides bureaucratic obstacles to cross-border banking, expansion into other GCC countries does not significantly improve diversification for banks, as all six economies are largely based on oil and gas. In addition, one of the main driving forces for cross-border expansion, namely trade in goods and services, is at a low level, and has only recently become more dynamic.

Chart 8 Balance sheet growth of GCC commercial banks and oil price developments



Source: Arab Monetary Fund (AMF).

Given that many economic activities are closely linked to oil price changes, they also have an impact on banks' balance sheets. Indeed, the growth of GCC banks' balance sheets is correlated with oil price developments (see Chart 8). On the liability side, it is worth noting that, overall, GCC banks are well capitalised. Moreover, financial institutions have been obliged to comply with the Basel standards. In order to prepare for a common financial area, regulation may require harmonisation across countries and increased cooperation between regulators across borders (see Chapters 3 and 6).

Capital markets in the GCC have only recently expanded and significantly differ in size between member states. In September 2004, the total stock market capitalisation of GCC countries amounted to 113% of GDP, up from 42% in 2002, reflecting the stock market boom in the wake of high oil prices. Stock market capitalisation ranges from 51% of GDP in Oman to 171% and 175% of GDP in Kuwait and Qatar, respectively. Formal and sophisticated trading infrastructures have only been established over the last decade in many countries, and most of the GCC stock exchanges still have considerable potential for development. The Saudi Arabian Monetary Agency (SAMA) sponsors a sophisticated computer-based stock trading system, Tadawul.[13] Qatar established the DSM (Doha Securities Market) in 1997, while the Bahrain and Oman exchanges have been in operation for several years. Bank assets exceed stock market capitalisation significantly in all countries except Qatar and Saudi Arabia. Total market capitalisation (measured by bank assets plus stock market capitalisation to GDP) is highest in Bahrain and Kuwait, while banking and stock market capitalisation combined are lowest in Saudi Arabia and in Oman (see Table 3).

[11] See Creane, Goyal, Mobarak and Sab (2004) and Berthélemy and Bentahar (2004).

[12] However, over 80% of bank assets in Bahrain are located in the offshore sector, which may only conduct banking activities with non-residents.

[13] A capital market law that enforces complete disclosure by listed companies was approved by Saudi Arabia's Council of Ministers on 15 June 2003.

Table 3 Financial sector indicators

(percentages)

	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	UAE	GCC
Bank assets/GDP	866	329	50	98	62	121	122
Stock market capitalisation/GDP	163	171	51	175	126	96	113

Sources: IMF International Financial Statistics (IFS) and AMF.
Note: Bank assets in 2003, stock market capitalisation in September 2004.

Unlike stock markets, secondary bond markets have not developed at all. Bonds issued by entities located inside the GCC equal less than 3% of GDP, around €13.3 billion. Most bonds are listed abroad, particularly in Luxembourg. Participation in the local capital markets is largely restricted to the local population. As a consequence, inward portfolio investment has been subdued.

A low degree of inward investment is also reflected in low rates of foreign direct investment (FDI). The ratio of FDI stock to GDP is, at around 11% (2003), considerably lower than the world average of 23% or the average for either developed countries or developing countries (20% and 31% respectively). In addition to the low figures in absolute terms, FDI flows have been highly volatile and closely linked to the oil price. After recording net FDI outflows for two years in 1999 and 2000, the GCC received positive net FDI inflows of some €0.6 billion in 2001, €1 billion in 2002 and €5.9 billion in 2003.

2.3 KEY ECONOMIC CHALLENGES

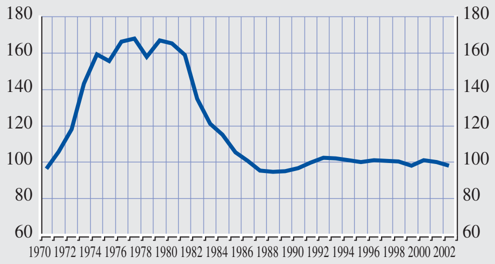
The GCC economy faces three major challenges to economic development, namely an increased need for diversification away from oil and gas; privatisation in view of the large size of the government sector; and labour market reform and education. The key issue behind these challenges is generating sustainable high growth in the private non-oil sector that can provide employment opportunities for a young and rapidly growing population.

2.3.1 DIVERSIFICATION

A main issue for the GCC economy is its strong orientation towards oil and gas, which makes it highly dependent on price developments in global markets. While providing an important source of income, the strong reliance on oil has also proven to be a liability. Oil production has lifted the level of economic development and living standards enormously in past decades, and the GCC countries went from being essentially subsistence economies in the 1960s to extremely wealthy countries by 1980. However, following the decrease in oil prices during the early to mid-1980s, income per capita fell considerably and has stagnated or even declined slightly since then (see Chart 9). The virtual stagnation of per capita incomes over the past 20 years is a major economic issue for the region, and sets it apart from many other emerging economies that by contrast witnessed a steady and often even rapid increase in incomes during the 1980s and 1990s.

Chart 9 Average GCC GDP per capita

(1995 = 100)



Sources: World Bank World Development Indicators (WDI) database, ECB staff calculations.
Note: Data for a limited number of years are not included for Bahrain, Kuwait, Qatar and UAE due to lack of availability.

Table 4 Oil dependency of the GCC and its member countries

Oil share in ...	GCC	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	UAE
GDP [1)]	36.0	25.7	45.9	43.1	56.8	34.9	28.1
Govt. revenue [2)]	79.3	73.0	91.5	78.4	64.2	80.6	75.3
Exports [3)]	67.0	66.7	83.8	64.5	34.5	85.5	38.8

Sources: AMF, national central banks, IMF, Institute of International Finance (IIF).
1) Oil and gas sector's share of GDP as a % in 2001.
2) Oil revenue/total government revenue as a % (includes gas revenues for Bahrain) in 2000.
3) Oil and oil products' share of total exports as a % in 2004.

The high oil dependency of the GCC economy is reflected in the share of the oil and gas sector in GDP, the share of oil revenues in government revenues and the share of oil exports in overall exports (see Table 4). Calculations by the Arab Monetary Fund (AMF) suggest that the oil and gas sectors contribute more than one-third of total GCC output. Taking into account the fact that over 80% of public services are financed by oil revenues, the share of GDP that depends directly and indirectly on oil and gas revenues exceeds 50% of the total.

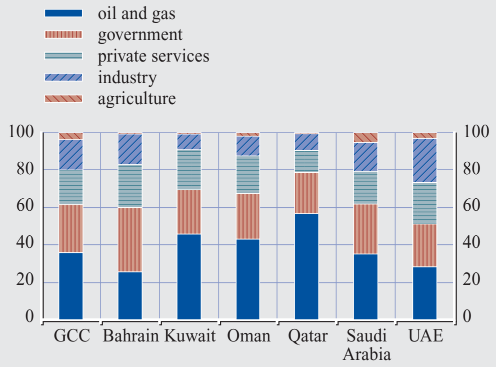
Oil income contributes around 80% to government revenues, while oil exports account for over two-thirds of total GCC exports. Only 10% of GDP is generated by manufacturing, and just 4% by agriculture (see Chart 10).[14]

The high contribution from oil to GCC countries' overall exports and government revenues implies that oil price volatility translates into volatility in current account balances and government budget balances. Since there is no personal income tax or a general consumption or value-added tax in any of the countries, the financial base of the GCC governments is particularly exposed to oil price volatility (see Chart 11).

[14] This reflects the adverse climatic conditions in all six countries. Accordingly, the share of the urban population exceeds 80% in each country, and is as high as 98% in Kuwait.

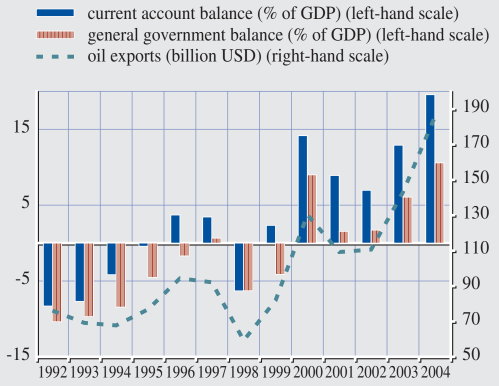
Chart 10 GDP shares by sector

(percentages)



Source: AMF.
Note: Data are for 2001.

Chart 11 Influence of oil exports on current account and government budget

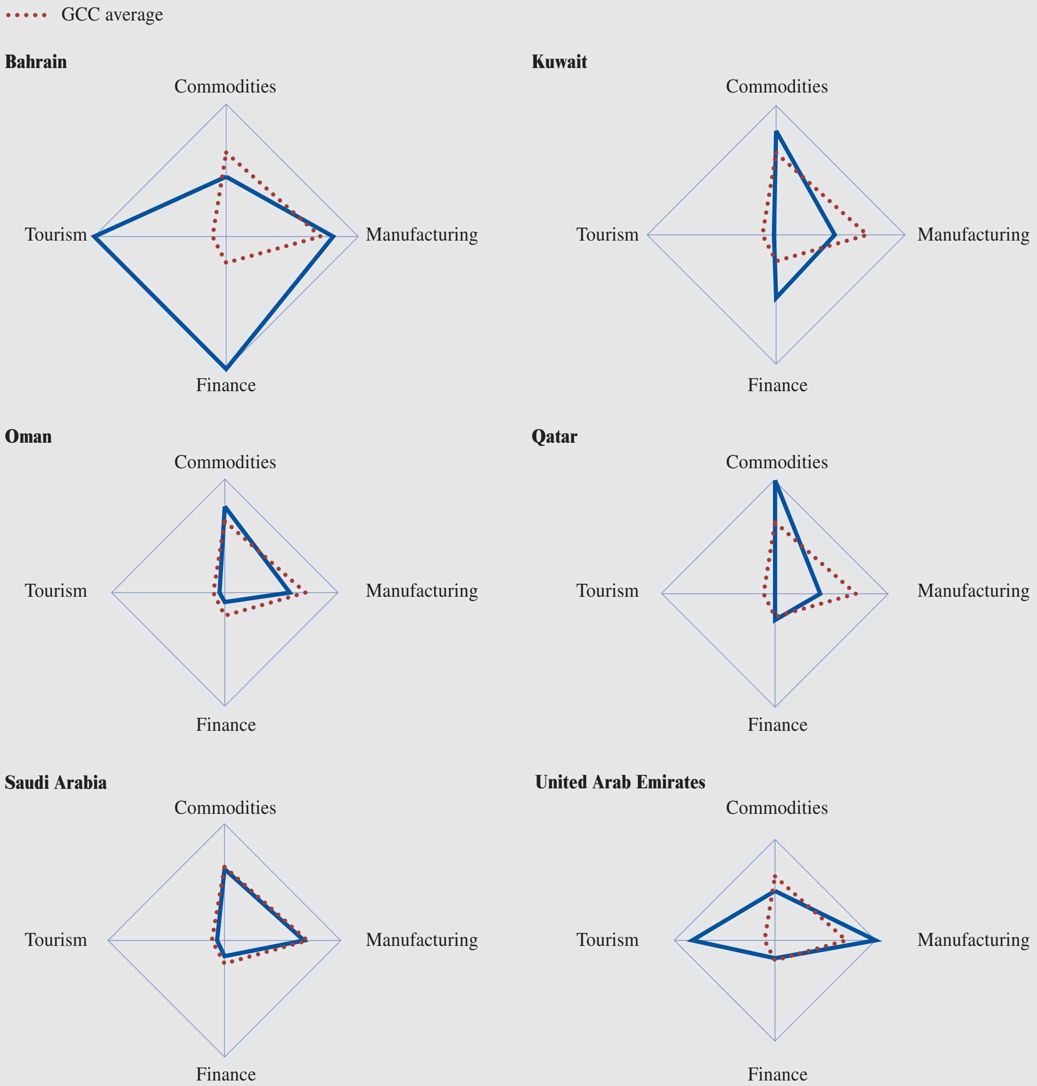


Sources: IMF, ECB staff aggregations for the GCC.

To reduce oil dependency, to enhance output and efficiency in other sectors and to smooth economic dynamics, diversification and privatisation have been declared key economic policy priorities. Moreover, governments have realised that neither the public sector nor the oil industry alone will provide sufficient job opportunities for their young and growing populations. The development of the private non-oil sector is therefore seen as crucial to ease labour market pressure.

The need for diversification is particularly strong in Bahrain and Oman, whose oil reserves are limited and are expected to run out during the next two decades. Every GCC member state

Chart 12 Diversification across GCC member states



Sources: ECB staff calculations on the basis of data from the AMF, the IMF, the World Tourism Organization and national authorities.
Note: The graphs give shares of the maximum of all six countries. "Tourism" refers to tourist arrivals per capita of national population; "Commodities" is income from oil and gas per GDP; "Finance" is stock market capitalisation plus bank loans per GDP; and "Manufacturing" is the share of manufacturing in GDP.

has made efforts to diversify and to privatise, including the opening up and liberalisation of markets and the creation of an environment more conducive to FDI inflows. In this context, Saudi Arabia is currently applying for World Trade Organization (WTO) membership, while the other five GCC countries are already members.

Using the percentage contribution of oil income to GDP, government revenue and exports as rough measures of oil dependence, the success of diversification efforts varies between the countries. Between 1986 and 1991, the export share of oil even rose, before stagnating around a level of 65% after 1995. While Bahrain and the UAE in particular have been successful in reducing their oil dependence, in the other four countries it is considerably higher. The oil share in exports has stagnated at levels around 80% of total exports in Kuwait and Saudi Arabia.

Chart 12 depicts the state of diversification in the four most likely areas for generating income in the GCC countries, namely commodities, manufacturing, finance and tourism.

These diversification results reveal the following marked differences between individual countries:

– Bahrain has established itself as a financial hub for the Gulf region and for the Arab world, particularly in Islamic banking. Tourism, transport and related services are other areas in which the country is gaining ground.

– The UAE has similarly diversified into tourism, manufacturing and transport, making it the only other country apart from Bahrain with a relatively low level of oil dependency.

– Kuwait remains highly dependent on commodities, while finance has developed recently.

– Oman, despite having diversified into manufacturing to a certain extent, is one of the countries where the need for structural change away from production of oil and gas is most pressing.

– Saudi Arabia is not focused completely on commodities either, but generates 10% of GDP in the manufacturing sector and is quite active in the construction sector. The exploration of natural gas resources is seen as another important source of diversification, and an area for which Saudi Arabia has great expectations.

– Qatar is even more focused on oil exploration, and is also developing large capacities for the extraction of natural gas. A switch from oil to gas as the main source of export revenues would not completely solve the problems related to the Gulf countries' role as primary commodity exporters. However, this move would still reduce the effects of price volatility, as natural gas prices tend to be less volatile than spot prices on the oil market.

The differences in both endowment of oil and gas and in diversification efforts may induce considerable differences in the economic structures across GCC countries. While today all the GCC countries largely rely on energy exports, this can be expected to change to a varying degree over the coming decades, as discussed above. This development may make the GCC economy more prone to asymmetric reactions to exogenous economic shocks (see Chapter 4).

2.3.2 PRIVATISATION

Privatisation is seen as the key to diversification and greater economic efficiency. A major problem for GCC economies is their large government sectors, in combination with the high degree of dependence of government budgets on oil and gas. Oil companies are nationalised, ensuring government control of this vital sector. Government spending on large infrastructure projects also strongly influences the non-oil sector of the Gulf economies. As this type of spending typically varies with fluctuations in budget balances and thus oil revenues, the volatility of oil prices also has a major impact on the non-oil sector (see also Chapters 4 and 5). Public sector companies are predominant in other key sectors such as telecommunications, energy and water supply, health and air transport. Moving away from this dependence requires intense privatisation efforts. Currently, government services contribute 25% to GCC GDP and are the main source of employment for nationals. The result in most cases is large administrations and a high share of wage payments in government budgets.

While all governments have embarked on the privatisation process, it is difficult to gauge the success of these efforts. Large privatisation projects, especially in public utilities, have raised the private sector contribution to GDP over the last decade. However, the distinction between the public and private sectors is not straightforward, as it is sometimes difficult to attribute shareholder ownership clearly to the two sectors.

The opening of capital markets is another aspect of efficient privatisation that needs further development. Foreign investment regulations have been changed considerably to permit foreigners to hold shares in GCC companies (see Chapter 3). However, restrictions on access to the stock exchanges and on majority holdings in GCC companies in several member states continue to prevent the allocation of international capital to the GCC market.

2.3.3 LABOUR MARKET REFORM AND EDUCATION

High population growth has become an increasing challenge for national governments, as it has been accompanied by rising unemployment, especially among the young. The GCC area has been characterised by one of the world's highest rates of population growth (3.2% per year over the past decade), resulting in a very young population. In 2002, almost 40% of the GCC population were below 15 years of age.

Besides high birth rates among nationals, immigration has contributed to population growth in some member states. The economies of the GCC rely to an extraordinarily high extent on expatriate workers. An educational mismatch of the local population has prevented GCC nationals from working in most industries that require higher education, especially technical skills. Accordingly, high-skilled labour is carried out to a considerable extent by expatriates. Non-nationals (mostly from South-East Asia or other Arab countries) also provide a large part of the unskilled labour. As a result, expatriates outnumber nationals in the workforces of some GCC countries. The share of nationals in the total population is only 65%, while the share in the workforce is even lower, as immigrant workers do not always bring their families (see Table 5).

Given high population growth and young populations, young GCC nationals find it increasingly difficult to obtain employment. While official unemployment figures do not exist for all countries, external sources estimate that unemployment in the GCC ranges

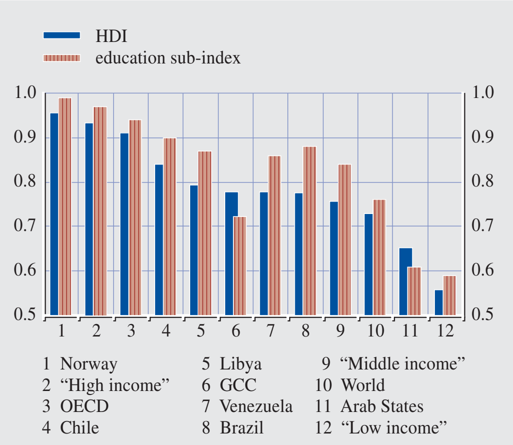
Table 5 Shares of nationals in total population

(percentages)

GCC average	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	UAE
65.1	60.0	33.4	77.3	26.3	74.6	24.3

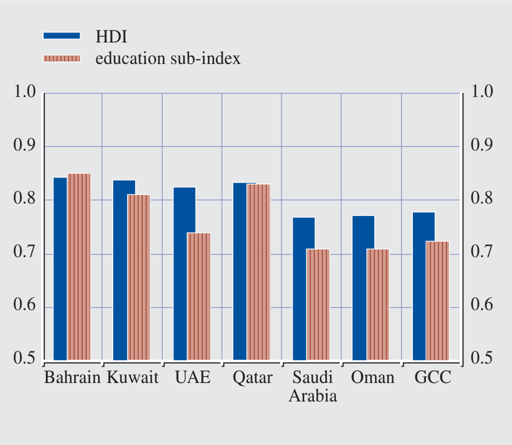
Source: ESCWA.
Note: Data refer to 2000.

Chart 13 Human Development Index and education sub-index



Sources: World Bank, ECB staff calculations.

Chart 14 Human Development Index and education sub-index in the GCC



Sources: World Bank, ECB staff calculations.

from 3% to 17%.[15] The Arab Human Development Report 2002 indicates that the population in the region will continue to grow rapidly, exceeding 44 million by 2020, some 140% of the current population.[16] The populations in Saudi Arabia and Oman are expected to grow by around 60% within two decades (i.e. between 2000 and 2020). In combination with low oil resources, the pressure on the labour market is especially strong in Oman. While Bahrain's population will also grow rapidly, the country seems sufficiently diversified to cope with running out of gas.

GCC governments have attempted to address this challenge by initially reserving positions in the public sector largely for nationals. Many nationals are employed in the services sector, a large part of which is public. Services employ over three-quarters of the active population, but only contribute 43% to GDP. More recently, quotas for nationals and stricter work permit requirements for the employment of expatriates have increasingly been imposed in the private sector as well.

This policy of regulation is complemented by efforts to enhance the education and training of nationals. While the level of education has been raised considerably over recent years, there is still room for improvement in tertiary education. Educational standards in the GCC countries lag somewhat behind the world average. The overall Human Development Index (HDI) for the GCC compares favourably with the world average (see Chart 13). But while income and life expectancy in the GCC exceed the world average, the sub-index for education compares unfavourably not only with the high and middle-income countries, but also with the world average. By contrast with the GCC, the education sub-index exceeds the overall HDI in both high-income and middle-income countries. The Arab states as a whole comprise the only country group in which the education index lags behind the HDI. Indeed, this index is fairly similar across GCC member countries (see Chart 14), and lags behind the HDI in every GCC country except Bahrain and (just) Qatar. In terms of adult literacy, none of the six countries matches the middle-income country average of 89% of the population.

[15] Figures from United Nations (2002). Estimated unemployment of the working-age national population in UAE is 2.6%, Bahrain 3.1%, Qatar 5.1%, Kuwait 7.1%, Saudi Arabia 15.0% and Oman 17.2%.

[16] United Nations (2002). Forecasts for growth in the period 2000-2020 are: UAE 23%, Qatar 29%, Bahrain 30%, Kuwait 30%, Saudi Arabia 61%, and Oman 63%. This corresponds to annual growth rates of between 1% and 2.5%.

Education levels vary widely, and are most advanced in Bahrain, Qatar and Kuwait, where enrolment rates at all levels of education of over three-quarters compare well with those of middle-income countries. In the GCC as a whole, enrolment rates are on average lower than in the Arab world as a whole. Enrolment rates in the range of 60% in Oman and Saudi Arabia indicate possible challenges regarding the development of labour market qualifications in these countries. This generates a potentially problematic mixture with population growth.

3 INSTITUTIONAL AND ECONOMIC INTEGRATION IN THE GCC

This chapter – after highlighting the relevance of the broader integration process for monetary union in the GCC – outlines the institutional underpinnings on which the GCC's economic integration project is based. It sets out the basic legal texts of the GCC and describes the main decision-making and implementing bodies. Furthermore, it summarises the development of the GCC's economic integration project since its inception in 1981. The chapter also briefly states the objectives of the process as set out in the statutes and the principal economic agreements. It then provides a summary assessment of progress made towards these objectives, using as a benchmark the so-called four freedoms – the free movement of goods, services, capital and natural persons.[17]

The key findings of this chapter are as follows. The project of monetary union in the GCC is not an isolated act of integration, but is embedded in a comprehensive integration project, aimed at the creation of a common market that would remove all barriers to the movement of goods, services, labour and capital. While both the objectives and timetable of economic integration in the GCC are ambitious and seem sufficient to underpin a sustainable monetary union, the effective implementation of the agreed objectives will be of paramount importance prior to the planned introduction of a single currency in 2010. In addition, with regard to areas such as capital markets, some services sectors and possibly labour mobility, the expected efficiency gains of a common market (and monetary union) are limited by the dominance of the public sector in GCC member states, which tends to bypass the allocation function of the market. The GCC has developed a broad range of institutions to support the economic integration process. The institutional framework of the GCC has so far relied heavily on an approach based on comprehensive intergovernmental coordination at the political and technical levels. While this construction has its merits and appears to have served its purpose well in the past, GCC institutions might need to be strengthened in the light of integration steps ahead.

3.1 RELEVANCE OF THE BROADER INTEGRATION PROCESS IN THE GCC FOR MONETARY UNION

As in any monetary union, the economic viability of the GCC's project to introduce a single currency crucially hinges on the degree of economic integration among its members. The expected economic benefits of adopting a single currency are associated with, among other factors, reduced uncertainty, lower transaction costs and the facilitation of cross-border trade and financial transactions. In order to reap these benefits fully, it is desirable to eliminate in the GCC, insofar as possible, non-monetary obstacles to integration. Moreover, a high degree of cross-border factor mobility can also serve to mitigate the economic impact of asymmetric shocks and can thus contribute to the sustainability of the monetary union.

The project of GCC monetary union therefore needs to be embedded in a broader effort towards comprehensive economic integration, which should ultimately aim to eliminate all barriers to the movement of goods, services, labour and capital. A logical sequencing of stages of integration is thereby warranted, with monetary union ideally being established only when economic integration has matured to an extent that lends credibility to the monetary integration project. The GCC's schedule in terms of economic integration – a fully fledged free trade area to be established via a customs union in 2003, then the completion of a common market in 2007, to be followed by monetary union in 2010 as outlined below – is consistent with this approach. The timing of this schedule is, however, ambitious. The challenge in the coming years will be to implement the envisaged stages of integration

[17] In the European context, these four freedoms were laid down as the hallmark of the establishment of the Single Market in the Single European Act (signed in 1986).

effectively. This will require, judging from the European experience, political commitment at the highest level, strong administrative capacities and enhanced multilateral surveillance.

3.2 THE INSTITUTIONAL FRAMEWORK OF THE GCC

3.2.1 LEGAL FOUNDATIONS

The six Heads of State of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the UAE founded the GCC by signing the "Charter of the Cooperation Council" in Abu Dhabi in May 1981. The Charter establishes the main bodies of the GCC, namely the Supreme Council, the Ministerial Council and the Secretariat General and lays down their composition, their functions and their mutual relations.[18] In November 1981 GCC leaders signed the "Unified Economic Agreement", which replaced previous bilateral agreements and stipulated in some detail the main objectives and measures of economic cooperation. The Unified Economic Agreement came into force in January 1982 and remained the legal basis for much of the GCC's integration process until it was replaced 20 years later by the new "Economic Agreement between the States of the Cooperation Council" concluded by the GCC Summit in Muscat in 2001. In addition to these founding documents, the Supreme Council has over time adopted a number of GCC laws and regulations.

3.2.2 GCC INSTITUTIONS

The institutional framework of the GCC today comprises three main pillars, namely the *intergovernmental decision-making and consultative bodies* with the *Supreme Council* and the *Ministerial Council* at its core, the *Secretariat General* as the major supranational institution, and a number of *specialised regional agencies*.[19]

Intergovernmental bodies

The *Supreme Council* is the GCC's highest authority and main decision-making body. It is composed of the Heads of State of the member states, and its presidency is rotated annually. The Supreme Council's main tasks are to provide policy direction, review reports and recommendations submitted by subsidiary bodies and to appoint the Secretary General of the GCC. Resolutions are passed on the basis of unanimity for substantive matters, and by simple majority for procedural matters. The Supreme Council meets twice a year (once formally and once informally), with the option of extraordinary sessions at the request of individual member states.[20]

The *Ministerial Council* is composed of Foreign Ministers or other ministers as delegated by member states. It proposes policies and prepares recommendations, studies and projects in all fields. Like the Supreme Council, resolutions are passed on the basis of unanimity for substantive matters and by majority for procedural matters. The Ministerial Council meets every three months, with the option of extraordinary sessions at the request of member states. At the ministerial level, a number of specialised committees have also been established, of which the most important in respect of economic integration is the *Committee for Financial and Economic Cooperation*, which is composed of the Ministers of Finance and Economics. These

[18] The Rules of Procedure for the Supreme Council, the Ministerial Council and the Commission for the Settlement of Disputes were also approved in May 1981.

[19] Among these institutions, only the Supreme Council (along with its Dispute Settlement Commission), the Ministerial Council and the Secretariat General were established by the 1981 GCC Charter. Since then, numerous intergovernmental committees and sub-committees have been established at various official and working levels; the Secretariat General has been extended and assigned new responsibilities; and common agencies have been established to provide technical and research services to the region.

[20] The Charter of the GCC also provides for a Commission for the Settlement of Disputes, which is attached to the Supreme Council. The Commission is formed on an ad hoc basis for each case. The Commission looks into the case and submits its (non-binding) recommendations to the Supreme Council. However, this provision has not been invoked since the founding of the GCC. In addition, in 1997 the Consultative Commission for the Supreme Council was established to provide advice on any subject referred to it by the Supreme Council. It comprises 30 members, with seats equally distributed among the six member countries.

ministerial committees are similar to the Ministerial Council in their working procedures, as they prepare studies and submit recommendations to the Supreme Council through the Ministerial Council. They in turn mandate various sub-committees to conduct studies, draft proposals and coordinate national policies at a technical level.

As a rule, the various intergovernmental bodies may pass binding and non-binding decisions only at their level and in their field of jurisdiction. While the Supreme Council's decisions are to be applied through decrees issued at least at the level of the member states' councils of ministers, the ministerial committees may approve common rules within the executive jurisdiction of the respective ministers. Central bank cooperation in the GCC takes place within the *Monetary Agencies and Central Bank Governors' Committee*, which meets twice a year and reports to the Committee for Financial and Economic Cooperation, and its sub-committees, which include the Banking Supervision Committee, the Payment Systems Committee, the Monetary Union Committee and the Training Committee.

The GCC Secretariat General

The *Secretariat General* is the GCC institution with the most pronounced supranational character (see Box for its functions and interaction with the intergovernmental bodies). In contrast to the above-mentioned bodies, the Secretariat General does not consist of representatives of the member states, as its mandate, according to the GCC Charter, is to work independently and for the common interest of the members. It is located in Riyadh with a staff of approximately 400, and is headed by the Secretary General, who serves a three-year term, renewable only once. The Secretary General nominates the Assistant Secretaries General, who are appointed by the Ministerial Council for renewable three-year terms. The Secretariat General is composed of six Directorates (Political Affairs, Economic Affairs, Military Affairs, Environmental and Human Resources, Legal Affairs and Financial and Administrative Affairs) and an Information Centre. The new monetary union unit, which the Supreme Council decided to establish at its 2002 session in Doha, has also been attached to the Secretariat General. This will increase the number of staff working on monetary affairs at the Secretariat General.

Box

FUNCTIONS OF THE GCC SECRETARIAT GENERAL AND ITS INTERACTION WITH INTERGOVERNMENTAL BODIES

The Secretariat General is not only in charge of the administrative preparation and follow-up of the meetings of the intergovernmental bodies, but also prepares studies and reports on issues related to the cooperation objectives, follows up the member states' implementation of GCC resolutions and recommendations, and drafts resolutions and common legislation. Its representatives participate in the consultations of the various specialised committees. Moreover, the Secretariat General acts as the common representative of the GCC in some international fora, such as the Financial Action Task Force on Money Laundering in Paris. There is also a GCC Permanent Mission to the European Commission in Brussels. A new task was assigned to the Secretariat General in Article 27 of the 2001 Economic Agreement, namely the settlement of disputes concerning the implementation of the Agreement and the ratified decisions based on it, including claims raised by private parties. In such cases, the Secretariat General will try to reach a harmonious solution between the parties, or will refer the matter to the GCC Commercial Arbitration Center or a newly formed judicial body.

The interaction between the Secretariat General and the various intergovernmental bodies in the process of GCC legislation can serve to illustrate the relationship between these two major pillars of the GCC institutional framework. In some cases, the Supreme Council can decide to harmonise national legislation in a specific field and then mandates the Secretariat General to draft a new GCC law/regulation. The competent branches of the Secretariat General study the existing national legislation and draft the common legal text in cooperation with experts from the member states. The draft is then presented to the specialised sub-committees of the Council for review. These committees can request modifications according to the wishes of the member states or decide to recommend its adoption by the Ministerial Council or the Supreme Council. Finally, the Ministerial Council or the Supreme Council decides whether to adopt the legislation and whether to accord it binding or exemplary character. Legislation has to be ratified by the relevant national bodies of member states, but this tends to be no obstacle given the consensus-driven approach to adopting legislation at the GCC level.

Specialised agencies

GCC member states have also set up a number of specialised agencies, such as the Standardization and Metrology Organization for GCC Countries,[21] the GCC Commercial Arbitration Center,[22] and the Patent Office.[23] While dealing with widely different substantive matters, these agencies share similar governance structures: each agency is headed by a board of directors composed of representatives of the member states, and has a permanent technical staff. Through a number of Supreme Council resolutions and implementing national legislation, the decisions of these agencies, namely arbitration rulings, patent grants and the issuance of Gulf standards, have been accorded directly binding status in all GCC member states.

3.3 THE PROCESS OF ECONOMIC INTEGRATION IN THE GCC

3.3.1 OBJECTIVES AND HISTORIC EVOLUTION OF THE INTEGRATION PROCESS

The Charter of the GCC lays down the basic objectives of the GCC as follows:

– to effect coordination, integration and interconnection between member states in all fields in order to achieve unity between them;

– to deepen and strengthen relations, links and areas of cooperation now prevailing between their peoples in various fields;

– to formulate similar regulations in various fields, including economic and financial affairs, commerce, customs and communications, education and culture, social and health affairs, information and tourism and legislative and administrative affairs;

– to stimulate scientific and technological progress in various fields;

– to establish scientific research;

– to establish joint ventures and encourage cooperation by the private sector.

[21] The Standardization and Metrology Organization was established in 1982 to define common product standards and measures. As most of the other GCC members at the time did not have national standards offices, the Saudi Arabian Standards Organization was entrusted with the operation of this agency until 2001, when the GCC Heads of State decided to set up an independent common standards organisation.

[22] The decision to set up the Commercial Arbitration Center in Bahrain was taken in 1993 with the adoption of its charter by the Supreme Council. The Center was declared fully operational in 1995.

[23] The Patent Office is the youngest agency in the GCC and is located in Riyadh. The Supreme Council approved its statute in 1992, and the Office became operational in 1998. By October 2002 it had granted some 30 Gulf patents.

These objectives were further spelt out in the 1982 "Unified Economic Agreement", which laid down the principles of a GCC free trade area, the free cross-border movement of GCC citizens, and the coordination of banking, financial and monetary policies. Over the following two decades the integration process saw periods not only of impressive progress but also of stagnation. While the implementation of the free trade area began in 1983 and the first services sectors were opened to GCC citizens as early as 1986, it took more than ten years after the initial deliberations in the Ministerial Council in 1989 to agree on a common external tariff. In the late 1990s, however, the integration process gained new momentum, culminating in the ratification of the new "Economic Agreement between the States of the Cooperation Council" at the Muscat Summit in 2001, which replaced the Unified Economic Agreement. The new document sets ambitious targets for the next stage of the integration process, drawing up a road map for the creation of a fully integrated common market and the preparation of a monetary union. Table 6 presents the evolution of the integration project as reflected in these two agreements.

In 2001 the Supreme Council agreed on a timetable for the implementation of some of the envisaged stages of integration. This timetable calls for the implementation of the customs union in January 2003; the establishment of implementation guidelines, including convergence criteria, for the monetary union by 2005; the completion of the common market by 2007; and, finally, the adoption of the single currency by 2010.

Given this sequence, the process of economic and monetary integration in the GCC is designed to follow an incremental approach, as it is intended that monetary union shall be established only after considerable groundwork in terms of economic integration has been laid. The scope of the GCC's economic integration objectives as laid out in the new Economic

Table 6 Integration objectives laid down in the economic agreements of 1982 and 2001

	Unified Economic Agreement (1982)	Economic Agreement (2001)
Trade in goods	– Specifies operational principles for the free trade area, including rules of origin – Provides for the subsequent creation of a customs union	– Specifies operational principles for the customs union, including a common external tariff and the single entry point principle – Lays down principles for the common market, including the harmonisation of all product standards
Trade in services	– Makes an implicit reference (exercise of economic activity)	– Common Market of the Gulf to include national treatment in the field of services
Movement of capital	– Calls for coordination of financial and banking policies	– Common Market of the Gulf to include national treatment of GCC capital – National treatment to be accorded to investments owned by GCC nationals – Calls for complete integration of financial markets and harmonisation of relevant regulations
Movement of persons	– Assures freedom of movement, work and residence – National treatment for GCC nationals regarding ownership, inheritance and bequests, exercise of economic activity	– Extends the scope of national treatment to include explicitly: – employment in both the governmental and the private sector – exercise of professions and all economic activities – real estate and equity ownership – social insurance and pensions, education, health and social services
Monetary integration	– Commitment to coordinate monetary policies – The prospect of monetary union is mentioned	– Envisages a timetable for the implementation of monetary union – Commitment to harmonise all relevant economic policies – Calls for the establishment of convergence criteria

Agreement is remarkable and goes beyond most other regional integration schemes worldwide. The agreed measures address the most crucial areas of policy coordination and harmonisation, and appear to be mutually consistent and complementary. The challenge for the GCC in the coming years will be the comprehensive and timely implementation of the envisaged stages of integration.

3.3.2 THE CURRENT STATE OF ECONOMIC INTEGRATION

Free movement of goods

On 1 January 2003, a GCC customs union finally came into effect with the enactment of a common external tariff, a unified customs code and the single entry point principle. This can be regarded as an important landmark in the GCC's efforts to promote the free movement of goods and to foster trade integration among its member states. While the low degree of trade integration achieved so far within the GCC (see Chapter 2) may largely be explained by the similar factor endowment of member states (i.e. oil and gas), continuing regulatory barriers also seem to have contributed to low levels of intra-regional trade. Thus, an effort to tear down these barriers and to foster trade integration is required, in particular with regard to non-oil trade.

Given that national tariff levels differed substantially (in 1999 the simple mean tariff was 12.6% in Saudi Arabia, compared with 4.8% in Oman), agreement on a customs union was a considerable achievement. The fact that in 2001, after a decade of discussion, GCC Heads of State finally agreed on a tariff level close to that of its most liberal members (5% on all tariff lines except tobacco products (100%) and exempted products) was therefore a display of their commitment to the integration project. In the same year they also adopted a unified customs code and a binding schedule for the introduction of the customs union, and in December 2002 a set of implementation provisions was approved, including a list of duty-exempt products (417 tariff lines).

The single entry point principle adopted in the context of the customs union implies that all customs procedures and duty payments for goods imported from outside the GCC are finalised at the first point of entry, irrespective of the final destination. In addition, domestically produced goods no longer require a certificate of origin in order to benefit from duty-free treatment in other GCC countries.[24]

Besides some transitory difficulties in the implementation of the customs union, which can be regarded as "teething problems", a number of trade barriers still remain in place in accordance with the agreed rules. The implementation measures provide for a three-year transition period, during which internal customs procedures are to be rolled back gradually. However, even in the final stage, beginning in 2006, intra-GCC border measures are set to remain, albeit limited to inspections for prohibited and restricted goods and animal and plant quarantine measures. In order to eventually eliminate the need for border inspections and reap the full benefits of integration, further efforts may therefore be warranted in terms of adopting common health standards and solving the problem of prohibited goods through internal rather than border measures.

In institutional terms, the Customs Union Committee, which is composed of national customs directors and reports to the Committee for Financial and Economic Cooperation, is responsible for monitoring and steering the implementation of the newly established customs union. Thus, the customs union follows the same intergovernmental approach

[24] The latter is a crucial point with regard to the free movement of goods in the GCC. A free trade area had already been established in the GCC in 1983, allowing for the duty-free movement of goods produced in any of the member states. However, imported goods still had to undergo customs procedures when crossing internal borders. Moreover, since GCC producers had to meet a 40% minimum domestic content rule if they wanted to benefit from duty-free treatment, burdensome procedures had to be followed to establish the national origin of manufactured goods. To overcome these inherent limitations and allow the free circulation of goods, a political step had to be taken, namely to agree a common external tariff schedule and to create a customs union.

that characterises the integration process in the GCC in general. This may however pose a challenge for the future, as the establishment of a customs union essentially forces member states to pursue common policies, rather than simply to coordinate their national policies, on the most important aspects of trade policy, in particular external tariffs. There are indications that it will not be easy to deal with such matters smoothly in such a consensus-based intergovernmental framework in the absence of an effective dispute settlement mechanism or a supranational body with the right to make authoritative interpretations.

Moreover, the free movement of goods remains incomplete even in a customs union, unless national product and production standards are sufficiently harmonised or mutually recognised.[25] GCC Heads of State were clearly aware of the importance of harmonised standards when they decided in 2001, as a complementary measure to the creation of the customs union, to upgrade the Gulf Standardization and Metrology Organization from a branch of the Saudi Arabian Standards Organization to an independent agency. In addition, the implementing provisions for the customs union establish the principle of mutual recognition of national standards. The European experience suggests that, pending the eventual complete harmonisation of national standards, the success of the common market will crucially depend on the implementation of the principle of mutual standard recognition.

Free movement of services

The free movement of services in the GCC seems to be less advanced than the free movement of goods, although in the case of services, an assessment is more complicated. From a purely economic point of view, trade in services is analogous to trade in goods. However, legal barriers to trade in services are much harder to assess or indeed to eliminate than barriers to trade in goods. Whereas the latter are essentially a matter of customs regulations and product standards, the former are usually deeply entrenched in national legislation. A brief glance at various areas of the implementation of the common market in the GCC reveals a highly heterogeneous picture across countries and sectors. For instance, while traffic legislation in a given country might already have been adapted to allow drivers to obtain insurance in another GCC country, its commercial law might still not allow foreign accountancy firms to operate on its soil.

However, a few horizontal issues point to the overall degree of integration in the field of services. Major determinants of the freedom of trade in services are the freedoms of movement of capital and of natural persons, as many business models require either consumers or producers to cross a border (supply modes 2 and 4 under the General Agreement on Trade in Services (GATS)), or require the commercial presence of the supplier (supply mode 3), and therefore some capital investment. A relatively high level of integration has been achieved in terms of movement of capital as well as people (these aspects are discussed in more detail in the following two sub-sections). The implementation of the common market is, by contrast, still incomplete with respect to laws of incorporation and of commercial real estate ownership, which are essential for cross-border commercial presence. Similarly, the recognition of professional skills and diplomas and the principle of equal tax treatment have not yet been fully accomplished. The former is not only important to foster the free movement of services, but also to increase labour mobility in general.

[25] As most GCC member states have only established national standardisation authorities relatively recently and in the past relied in many cases on foreign (mainly British) standards, the differences in national standards among GCC states should be relatively limited. Another favourable factor in this respect was the creation in 1983 of the Gulf Standardization and Metrology Organization, which has since its creation issued more than 1,700 Gulf standards.

While there seems to be a strong commitment to eliminate such barriers over time, GCC countries might not be able to reap the benefits of free movement of services due to another limiting factor: the prevalence of monopolies and public entities in the services sector. In countries where water, for instance, is provided free of charge, there is little opportunity for efficiency gains to be achieved by allowing companies from other GCC countries to compete. While privatisation efforts are also underway in the services sector at the national level in all GCC member states, there seems to be some scope for further action in this regard at the GCC level.

Free movement of capital

GCC member states share a tradition of relatively liberal capital accounts. However, a number of regulatory and structural factors have limited cross-border capital mobility, and there seems to be a commitment in the GCC to eliminate these regulatory barriers. Living up to this commitment and enhancing capital mobility with the objective of achieving the full integration of GCC financial and banking markets is particularly important in view of the plans for monetary union.

The factors that have impeded intra-GCC capital flows include restrictions on foreign ownership of equity and real estate, regulatory barriers to cross-country banking operations, and underdeveloped capital markets (see Chapter 2). In recent years, many GCC governments have given higher priority to attracting private investment, and in particular FDI, as a vehicle of economic diversification. It is in this context that Article 5 of the 2001 Economic Agreement calls for the creation of an "investment climate characterised by stability and transparency", including the complete integration of capital markets in the region. To achieve this goal, member states committed themselves to harmonising their regulations regarding investment, banking and financial markets, to eliminating all discriminatory regulations regarding the trading and ownership of assets, and thereby effectively to removing all barriers to cross-border banking services and investment.

The number of banks operating across GCC countries is still very limited,[26] although all member countries allow in principle the establishment of banks from other GCC countries on their territory. This may be due to the fact that the equal treatment principle has not yet been implemented completely in national banking and commercial legislation. Furthermore, while basic harmonisation has been achieved, legislation in the areas of banking regulation and supervision continues to display differences across countries, complicating the establishment of cross-border branches by GCC banks. In addition to the regulatory environment, which is set to be improved by implementing the provisions of the Economic Agreement, some structural barriers to the integration of banking systems deserve attention, such as the low level of intra-GCC trade. Further trade integration, as recently observed with the increase in intra-GCC trade, will be an important source of demand for cross-border financial services. This points to the need to follow a truly comprehensive approach with regard to the implementation of the common market, as the "four freedoms" are intrinsically linked to each other.

With regard to capital markets, the most prominent restriction to capital mobility in the past was the requirement in all GCC countries of majority national ownership in all corporations. This is now being abandoned or replaced by the principle of majority ownership by GCC nationals. In some countries, share ownership in certain sectors, such as finance, is still restricted to nationals. In 2002, 28% of GCC joint stock companies were covered by such provisions. Apart from these restrictions, stock markets seem to be freely accessible to GCC investors, and a number of cross-listing agreements between stock exchanges now provide national companies with access to

[26] Bahrain is an exception in this respect due to its role as an offshore financial centre.

GCC capital.[27] However, up till now the number of cross-listed stocks and their share in market capitalisation appears to be very small.

In addition, the high proportion of publicly owned companies in the GCC economies has so far limited the potential for gains from cross-border capital mobility. By analogy with what has been noted with regard to the liberalisation of services, there is a strong case for stepping up privatisation efforts in order to benefit fully from the efficiency gains that the common market and, to an even greater extent, the monetary union entail.

Free movement of natural persons

The free movement of natural persons is fairly advanced for GCC nationals. However, expatriates are not covered by the integration endeavours in this area. Given the large share of expatriates in the population and, in particular, in the workforce, this may limit the overall economic gains from the completion of the common market.

By and large, GCC nationals are free to travel to all member states without having to obtain a visa, and, in most cases, even without a passport. They largely enjoy equal treatment regarding employment in the private sector, and are entitled to temporary and permanent residence. Implementation of the national treatment principle is also relatively advanced with respect to personal real estate ownership, employment in the private sector, education, health and social services and the exercise of most professions (except those included in a negative list). At the same time, equal treatment is still not fully ensured in other areas such as employment in the public sector and access to social insurance and pension schemes. However, efforts continue to be made to implement the principle of Gulf Citizenship in these areas, as well as to reach full mutual recognition of diplomas and certificates of qualification.

As a result, the number of GCC citizens who have obtained a licence to conduct economic activity in other member states remains extremely low. Only in the UAE does their number exceed 0.1% of the total population. Similarly, only around 0.15% of GCC citizens own real estate in another GCC country.

The free movement of non-nationals between GCC countries is not explicitly a subject of the integration objectives as set out in the Economic Agreement. Some countries grant expatriate residents of other GCC states preferential visa treatment, and there seem to be plans to introduce a common GCC visa for foreign businesspeople. As long as there is no common visa or residence permit for expatriate workers, however, labour mobility will not apply to a significant proportion of the labour force in GCC countries. Given the importance of expatriate labour in the private sector in GCC countries, this may represent an impediment to economic integration, especially in the areas of trade in services (which often involves the movement of natural persons) and cross-border transport. It also raises the issue whether the overall degree of labour mobility is compromised, which can play an important stabilising role in a monetary union in the event of asymmetric shocks. However, in this context it has to be taken into account that even in the absence of free migration of expatriates between GCC member states, overall labour mobility remains high, given the ability to adjust swiftly the overall number of expatriate workers in a country when, for instance, it faces the consequences of an asymmetric shock.

[27] No information was available on private bond markets; however, these are of marginal importance in the GCC countries.

4 ECONOMIC CONVERGENCE OF GCC MEMBER STATES

When analysing economic convergence, a crude distinction can be made between monetary, fiscal and structural convergence. Monetary convergence refers to variables mainly determined by monetary policy, such as inflation, interest rates and exchange rates, whereas fiscal convergence refers to indicators such as budget deficits and debt levels, which are strongly influenced by fiscal policy. Structural convergence is not as straightforward to assess in quantitative terms, and refers mainly to an increasing similarity in economic structures and economic dynamics. This is relevant for a monetary union, as it reduces the probability and severity that a group of countries' economies will be hit by asymmetric shocks. Given that economic dynamics will never be identical and that some asymmetric shocks will always remain, the capability to cope with such shocks is also of relevance. There are a wide range of indicators that can provide information on structural convergence. The most commonly used are variables such as income levels, GDP growth cycles and the sectoral structure of the economy, which can provide hints to assess this aspect.

This chapter reviews the state of monetary, fiscal and structural convergence among GCC member states. When looking at the overall picture concerning the convergence of GCC economies, the following features stand out:

(i) The degree of monetary convergence among GCC economies with low and similar inflation rates, co-moving interest rates and low interest rate differentials and stable exchange rates is remarkable, and exceeds the convergence achieved in this field by euro area countries in a comparable period prior to the introduction of the euro in 1999. In particular, the degree of exchange rate stability for almost two decades is noteworthy, all the more so in an environment of relatively free capital flows.

(ii) Fiscal convergence is less marked than monetary convergence in GCC economies. While government revenues and expenditure and the budget balance tend to move in parallel due to the dependency of public finances on oil revenues, the level of deficits/surpluses varies significantly between countries. In some countries, high and persistent fiscal deficits have become the norm until recently and have led to a build-up of public debt, the level of which also seems to vary significantly between GCC member states. An in-depth assessment of this would require enhanced transparency of data.

(iii) Concerning structural convergence, neither the pattern of growth cycles, nor the differences in GDP per capita between member states, nor the economic structure of member states provide an argument against further monetary integration and the introduction of a single currency. Growth cycles tend to be relatively synchronised due to the role of oil in the economy. Differences in GDP per capita are significant, but not more so than in the euro area, and as such seem to form no impediment to a functioning monetary union. Economic structures are broadly similar, thus reducing the likelihood of asymmetric shocks and the need to resort to exchange rate adjustments.

(iv) An important qualification has to be made regarding the possible future development of economic structures. The high degree of structural homogeneity cannot be extrapolated into the future, as progress in diversification efforts might reduce the structural similarities of the GCC economies. If some countries diversify more successfully and faster than others (i.e. if the differences in the degree of oil dependency widen significantly between countries), or if diversification takes a different path in individual GCC countries, then the likelihood of asymmetric shocks may increase. Thus, by achieving the reasonable key policy objective of economic diversification in the GCC, which could even be supported by a single currency, the potential macroeconomic costs associated with a monetary union might increase, particularly as it is conceivable that a GCC monetary union could in the future comprise both highly oil/gas dependent countries and non-oil/gas dependent countries. However, this point should not be seen as a prima facie argument against monetary union in the GCC. Rather, it points to the increasing importance of the economies' ability to deal with shocks using tools other than nominal exchange rate adjustments, in the event that asymmetric shocks become more likely in the wake of ongoing diversification after monetary union. This lends further support to efforts to liberalise product markets and to enhance labour market flexibility and labour mobility in GCC economies.

4.1 MONETARY CONVERGENCE

This section analyses monetary convergence in GCC member states, focusing on inflation rates, interest rates and exchange rate stability.

4.1.1 INFLATION

The GCC countries have been characterised by relatively low inflation rates over the past two decades, and inflation rates have also tended to move broadly in parallel between countries during this period. Inflation has rarely exceeded 5%, which was the case only in a few countries in exceptional years. This period of a high degree of price stability has lasted since the mid-1980s, but was preceded by significantly higher inflation rates in the 1970s when, as a result of the oil boom, inflation rates reached double-digit levels before starting to stabilise around 1980 (see Chart 15).

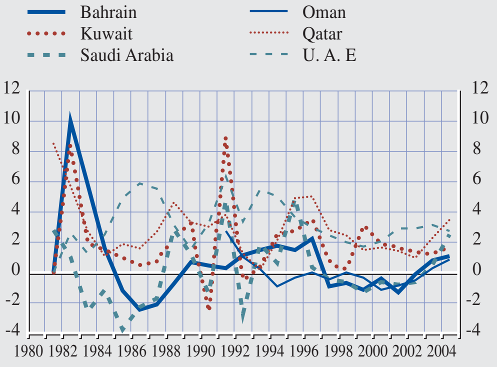
The average inflation rate over the last two decades has been highest in the UAE (3.7%) and lowest in Saudi Arabia and Oman (0%). The difference between the highest and lowest inflation rates in GCC countries seems to have gradually narrowed and to have become less volatile over the past 10 years, pointing to increased convergence (see Chart 16). Over the past two years, average inflation in the GCC has somewhat increased to reach 2.1%[28] in 2004 owing to recent oil price peaks, with inflation ranging from 0.8% in Oman to 3.5% in Qatar.

Turning to country-specific developments, inflation rates were temporarily higher after the 1990 Iraqi invasion of Kuwait in several GCC countries, most notably in Kuwait itself in

[28] Unweighted average.

Chart 15 Inflation in GCC member states

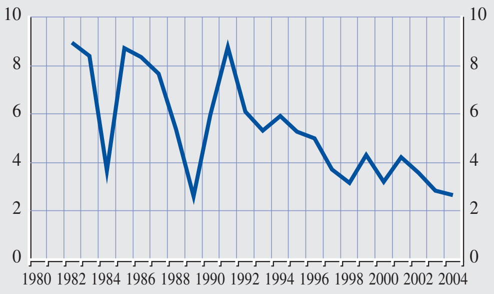
(annual percentage changes)



Sources: IMF WEO and IFS.

Chart 16 Difference between highest and lowest inflation rate in GCC member states

(percentage points)



Sources: IMF WEO and IFS.

view of the reconstruction of the country. Qatar exhibited relatively high inflation rates in the mid-1990s due to dynamic growth in the natural gas sector. In addition, inflation rates in the UAE were persistently higher than in other GCC countries in the late 1980s and the first half of the 1990s. However, this development does not seem to have been driven by significantly divergent economic developments or monetary policy, and, despite a real appreciation of the currency, does not seem to have led to a loss of competitiveness of UAE exports.

In conclusion, the high degree of inflation convergence of GCC member states at low levels of inflation over the past 20 years is remarkable. The major factor explaining the persistently low inflation rates is the (at least de facto) continued peg of the currencies to the US dollar (see sub-section 4.1.3). The GCC countries' choice of an external anchor for monetary policy has obviously been credible and served them well in the past to anchor inflation expectations and to import monetary stability from the anchor economy. Another factor that seems to have contributed to low inflation rates has been the relatively low level of central bank credit to governments in GCC countries. Unlike in some other Middle East countries, GCC member states did not extensively use monetary policy to accommodate budget deficits. This was facilitated by accumulated foreign assets, which they could resort to in times of budgetary strain, for instance in periods of low oil prices. Moreover, the low level of inflation achieved in all GCC member states in the last 20 years points to a shared policy preference for price stability, which also seems to enjoy support among the respective populations.

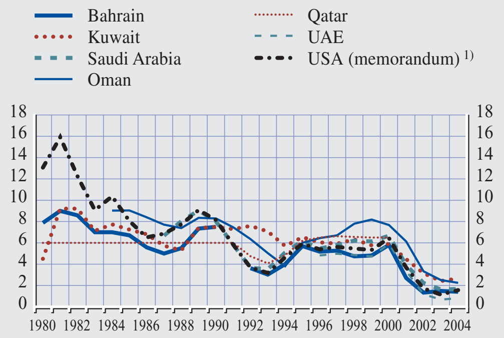
4.1.2 INTEREST RATES

Over the past 20 years, interest rates in GCC member states have co-moved in similar ranges. The high degree of interest rate convergence reflects the inflation convergence and the degree of exchange rate stability among GCC member states, resulting from their long-standing orientation towards the US dollar. Hence, interest rates have tended to move in line with US interest rates (see Chart 17). The spread between GCC and US interest rates is generally low and reflects the credibility of the exchange rate peg. The spread tends to be influenced by oil price developments, in particular in the case of Saudi Arabia, where falling oil prices normally lead to a spread widening (see Chart 18).

It should be noted that the Gulf region is generally characterised by short-term credit relations. Therefore, long-term interest rates,

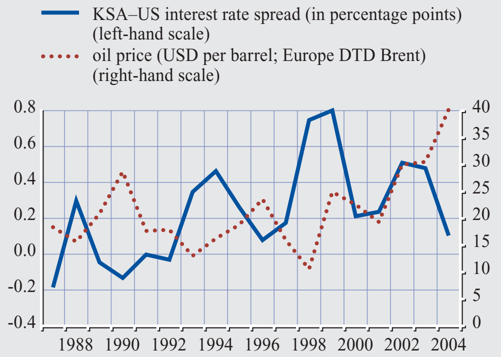
Chart 17 Interest rates in GCC member states

(3-month deposit rate, percentages)



Sources: IMF IFS, and national sources for UAE.
1) Certificates of deposit interest rates.

Chart 18 Interest rate spreads Saudi Arabia – USA and oil prices



Source: Bloomberg.

for instance for ten-year bonds, do not exist on a comparable basis. The analysis of interest rate convergence must thus focus on short term interest rates, for which a three-month deposit rate is chosen here in view of data availability and comparability.

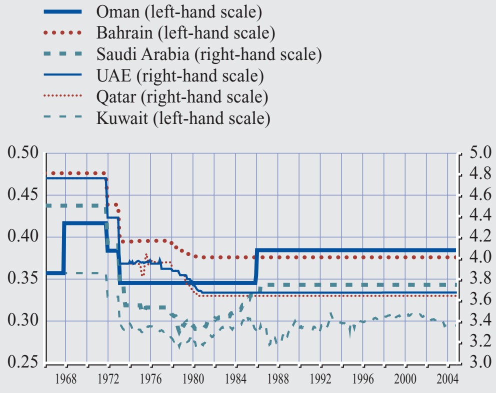
Specific developments can be observed for Kuwait in the early 1990s connected to the situation after the Iraqi invasion; for Oman in the second half of the 1990s due to interest rate regulations; and for Qatar, whose interest rate was fixed until 1991 but, once it was allowed to fluctuate, moved in line with the interest rates of the other GCC countries. In the last decade the spread between the highest and the lowest rate was highest in 1993 with 4.1 percentage points (7.1% in Kuwait versus 3.0% in Bahrain), and lowest in 1995 with 0.8 percentage point (6.5% in Kuwait versus 5.7% in Bahrain).

4.1.3 EXCHANGE RATES

The degree of nominal exchange rate stability among GCC currencies in the past two decades is remarkable and probably unparalleled in the world economy. It reflects the long-standing common orientation of GCC countries' exchange rate policies towards the US dollar (see Chart 19). The orientation of GCC countries' exchange rate policies towards a common external anchor has not only limited intra-GCC currency fluctuations, but has also significantly contributed to the convergence of inflation and interest rates, as described in the previous sections.

Chart 19 Exchange rates against USD for the GCC member states

(national currencies per USD, 1966-2004)



Source: IMF IFS.

Since the beginning of 2003 all GCC currencies have been both de jure and de facto pegged to the US dollar as part of the GCC's road map to introduce a single currency. The peg is a conventional peg according to the IMF classification and, with the exception of the Kuwaiti dinar, there is no horizontal band around the rate at which the currencies are pegged to the US dollar. The Kuwaiti dinar fluctuates in a band of ± 3.5% around the central rate. As a result of the common US dollar peg, there are no exchange rate fluctuations between five of the GCC currencies, and only limited fluctuations between those five and the Kuwaiti dinar.

The transition to a common US dollar peg with the aim of further enhancing exchange rate stability among GCC currencies and bringing their exchange rate regimes formally into line in view of the planned monetary union did not require any major modifications to the GCC countries' long-standing exchange rate regimes, with the exception to a limited extent of Kuwait. In fact, the exchange rate regimes of GCC countries had already shown a high degree of homogeneity for an extended period. The Omani riyal has been de facto pegged to the US dollar since 1973; the Bahraini dinar, the Qatari riyal and the UAE dirham since 1980; and the Saudi riyal since 1986. Notwithstanding the de facto peg to the US dollar, until the beginning of 2003 Bahrain, Qatar, Saudi Arabia and the UAE had de jure[29] pegged their currencies to the Special Drawing Rights (SDR) currency basket, with a fluctuation band of ± 7.25% in the cases of Bahrain, Qatar and the UAE. Oman was the

[29] As notified to the IMF in the Annual Reports on Exchange Rate Arrangements and Exchange Restrictions.

only GCC country which also had a de jure US dollar peg. Thus the transition to a common US dollar peg in early 2003 meant only an adjustment of the de jure exchange rate regime to the long-standing de facto regime.

Kuwait's exchange rate regime differed slightly from those of the other five GCC member states. Until the beginning of 2003 the Kuwaiti dinar was pegged to a basket of currencies of the country's main trading and financial partners. The composition of the basket was not disclosed, but obviously the US dollar had a dominant weight, as only minor fluctuations occurred vis-à-vis the US dollar, and as a result, exchange rate fluctuations vis-à-vis the other five GCC currencies were also very limited. Nevertheless, the limited exchange rate flexibility enjoyed by Kuwait in the past explains the fact that under the present common US dollar peg, the Kuwaiti dinar is the only currency which is granted a narrow fluctuation band.

The last major adjustments of parities vis-à-vis the US dollar, and thus among the five GCC currencies pegged to the US dollar, took place in 1986 (in Oman and Saudi Arabia), while the parities of Bahrain, Qatar and the UAE have remained largely unchanged since 1979.[30] Accordingly, there has been almost complete exchange rate stability among five of the six GCC currencies over the last 18 years. In the last decade, the fluctuations of the Kuwaiti dinar did not exceed ± 3.5% vis-à-vis either the US dollar or the other five GCC currencies.

With regard to real exchange rate developments, higher inflation rates have induced an appreciation of the real effective exchange rates of the Kuwaiti dinar, the Qatari riyal and the UAE dirham over the last decade. Interestingly, although the real appreciation is significant, in particular for the UAE dirham, this has not resulted in a loss of competitiveness or a rising current account deficit and, subsequently, in pressure on the nominal exchange rate, as standard economic theory would suggest. This may be explained by stronger productivity growth in the UAE, which is more advanced in its degree of diversification (see Chapter 2). However, the dominance of oil in foreign trade may also be part of the explanation, as the price of and demand for oil is not influenced by domestic price developments.

Exchange rate stability among the GCC countries is all the more remarkable as it has evolved in an environment of relatively open capital accounts, and thus cannot be explained by foreign exchange restrictions. Moreover, this exchange rate stability has withstood various instances of severe economic and political turbulence, such as large oil price fluctuations, crises in various emerging market economies with a global impact, the 1990/1991 Gulf War following the Iraqi invasion of Kuwait, and most recently the military intervention in Iraq in 2003.

This stability can be explained by three main factors: (i) the similarity of economic structures of GCC member states, notably the role of oil in their economies, which reduces the potential for asymmetric shocks and thus the need to resort to exchange rate adjustments; (ii) economic policies in GCC member states, which have largely been consistent with the exchange rate pegs and have not undermined their credibility; and (iii) the accumulation of significant foreign exchange reserves by GCC member states, which have underpinned the credibility of the peg and deterred speculative attacks. Such attacks occasionally occur, mainly in the wake of low oil prices, and tend primarily to target the Saudi riyal, as it exhibits by far the most liquid foreign exchange market among GCC currencies. Past attacks have led to a temporary widening of interest rate spreads vis-à-vis the US and to interventions in the foreign exchange markets to defend the peg. No formal arrangement exists among GCC monetary agencies and central banks to support each others' currencies when the exchange rate

[30] A very small adjustment of the UAE dirham took place in 1997.

peg is under strain. However, it is widely acknowledged that monetary agencies and central banks would be able to coordinate support informally on an ad hoc basis if deemed necessary.

The US dollar orientation of the GCC countries' exchange rate policies is explained by the fact that oil revenues, which constitute their main income flow from exports, are priced in US dollars. The US dollar pegs thus serve the aim of stabilising export revenues, and, given the prominent role of oil revenues in GCC member states' budgets, fiscal revenues as well. The repercussion of these US dollar pegs is that the GCC countries' terms of trade are to a considerable extent exposed to fluctuations in the US dollar vis-à-vis other major currencies, given their foreign trade patterns (see Chapter 2).

4.2 FISCAL CONVERGENCE

Fiscal convergence is examined here on the basis of deficit-to-GDP ratios and debt-to-GDP ratios in order to provide a cursory overview of the fiscal situation.[31]

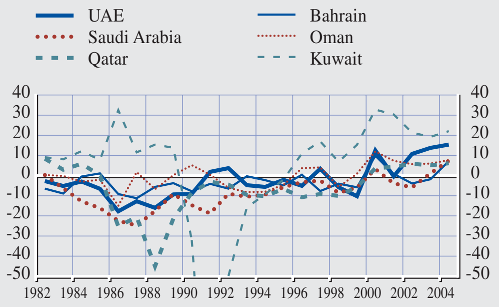
4.2.1 BUDGET DEFICITS

While GCC budget balance-to-GDP ratios tend to exhibit a considerable degree of co-movement, significant differences regarding the level of deficits/surpluses remain (see Chart 20).

Three major periods can be distinguished within the past three decades. In the 1970s, following the dramatic increases in oil prices, GCC budgets exhibited surpluses which were in some cases massive in relation to GDP. The early 1980s marked the transition to deficits, which remained the norm until the late 1990s. Most recently, fiscal revenues have significantly increased due to the pick-up in oil prices, and budget balances have moved into surplus again. However, the magnitude of the budget balance-to-GDP ratios differed between GCC member states, with Saudi Arabia exhibiting the highest annual average deficit (-8.8% of GDP) in the period 1985-2004, and Oman the lowest (-0.1% of GDP). Unsurprisingly, the budget balances are strongly influenced by oil price developments, and thus show a significant degree of co-movement (see Chart 21). However, country-specific developments leading to a divergence from the general trend can be identified, such as the high Kuwaiti deficit in the early 1990s due to the reconstruction effort following the Iraqi invasion.

Chart 20 Budget balances in GCC member states

(as a percentage of GDP)

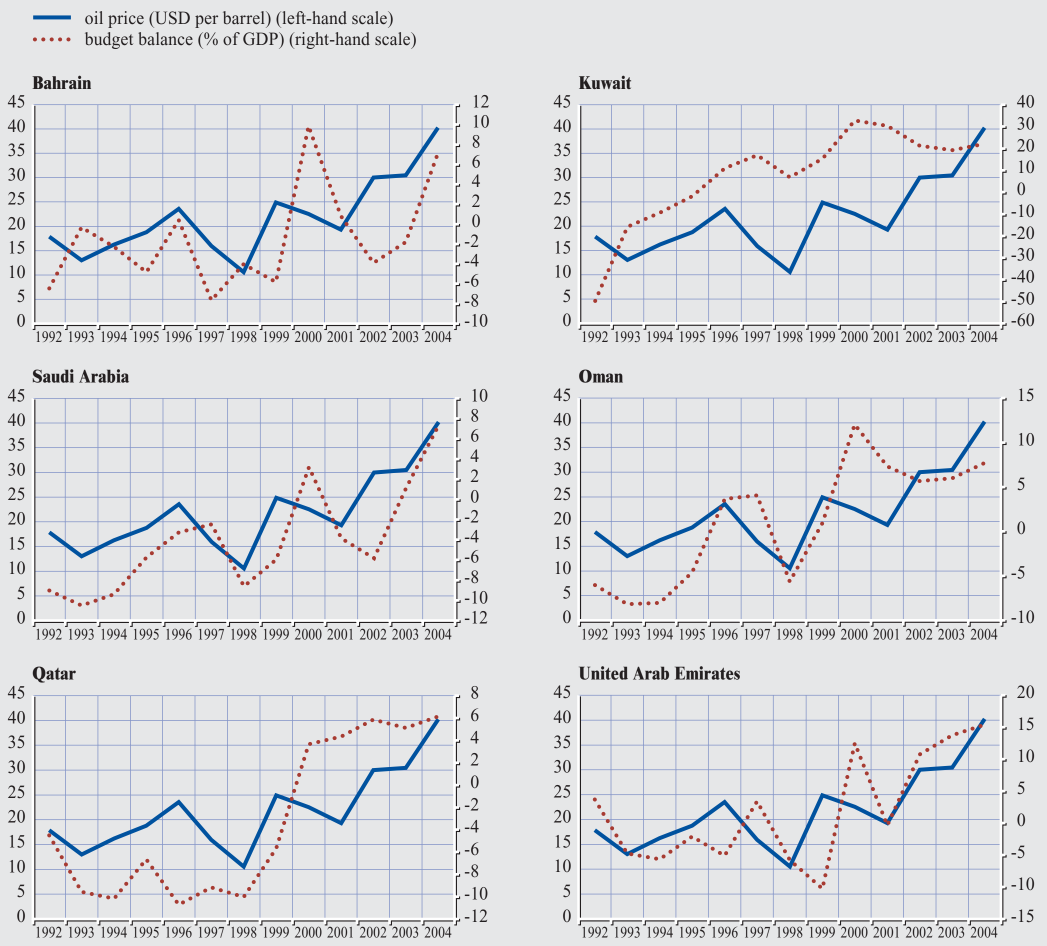


Source: IMF WEO.

The underlying components of the budget deficits – government revenue and expenditure – also exhibit a high degree of co-movement, although to a slightly different extent. Revenue growth tends to be highly correlated in all GCC member states, due to the high dependency of government budgets on oil as the major source of revenue. Thus revenue in all GCC countries increases sharply in times of high oil prices, and decreases when oil prices fall. Government expenditure growth tends to follow closely revenue growth and thus oil prices; accordingly, spending cycles of GCC member states are also correlated, although to a slightly smaller extent than revenues, with Kuwait in the early 1990s being the major outlier.

[31] This does not imply that these would be appropriate fiscal convergence criteria in the GCC context in view of the role of oil in budget revenues (see Chapter 5, Section 5 on the issue of fiscal convergence criteria in the GCC).

Chart 21 Oil price and budget deficits in GCC member states



Sources: IMF WEO and Bloomberg.

Government spending is mainly driven by revenue and thus tends to be pro-cyclical.[32] As a result of the large inflow of oil revenues in the 1970s, GCC member states launched large development projects and introduced far-reaching schemes for welfare spending and subsidies, thereby sharply raising the level of government spending. Once revenues declined, it proved difficult to reduce spending, leading to two decades of deficits since the early 1980s.

4.2.2 PUBLIC DEBT

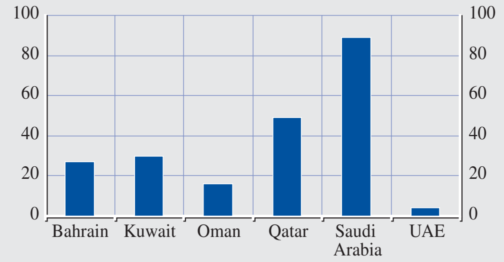
Based on available data, the ratio of total public gross debt to GDP in GCC countries seems to vary significantly and reflects different paths of fiscal policies pursued over the past two decades. Saudi Arabia, with a debt-to-GDP ratio of over 80%, has accumulated by far the largest public debt burden among the GCC countries, while the UAE exhibits the lowest debt ratio, at below 10% of GDP (see Chart 22).[33] Recently, gross debt levels have tended to decline. Several GCC countries have used high budgetary revenues as a result of high oil prices to reduce public debt significantly, notably Saudi Arabia.

[32] See Fasano and Wang (2002), who provide empirical evidence that government spending in GCC countries follows revenues.

[33] The latest available and comparable data for all six GCC countries refer to 2002.

Chart 22 Total government gross debt of GCC member states

(as a percentage of GDP, 2002)



Source: IMF estimates.

Data on public debt in GCC countries have to be interpreted with great caution, however. Different sources point to very different levels of debt, and the net position of the public sector in particular remains unclear, as several GCC countries have reportedly accumulated large foreign assets which are not disclosed. Furthermore, it is difficult to gauge the appropriate delineation of the public sector. For instance, in Saudi Arabia, a large proportion of public debt is owed to public social security institutions. Given the importance of the public debt level for the sustainability of public finances, an improvement in data availability and quality as well as a comparable, comprehensive and concise delineation of what constitutes public debt in GCC member states seems indispensable for a meaningful assessment of fiscal convergence.

4.3 STRUCTURAL CONVERGENCE

This section examines structural convergence with a view to the likeliness of asymmetric shocks and the availability of adjustment mechanisms, focusing on sectoral structures, trade patterns, labour markets, GDP growth and GDP per capita.

4.3.1 ASYMMETRIC SHOCKS AND ADJUSTMENT MECHANISMS IN THE CONTEXT OF MONETARY UNION

A key precondition for a viable monetary union is the existence of economic structures in the prospective member states that allow for a smooth conduct of a single monetary policy. The macroeconomic cost of relinquishing national monetary policy in the context of a currency union depends on a) the frequency and severity with which member states are exposed to asymmetric shocks, and b) the adjustment mechanisms available to mitigate the impact of such shocks, given that adjustments in national monetary policies and nominal exchange rates are impossible.[34] The most important mechanisms that can facilitate this adjustment process are domestic price flexibility and, in particular, wage flexibility, cross-border factor mobility and fiscal and financial integration. Where asymmetric shocks are rare or can easily be mitigated or dispersed among member states, a single monetary policy focused on the aggregated macroeconomic situation of the currency area should not present significant problems for any particular region. By contrast, in the presence of shocks that persistently affect some but not all member states, it might be difficult to devise a single monetary policy that is appropriate for all.

The past record of economic convergence can shed some light on the similarities and differences of economic structures in the member states that may either facilitate or impede a single monetary policy. Certain economic features, such as the degree of similarity in the sectoral structure, the degree of trade integration, labour market flexibility, per capita income levels, the co-movement of GDP growth cycles and exchange rate stability, can provide indicators of the frequency and severity with which GCC member states have been hit by asymmetric shocks in the past, and of their ability to cope with such shocks.

4.3.2 SECTORAL STRUCTURES

As pointed out in Chapter 2, the sectoral structures of GCC economies exhibit a high degree of similarity owing to their common dependency on oil, and to a lesser extent on natural gas as well. The oil and gas sector

[34] For an overview of the literature on optimum currency area (OCA) theory, see Mongelli (2002).

accounts for more than one-third of GDP in the GCC as a whole, and, except for Bahrain, is the largest sector in the economy, ranging from roughly a quarter in Bahrain to almost 60% in Qatar (see Chart 10, Chapter 2).

The similarity in sectoral structures reduces the GCC economies' susceptibility to asymmetric shocks. In this context, it is worth recalling the GCC economies' extraordinary record of exchange rate stability. The structural features of the GCC economies (most notably the fact that the competitiveness of their external sector is independent of domestic price and wage developments, and that oil price changes constitute symmetric shocks in view of their shared oil dependency) have enabled member states to pursue such policies without incurring significant costs in terms of employment or inflation. The stability of nominal exchange rates can thus be understood as an indication that the GCC economies (i) have not been subjected to frequent and severe asymmetric shocks, given their similar economic structure, and (ii) have so far been able to cope with the few shocks they have faced, such as the invasion of Kuwait, without having to resort to nominal exchange rate adjustments or to make use of their monetary autonomy.

The differences in the economic structures of GCC countries may, however, increase in the future in the course of further economic diversification. While all GCC countries have declared that diversification and the reduction of their dependency on oil is a major goal of economic policy, the pace and direction of diversification may differ from country to country. In particular, the pace of diversification could be influenced by the fact that some GCC countries face the exhaustion of their oil reserves at current levels of production during the next two decades (i.e. Bahrain and Oman, see Chapter 2, sub-sections 2.2.1 and 2.3.1), while others, like Kuwait, the UAE and Saudi Arabia, will not run out of oil reserves for a much longer period. Therefore, it is not unreasonable to assume that the economic structures of GCC countries will be more heterogeneous in 20 to 30 years' time than they are today. The increasing heterogeneity may foster economic integration and intra-GCC trade. At the same time, price flexibility in product and factor markets will become an increasingly important alternative adjustment tool, once the option of nominal exchange rate adjustments has been relinquished. In the same vein, a well-designed system of intra-GCC fiscal transfers could potentially contribute to smoothing adjustments to asymmetric shocks and to enhancing the cohesion of the monetary union. The development of such adjustment mechanisms will determine whether, in the long term, the GCC, when exposed to more frequent asymmetric shocks, will be in a position to make smooth adjustments under a single monetary policy, or will find itself in a more problematic situation in which

Table 7 Asymmetric shocks and adjustment mechanisms as future challenges to the GCC monetary union

Adjustment mechanisms Risk of asymmetric shocks	Not developed	Developed
Low	**unproblematic:** asymmetric shocks are rare, therefore no imminent need for developed adjustment mechanisms; GCC today	**unproblematic:** asymmetric shocks are rare and can be absorbed without endangering the cohesion of the monetary union;
High	**problematic:** asymmetric shocks may put the sustainability of the monetary union at risk. GCC 2030?	**unproblematic:** asymmetric shocks may occur, but can be absorbed without endangering monetary union. GCC 2030?

adjustment mechanisms are underdeveloped, which may challenge the sustainability of the monetary union (see Table 7).

4.3.3 TRADE PATTERNS

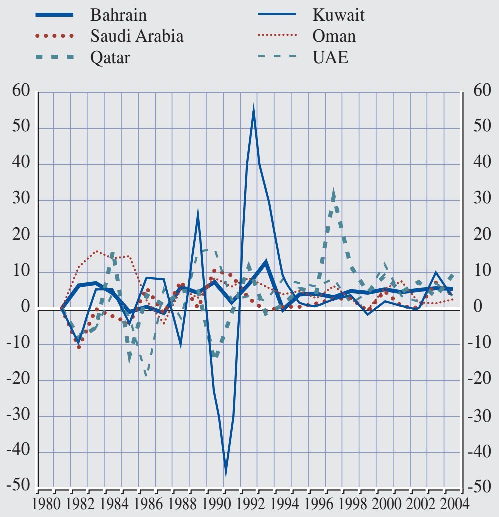
The level of trade integration in the GCC is relatively low when looking at overall exports (5% intra-GCC exports, see Chapter 2, Table 2). However, this is due to the dominance of oil in GCC exports. The share of intra-GCC trade increases to roughly one-third when only non-oil exports are taken into account, although this share is still significantly lower than the Chart for intra-trade in, for example, the EU or the North American Free Trade Agreement (NAFTA) (62% and 55% respectively). While the share of intra-GCC trade remains relatively low, it has significantly increased over the past decade, pointing to a process of trade integration which has been facilitated by the efforts undertaken by the GCC to eliminate barriers to intra-regional trade (see Chapter 3).[35] In terms of the direction of trade, GCC countries tend to exhibit a relatively homogeneous pattern, with Asia as the major export destination and Europe as the dominant source of imports (see Chapter 2, Tables 1 and 2).

4.3.4 LABOUR MARKETS

Labour markets in the GCC, although fragmented between nationals and expatriates, appear to exhibit a considerable degree of flexibility thanks in particular to the high share of expatriate workers, whose number can be adjusted in response to demand shocks. Typically, nationals of GCC countries provide the bulk of the labour force employed in the public sector, which tends to exhibit many rigidities, while expatriates are employed mainly in the private sector, which is highly flexible. This flexibility might be reduced, however, in the course of ongoing efforts to increase the participation of nationals in private sector labour markets and to reduce the reliance on expatriates. As national employees may enjoy greater bargaining power than the expatriates that currently dominate the private sector labour force, it could be expected that their increasing participation in labour markets would give rise to institutional arrangements entailing a higher degree of wage rigidity and job protection. Therefore, it will be a policy challenge to ensure that the process of "nationalisation" of the labour force in the private sector is not accompanied by a reduction in the flexibility that currently prevails. To promote stability in the context of monetary union, the cross-border mobility of (national and expatriate) labour will become more important as an adjustment mechanism in the future. By comparison with other regional integration projects, the high degree of cultural and linguistic homogeneity in the GCC, in particular of nationals, should greatly facilitate the achievement of labour mobility, which would be enhanced by the removal of the remaining legal obstacles to the free movement of natural persons (see Chapter 3).

Chart 23 Real GDP growth in GCC member states

(annual percentage changes)

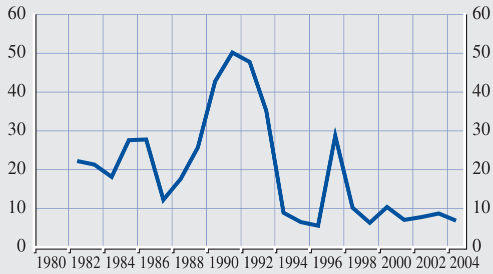


Source: IMF WEO.

[35] The overall impact of trade integration on economic convergence is theoretically ambiguous. While strong trade links can serve to transmit and thereby moderate asymmetric shocks, they may also promote regional specialisation, and thereby potentially increase the risk of asymmetric shocks.

Chart 24 Difference between highest and lowest real GDP growth rate of GCC member states

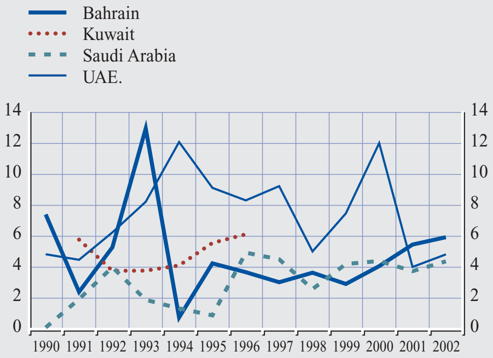
(percentage points)



Source: IMF WEO.

Chart 25 Real growth of the non-oil private sector in GCC member states

(annual percentage changes)



Source: GCC member states.

4.3.5 GDP GROWTH

GDP growth rates in the GCC countries tend to be volatile and show some correlation over the past three decades (see Chart 23). The growth performance of GCC member states depends to a great extent on oil, and the importance of the oil sector in their economies explains well the volatility in and a certain degree of synchronisation of their business cycles. Large oil price fluctuations can be interpreted as symmetric shocks to GCC economies.

The 1970s and early 1980s were characterised by very high GDP growth following the two large increases in oil prices in 1973 and 1979, while growth rates since the early 1980s have been significantly lower. The most significant deviation from the general growth cycle of GCC countries can be observed for Kuwait in the early 1990s due to the Iraqi invasion and the subsequent reconstruction, which in economic terms can be seen as an asymmetric shock affecting one GCC member state in particular. Another asymmetric development discernible from these data is the rapid development of the natural gas sector in Qatar in the mid-1990s. Furthermore, GDP growth in Bahrain tends to be less cyclical than in other GCC member states, reflecting the country's lower dependence on oil. Looking at levels of growth over the longer term, in the period 1980-2004 Oman, which was the country with the lowest GDP per capita at the outset (see next section), recorded the fastest GDP growth, with an annual average increase of 6.1%. Saudi Arabia, by contrast, exhibited the lowest average growth (1.7%). Over the last decade, Qatar was the fastest growing GCC economy with annual growth averaging 9.1%, while Kuwait followed by Saudi Arabia had the lowest growth rates (2.1% and 2.3% respectively).

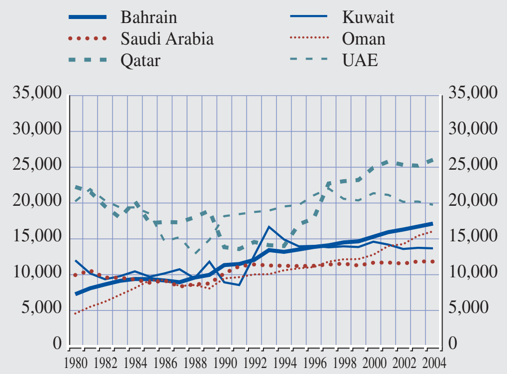
Although the difference between the highest and the lowest growth rates among GCC economies tends to be high, it has been declining over the last two decades, with one notable interruption in the early 1990s due to the volatility of growth in Kuwait in the wake of the Iraqi invasion (see Chart 24).

Naturally, growth in the non-oil sector of GCC member states is less correlated than total GDP growth, and the differences between countries regarding the level of non-oil sector growth also seem to be significant (see Chart 25).[36] In particular, non-oil growth in the UAE was consistently high throughout the 1990s, making the UAE the most diversified economy in the GCC besides Bahrain (see Chapter 2).

[36] Based on available data for four GCC countries.

Chart 26 GDP per capita (PPP) in GCC member states

(in USD)



Source: IMF WEO.

4.3.6 GDP PER CAPITA

Differences in GDP per capita in PPP terms between GCC member states are significant, but are smaller than those that exist in the euro area. GDP per capita growth has been subdued over the past two decades, and differences in GDP per capita have somewhat declined over this period (see Chart 26).

GDP per capita rose steeply following the 1973 oil price increase and reached a peak in most GCC countries in around 1980, after the second oil price hike. It declined in the early 1980s and broadly stagnated or only slightly increased over the following decade in most countries. The most marked developments over the past decade have been the significant growth in GDP per capita in Qatar due to the development of the gas sector combined with relatively low population growth, the decline and recovery in GDP per capita in Kuwait in the early 1990s, and Oman's steady catching-up process. The fact that GDP per capita has stagnated in many GCC countries over an extended period shows that real GDP growth was not sufficient to raise per capita income levels in view of the prevailing high population growth.

Differences in GDP per capita between GCC member states, which were most pronounced around 1980, when the GDP per capita of the poorest member state (Oman) was only about 20% of that of the wealthiest in PPP terms (Qatar), remain significant. These differences decreased in the first half of the 1980s and then remained broadly stable before widening once again as a result of recent dynamic development in Qatar. In 2004 Saudi Arabia and Kuwait had the lowest GDP per capita in PPP terms of the GCC countries, corresponding to around 44% and 52% respectively of the highest GDP per capita in Qatar. Although large, the differences in GDP per capita between GCC member states are, in fact, smaller than those found in the euro area.[37]

Large differences in GDP per capita within a monetary union may be relevant if, for example, they result in a catching-up process, which in turn may lead to structural differences in inflation rates via the Balassa-Samuelson effect, implying higher inflation rates in the catching-up countries. While increases in productivity in trading sectors may prevent a direct loss of competitiveness, wage increases can spill over into the non-trading sectors and have an indirect bearing on competitiveness. However, GDP per capita differences and their development in the GCC are not primarily driven by productivity, but rather by oil sector developments, e.g. production increases. This suggests that GDP per capita differences and the Balassa-Samuelson effect are of less relevance in the GCC context.

[37] For example, in 2004 GDP per capita in Greece was 31.6% of GDP per capita in Luxembourg (in PPP terms).

5 SOME CONSIDERATIONS ON CONVERGENCE CRITERIA FOR THE GCC

Decision-makers in the GCC will face some fundamental policy choices prior to the introduction of a single currency, in particular concerning the design and implementation of convergence criteria. Therefore, after demonstrating the relevance of assessing economic convergence and the need for a basic policy consensus, this chapter discusses conceptual issues arising in the design of convergence criteria which are relevant beyond the concrete case of the GCC. Furthermore, the role of multilateral surveillance is highlighted as a tool for pursuing convergence both in the run-up to monetary union and after the introduction of a single currency. Given their particular relevance in the GCC, fiscal convergence criteria and the specifics applying to the GCC context are dealt with in a final section.

The main findings can be summarised as follows:

(i) Given the relevance of assessing economic convergence and in particular the need for a policy consensus, the GCC may benefit from a well-defined set of criteria that capture monetary and fiscal convergence. These criteria should be monitored in an effective framework of multilateral surveillance. Monetary criteria are sufficient to function as entry criteria, while fiscal criteria could play a useful role both as entry criteria and as permanent criteria, providing the foundation for a set of fiscal rules and policy coordination. The criteria will function as a useful information tool for assessing policies, and may additionally serve as an anchor for expectations. However, their role as a disciplining device for policies may remain limited, since there is consensus in the GCC that they shall not represent selection criteria determining which countries are allowed to join the envisaged monetary union.

(ii) Monetary criteria could serve a slightly different purpose in the GCC than in the European context prior to the introduction of the euro. This is due to the high degree of monetary convergence already achieved among GCC member states. Monetary convergence criteria would thus not require a major shift in policies to achieve compliance, as was the case in several EU Member States in the 1990s. There is no need for disinflation, and exchange rate parities have been stable for two decades. The monetary convergence criteria would therefore not be a newly introduced anchor for policies and expectations, or a disciplining device, but rather a tool to check whether the high degree of monetary convergence achieved in the past has been maintained in the run-up to monetary union (a "lock-in" of monetary convergence).

(iii) Designing appropriate fiscal criteria constitutes a challenge for GCC countries. This is due partly to the much lower degree of fiscal convergence achieved so far compared with the monetary sphere, and partly to the specific nature of the budgetary situation in GCC countries as a result of their heavy reliance on oil revenues, which poses both short-term challenges stemming from the volatility and unpredictability of oil prices, and long-term challenges in view of the exhaustibility of oil reserves and the need for asset accumulation to ensure fiscal sustainability. Any fiscal framework will face the unavoidable trade-off between transparency and simplicity on the one hand, and economic optimality considerations and the desire for country-specific tailor-made solutions on the other.

(iv) In general, when designing convergence criteria, a reference period for their assessment that is meaningful in view of the sustainability of convergence needs to be defined. The thresholds need be chosen so that they are both reasonable and plausible in the specific circumstances of the region, although it should be acknowledged that these necessarily involve some degree of arbitrariness. The trade-off between the scope for interpretation and political discretion on the one hand and the credibility of the criteria on the other also needs to be taken into account. Finally, the quality and availability of statistical data must be sufficient to allow meaningful cross-country comparisons in the GCC.

5.1 THE RELEVANCE OF ASSESSING ECONOMIC CONVERGENCE

As with any monetary union, monetary union and the introduction of a single currency[38] in the GCC necessarily require a single and indivisible monetary and exchange rate policy. Given this indivisibility principle, monetary union is more than just a particularly tight exchange rate arrangement, and a mere coordination of national monetary policies is not sufficient to sustain a single currency. A single monetary and exchange rate policy has to be geared to economic, monetary and financial conditions in the single monetary area as whole. This, first and foremost, implies (i) that the participating member states have to agree on the basic orientation of monetary and exchange rate policy, and (ii) that member states are deprived of monetary and exchange rate policy as an adjustment tool to cope with divergent economic developments, for example in the event of an asymmetric shock.

These basic implications of a monetary union point to the role of economic convergence both during the process of monetary integration prior to the introduction of a single currency and afterwards. The level of economic convergence achieved between countries provides some indications as to whether the following three prerequisites for a successful monetary union are in place:

– a consensus on the role and objectives of monetary policy and the exchange rate regime;

– a shared commitment to fiscal policies that at least do not contradict these objectives; and

– economic structures that allow for the smooth conduct of a single monetary policy.

Hence, there is a case for closely monitoring and thoroughly assessing the degree of economic convergence prior to the introduction of a single currency, and in particular the sustainability of convergence, as it is essential to achieve convergence not only at a specific point in time, but on a sustainable basis.[39] In order to monitor and assess economic convergence, appropriate criteria need to be defined.

In terms of the distinction between monetary, fiscal and structural convergence outlined in the previous chapter, it is important to note that a high degree of monetary convergence is in fact achieved by the establishment of a monetary union. The irrevocable fixing of exchange rates and thus the elimination of any exchange rate fluctuations between participating countries is the constitutive element of a monetary union. Once a single monetary policy is being conducted, the scope for differences in inflation rates and interest rates is also limited, although these variables are influenced by a variety of other factors, such as national fiscal policies and wage policies. Thus, the monitoring of monetary

[38] Monetary union does not necessarily require the introduction of a single currency. As the GCC has decided not only to establish a monetary union but also to introduce a single currency, the terms "establishment of monetary union" and "introduction of a single currency" are used synonymously in this paper, and the pros and cons of taking the latter step after a monetary union has been established are not discussed.

[39] In the EU the concept of sustainable convergence is enshrined in the Treaty establishing the European Community (Article 121) with respect to EMU, and was emphasised in the convergence reports of the European Monetary Institute (EMI) between 1995 and 1998 in the run-up to the introduction of the euro.

convergence is of prime importance prior to the establishment of monetary union, in particular to assess the direction of monetary policy and the underlying degree of policy consensus, although this motive becomes less relevant once the monetary union has been established.

In contrast, the monitoring and assessment of fiscal convergence is essential both before and after the introduction of a single currency if fiscal policy is not substantially centralised in the monetary union. In a monetary union in which fiscal policy remains a national prerogative and national fiscal policies determine the fiscal stance in the union as a whole in the absence of a large, macroeconomically dominant budget, as is currently the case in the euro area and is also likely to be the case in a GCC monetary union, there is a strong case for both (i) fiscal convergence in the run-up to the establishment of monetary union, and (ii) a framework for permanent fiscal policy coordination underpinned by appropriate fiscal rules after the monetary union has come into effect.

In a similar vein, while the introduction of a single currency can be expected to encourage the integration of goods, services and factor markets, it by no means guarantees a sufficient degree of structural convergence. Rather, a high degree of multilateral surveillance and coordination in many areas of economic policy is required even after the implementation of monetary union in order to ensure a level of structural convergence that supports the smooth conduct of a single monetary policy.

5.2 THE NEED FOR A POLICY CONSENSUS

An important prerequisite for a sustainable monetary union is sufficient consensus on the basic orientation of monetary policy, and on economic policy in general. In particular, consensus on the role and tasks of monetary policy – in particular in the central banking community, but also among other economic policymakers and among the wider public – is essential for the smooth functioning and credibility of a monetary union.[40] Crucial questions in this context include the following. Should price stability be the primary objective of monetary policy, or should this objective be on an equal footing with other potential objectives? Should monetary policy be medium term-oriented or used to fine-tune the economy? Is there a trade-off between price stability and growth in the medium and long term? What is the preferred status of the central bank? What should be the main features of the exchange rate regime of the single currency? In the absence of a basic consensus on such fundamental monetary issues, diverging policy preferences and views on the functioning of the economy may lead to conflicts over the orientation of a single monetary policy and may possibly undermine the cohesion of a monetary union. Economic convergence between countries points to similar policy preferences and views about the functioning of the economy, and thus to a lower potential for conflict once the monetary union has been established. In the EU, such a consensus has evolved over the last two decades, based on, among other things, the conviction that price stability should be the primary objective of monetary policy, that monetary policy should not be used to fine-tune the economy, that price stability is the best contribution that monetary policy can make to economic growth and employment, that there is no trade-off between price stability and growth in the medium and long term and, lastly, that price stability is best achieved by an independent central bank.

In the GCC, there seems to be a shared preference for price stability, as reflected in the low inflation rates over the past two decades. The main question on which policymakers in the GCC will have to reach a consensus is likely to be the exchange rate regime of a single currency. Up till now, all GCC member states have chosen to peg their currencies to an external anchor and, in so doing, have achieved a remarkable degree of macroeconomic stability. However, there

[40] See Blackburn and Christensen (1989) on the role of policy consensus in the credibility of monetary policy.

might be considerations in the context of the introduction of a single currency to modify the external anchor or to move to a more flexible exchange rate regime, thus allowing more autonomy for a domestically oriented monetary policy. Whichever path is chosen, many of the other institutional and policy decisions to be taken ahead of the launch of the GCC single currency may depend to some extent on the choice of exchange rate regime for the future single currency. Therefore, reaching a broad consensus in the GCC on this fundamental orientation of monetary and exchange rate policy before the monetary union is established would help to avoid possible conflicts later on.[41]

Another matter of importance is the need to reach a consensus among member states on some basic aspects of fiscal policy, given that undisciplined fiscal policies may clash with a stability-oriented monetary policy. This is true for the interaction of fiscal and monetary policy in general. Moreover, under the specific circumstances of a fiscally decentralised monetary union, national fiscal policies may cause significant spillover effects in other members of the monetary union and in the union as a whole.[42] National fiscal policies have, for example, an impact on common economic variables such as interest rates, the inflation rate and the exchange rate, and through these variables on other members of the union.[43] The impact will tend to be the greater the larger a member state is relative to the other members of the union, implying that the issue will become potentially more important if large asymmetries exist in the economic sizes of member states, as is the case in the GCC. Thus, undisciplined fiscal policies in the member states of a monetary union may ignite severe conflicts within the union. While sound fiscal policies are beneficial in general for the economic performance of a country and should thus be pursued irrespective of membership of a monetary union, the case for fiscal discipline underpinned by commonly agreed rules becomes even stronger in the context of such a union. It also has to be taken into account that in a monetary union there may be greater incentives to run excessive deficits in member states, as the negative effects of such deficits can be externalised.[44]

5.3 KEY POLICY CHOICES REGARDING CONVERGENCE CRITERIA: PURPOSE, ECONOMIC CONTENT AND DESIGN

An effective monitoring and assessment of economic convergence requires a set of convergence criteria to be defined which the countries participating in the process of monetary integration must in turn meet, and which can be considered appropriate in the specific economic context of the region.[45] When defining convergence criteria, decision-makers in the GCC face a number of fundamental policy choices with regard to three basic aspects (see Table 8): (i) the *purpose* of convergence criteria must be clarified (i.e. what role they are to play in the monetary integration process); (ii) their *economic content* must be decided (i.e. the underlying set of economic variables and thus the policy areas that are to be covered); and (iii) choices have to be made concerning the specific *design* of the criteria. The three aspects are intrinsically linked: the purpose and

[41] The issue of the appropriate monetary and exchange rate policy in the GCC after the launch of the single currency falls outside the scope of this paper and hence is not addressed.

[42] See ECB (2003) and Detken, Gaspar, Winkler (2004).

[43] Excessive government deficits will tend to increase union-wide interest rates if the single monetary policy is not accommodating, thereby potentially reducing growth in the union (and possibly leading to pressure on the central bank to loosen monetary policy). If the single monetary policy accommodates an excessive deficit in one or more member states, this will result ceteris paribus in higher inflation rates for the union as a whole. Thus, irrespective of the reaction of the single monetary policy to an excessive deficit in a member state, the latter tends to lead to a welfare loss for the other members. If a member state defaults as a result of accumulated excessive deficits, this may put pressure on other governments to bail out the country in question in view of the threat of contagion and systemic risk.

[44] The economic literature is inconclusive on this point, however. There is a different strand of thought that implies the opposite, i.e. that monetary union may foster fiscal discipline in member states because, for example, the option of monetising public debt is more difficult to realise. For an overview of the arguments regarding the incentives for fiscal policy in a monetary union, see Sturm (1997).

[45] See Bini-Smaghi, Padoa-Schioppa and Papadia (1993) for an overview of the discussion on convergence criteria in the run-up to the Maastricht Treaty.

Table 8 Key policy choices regarding convergence criteria

	Purpose	Economic content	Design
Key policy choices	– information tool – anchor for policies and expectations – disciplining device	– monetary criteria – fiscal criteria – structural criteria	– entry criteria vs. permanent criteria – selection criteria vs. indicative targets – further issues (reference period, thresholds, scope for interpretation, etc.)

economic content of criteria, for example, to a large extent influence the design, while the design determines the objectives that can be achieved with such indicators, as discussed in the following sections.

5.3.1 PURPOSE OF CONVERGENCE CRITERIA

Convergence criteria can, in principle, serve as

– an information tool,
– an anchor for policies and expectations, and as
– a disciplining device.

In serving these purposes, they may function as an important instrument that can provide credibility to the GCC monetary integration project. The extent to which convergence criteria may fulfil some or all three functions largely depends on how they are designed, applied, sanctioned and embedded in an institutional framework. These issues are discussed in more detail in the sections below. The role of convergence criteria tends to be strongest if they serve as a disciplining device for policies, and weakest if they serve as a mere information tool to assess policies. In the latter case it might be more appropriate to speak of convergence benchmarks rather than criteria. The potential impact of the criteria on the convergence process can be expected to correlate with the consequences a country faces in the event of non-compliance, as this determines the incentives to gear policies towards fulfilling the criteria. This implies that appropriate sanctions have to be part of an institutional framework aimed at disciplining policies effectively.

Furthermore, the time horizon over which certain criteria should be met plays an important role in determining the convergence process. The European experience with Economic and Monetary Union (EMU) suggests that the combination of a clearly defined set of convergence criteria plus a binding timetable for the introduction of a single currency can be a strong instrument for fostering economic convergence. The GCC already has a deadline for the end point of the process of monetary integration with the decision taken by the Supreme Council in Muscat to introduce a single currency in 2010. A decision has also been taken to define convergence criteria by 2005 and to strive to meet these criteria between 2005 and 2010. Thus, the decision on the basic approach to be followed by the GCC to promote economic convergence has been taken by combining convergence criteria with a timetable which, in view of the European experience, represents a promising way to entrench and foster convergence. The major difference to the EU is that the GCC does not intend the criteria to be selection criteria, which raises questions with regard to, for example, incentives for compliance (see sub-section 5.3.3).

5.3.2 ECONOMIC CONTENT OF CONVERGENCE CRITERIA

With regard to the set of economic variables underlying convergence criteria, a basic distinction can be made between *monetary*, *fiscal* and *structural* convergence criteria, whereby monetary criteria concern indicators determined mainly by monetary policy, fiscal criteria concern indicators strongly influenced by fiscal policy, and structural criteria relate to the probability and severity of asymmetric shocks and the ability to cope with them (see Chapter 4). Whether monetary, fiscal or structural criteria are more appropriate for the GCC in order to achieve a convergence process depends largely on the focus and on the time horizon to be observed.

If the focus is primarily on policy convergence, in particular in the area of monetary and fiscal policies, and if a short to medium-term time horizon is to be captured, an emphasis on monetary and fiscal criteria is warranted. Accordingly, if convergence criteria primarily serve the purpose of indicating whether a sufficient degree of convergence in the area of monetary and fiscal policy has been achieved in order to enable a transition to a single monetary policy and to subject fiscal policy to commonly agreed rules, then this purpose is best served by criteria that refer to monetary and fiscal variables. Such criteria can also assist in the assessment of whether a sufficient consensus on the basic orientation of these policies exists as a crucial prerequisite for avoiding tensions and conflicts in a monetary union.[46]

If however the focus is primarily on structural convergence over a longer time horizon, then structural criteria may be appropriate. Accordingly, if convergence criteria primarily serve the purpose of answering the question of whether a group of countries exhibit a sufficient degree of structural similarity to form a successful monetary union (i.e. whether on the basis of the optimum currency area (OCA) theory the establishment of a monetary union is advisable), a focus on structural criteria may be warranted.

Thus, the choice regarding the underlying economic variables in terms of monetary, fiscal and structural convergence largely depends on the kind of information policymakers in the GCC want to extract by monitoring and assessing the criteria. Given the interaction of monetary, fiscal and structural variables in the economy, some criteria may capture developments in more than one sphere. For instance, a criterion concerning exchange rate stability, although clearly a monetary criterion, may also be a useful structural indicator to assist in examining whether economies have been hit by asymmetric shocks and whether adjustment mechanisms other than nominal exchange rate adjustments are in place.

At the same time, monetary and fiscal criteria on the one hand and structural criteria on the other tend to differ with regard to (i) the degree to which they can be influenced by the authorities' policies, and (ii) the time horizon over which major variations of the underlying economic variables may occur. While the development of monetary or fiscal variables such as the inflation rate or the budget deficit depend to a large extent on the course taken by monetary and fiscal policymakers, structural variables such as the sectoral structure of the economy, trade patterns, labour market features or growth cycles are largely beyond the authorities' immediate control. They are influenced by various domestic and external factors and by the decisions of a variety of private and official agents. This also largely explains the different time horizons over which monetary and fiscal variables on the one hand and structural variables on the other can be influenced. While monetary and fiscal data usually reflect a shift in the respective policies relatively quickly, the effects of policies designed to, for example, enhance growth or reduce unemployment, or to foster structural change or trade integration, typically take longer to show.[47] The key features of monetary, fiscal and structural convergence criteria are summarised in Table 9 below.

[46] See Corden (1993) on the role of stability preferences in the formation of monetary unions.

[47] Moreover, structural variables are of less concern in the context of a monetary union if price stability is the primary objective of monetary policy, and if monetary policy is considered to be neutral in the medium and long term with regard to its real effects. While this does not imply that such variables are irrelevant, structural features of the economy, such as the synchronisation of business cycles, would deserve more attention if monetary policy is assigned the task of fine-tuning the economy and influencing real variables such as growth and employment. The fact that the former view of monetary policy is part of the policy consensus upon which the Maastricht Treaty (as the monetary constitution of the euro area) was built explains to a large extent why only monetary and fiscal convergence criteria were incorporated into the European Community (EC) Treaty.

Table 9 **Key features of monetary, fiscal and structural convergence criteria**

	Monetary criteria	Fiscal criteria	Structural criteria
Primary purpose	assess direction of policy, policy consensus	assess direction of policy, policy consensus	assess structural features of the economy, OCA compatibility
Responsiveness to policy decisions	high	high	low
Time horizon for changes in underlying variables	short/medium term	short/medium term	long term
Quantification	easy	easy	difficult
Relevant time for application	prior to monetary union	prior to and during monetary union	prior to and during monetary union

In the context of the GCC, the political decision to introduce a single currency has been taken. Thus, the function of convergence criteria is not to determine whether GCC countries should form a monetary union, or indeed whether they can be regarded as an OCA. This understanding is reinforced by the GCC member states' intention to design the criteria not as selection criteria, and to start monetary union with all member states (see sub-section 5.3.3 below, second indent, on issues arising in this context). The time frame for the convergence process has also been determined by setting 2010 as the date for the introduction of a single currency, and 2005 as the point in time when member states shall begin to strive to fulfil the convergence criteria. In view of this framework and the above considerations, a focus on monetary and fiscal criteria tends to be the most appropriate approach for the GCC's current deliberations on the design of convergence criteria. Regarding structural convergence, the difficulties in formulating meaningful criteria in quantitative terms may also justify some caution in designing and using such criteria. Nevertheless, it is advisable that structural convergence and the underlying features of the economies are subject to a multilateral surveillance process (see Section 5.4).

5.3.3 ISSUES RELATING TO THE DESIGN OF CONVERGENCE CRITERIA

Basic issues concerning the design of convergence criteria in the GCC are the time horizon over which they are applied, i.e. whether they are *entry criteria* or *permanent criteria*, and whether the criteria are designed as *selection criteria* for participation in the monetary union or as mere *indicative targets*.

– Entry versus permanent convergence criteria

Convergence criteria can be designed as mere entry criteria. Thus, they have to be met at a specific point in time or throughout a reference period prior to the creation of a monetary union to provide a basis for deciding whether the monetary union should be established or which countries should participate. After the monetary union has been established, such criteria naturally cease to be relevant.

In addition to being just entry criteria, convergence criteria can also serve as an anchor for policies after the establishment of a monetary union, to be fulfilled by member states on a permanent basis. As previously pointed out, the act of establishing a monetary union ensures a high degree of monetary convergence, but fiscal convergence is not permanently secured in a union if fiscal policies remain a national prerogative, even though a high degree of fiscal convergence may have been achieved prior to the introduction of a single currency. Thus, the permanent risk exists that national fiscal policies may undermine a stability-oriented single monetary policy if fiscal policies are unrestrained by fiscal rules or a policy coordination mechanism. Against this background, there is a case for designing monetary criteria as pure entry criteria for monetary union, while at the same time using fiscal criteria as both entry criteria and permanent criteria. The latter may continue to serve as a disciplining device once the monetary union has been established. The disciplining effect of the criteria depends to a large extent on the sanctions which countries face in the event of non-compliance. Potentially the strongest sanction for failing to meet the entry criteria is non-admittance to the union, provided the entry criteria are designed as selection criteria. This sanction is no longer available once a country has joined a monetary union,[48] implying that alternative ways and possible sanctions to ensure continued compliance with the criteria need to be considered.

– Selection criteria versus indicative targets

Convergence criteria can be designed as selection criteria with the aim of helping to determine which countries are suitable to form a monetary union. They can also serve the purpose of determining when countries that did not take part in the first round of membership can subsequently join the union. Alternatively, convergence criteria can serve as mere indicative targets to be achieved by member states. In this case, their function is restricted to being a tool that provides information on the development of certain economic indicators deemed relevant for monetary union on a systematic and comparable basis, with the criteria serving as benchmarks.

Selection criteria obviously provide a stronger incentive for compliance, as the potential sanction in the case of non-compliance is denial of access to the monetary union. This is a potentially strong sanction. The non-admittance to a "club", the membership of which is considered to be attractive, due to a failure to fulfil the entry criteria may entail high economic and reputational costs for the authorities.[49] Accordingly, the disciplining effect of selection criteria on monetary and fiscal policies can be regarded as high, and thus they may also serve as an effective anchor for expectations. This presupposes that the criteria are credible, i.e. there is an expectation that they will actually be implemented as selection criteria and that their role in the decision-making process will not be diluted for political reasons. The European experience suggests that the Maastricht criteria, which were designed as selection criteria, were indeed effective as a disciplining device and as an anchor for policies and expectations.

Convergence criteria that have been designed as mere indicative targets, while being a helpful information tool, will tend to have a more limited effect on disciplining policies, and thus will also tend to be less effective as an anchor for policies and expectations. Peer pressure will be the only available instrument to foster convergence and to press for the fulfilment of the criteria. While peer pressure may potentially be strong, its effectiveness in disciplining policies is likely to fall short of that of the potential sanction imposed on a country that does not comply with the selection criteria.

The GCC does not intend to design convergence criteria as selection criteria. Rather, there is a political consensus to establish a monetary union in 2010 comprising all six member states. Given this intention, the authorities face the challenge of fostering convergence in the absence of strong incentives to comply with the criteria, particularly if this might involve unpopular decisions in the area of fiscal policy. Sufficient peer pressure among the authorities will be crucial to ensure that countries make a serious effort to meet the criteria and to prevent the

[48] Notwithstanding the theoretical possibility of exclusion from the union, which would be such a draconian measure that it can be ruled out as a feasible sanction.

[49] The economic costs can, for example, take the form of higher interest rates, pressure on the exchange rate or a change in the general market perception of a country once it has officially failed a convergence test.

criteria from suffering a lack of credibility. GCC countries may, in any case, face a situation prior to 2010 in which it becomes clear that not all member states will fulfil the criteria for the introduction of a single currency. They will then have to decide whether to postpone the transition to monetary union until the criteria are fulfilled by all countries, or to introduce the single currency according to schedule despite some countries' non-compliance with the criteria.

– Further issues related to the design of convergence criteria

Reference period

As pointed out above, particular attention should be paid to the sustainability of economic convergence with a view to the establishment of a GCC monetary union. Such an emphasis on sustainability can be reflected in the design of convergence criteria, in particular of entry criteria. The concept of sustainability requires the reference period for assessment of the compliance with the criteria to be not too short. Looking, for instance, only at a single year prior to the introduction of a single currency would hardly be sufficient to come to any meaningful conclusion regarding sustainability, and may even lead to undesirable policy reactions. In the case of fiscal criteria, the choice of a short reference period may lead to a fiscal tightening targeted only at the budget balance in the reference period, for example through the use of one-off measures to bring down budget deficits. This, however, would not improve the fiscal position in the medium term – indeed, it could even worsen it.[50] In the same vein, in respect of monetary criteria, a short reference period may encourage a sudden tightening of policies to bring down inflation in the period concerned, entailing a high cost in terms of output loss, without representing a sustained stabilisation effort. In order to avoid such counterproductive behaviour and to provide an appropriate view of sustainability, the development of the underlying indicators should be observed over a longer period, preferably throughout a business cycle.

Thresholds

In the design of any convergence criterion, thresholds, or reference values, have to be chosen to decide at what point the criterion is considered to be fulfilled, as well as to determine when it has not been fulfilled. Theory cannot generally help with regard to the optimal reference value for a certain criterion. There is, for instance, no way to reliably define an optimal rate of inflation or to determine a reference value above which a budget deficit can in itself be regarded as excessive, or above which a debt level can be regarded as unsustainable. Thus, any choice of threshold necessarily involves a certain degree of arbitrariness. This unavoidable arbitrariness is, however, not an argument against using convergence criteria in principle. Rather, it points to the need to find thresholds which are reasonable and plausible under the specific circumstances of a country/region, and which are mutually consistent within a set of criteria.

This point can be illustrated by the 3% of GDP reference value for budget deficits in the EU. This threshold, which indicates whether or not a budget deficit should be regarded as excessive, was derived from the average public debt-to-GDP ratio of around 60% in the then 12 EU Member States at the time when the Maastricht Treaty was concluded in 1991. Given certain assumptions regarding real GDP growth and inflation, a deficit of 3% of GDP stabilises a debt level of 60% of GDP.[51] Moreover, a deficit

[50] The EMI's 1998 Convergence Report quantified the effects of temporary fiscal measures taken by EU countries in order to reduce their budget deficits in the crucial reference year 1997 at between 0.1 and 1 percentage point of GDP, with the level varying according to the country. In view of these incentives of a short reference period, the Treaty calls for the sustainability of convergence to be assessed prior to the adoption of the euro.

[51] A debt-to-GDP ratio of 60% is stable at a budget deficit of 3% of GDP and a nominal growth rate of 5%. The assumption of a nominal growth rate of 5% was derived from an estimate of 3% trend growth for the EU in the early 1990s and an inflation norm of 2%. The change in the debt-to-GDP ratio (Δb) is approximately a function of the budget deficit (d) the nominal growth rate (n) and the initial debt-to-GDP ratio (b): $\Delta b = d - nb$. Therefore, given the underlying assumption for growth, a debt-to-GDP ratio which is higher than 60% will decline to 60% over time if budget deficits do not exceed 3% of GDP, while a debt-to-GDP ratio of less than 60% will rise to 60% if budget deficits stay at 3% of GDP. Consequently, debt-to-GDP ratios will converge at the 60% level.

ceiling of 3% of GDP in EU countries leaves enough room for the automatic stabilisers to work in a recession without breaking the ceiling, if the budget is balanced or in surplus over the medium term.[52] This is the basic rationale behind the EU's Stability and Growth Pact as a framework for fiscal policy. Thus, the 3% of GDP threshold can be considered to be reasonable, although it cannot be argued from a theoretical point of view that a deficit of for instance 3.2% is excessive, whereas a deficit of 2.8% is not – or, indeed, that 60% of GDP is the optimal level of public debt. Nevertheless, a threshold has to be chosen and, for it to have a disciplining effect, mechanisms to enforce compliance must be in place.[53] The inevitable degree of arbitrariness involved in any threshold for convergence criteria can therefore not be used in itself as an argument against such criteria or mechanisms to enforce them, as long as they seem reasonably plausible.

Scope for interpretation and political discretion

When designing convergence criteria in the GCC, it has to be decided to what extent they should be open to interpretation, leaving policymakers some discretion in deciding whether or not the criteria have been fulfilled or not. A certain degree of discretion may be warranted to avoid too mechanistic an application of the convergence criteria, which may not allow for due consideration of the overall picture, in particular in view of the arbitrariness necessarily involved in the choice of thresholds, or developments that extend beyond the reference period. However, it has to be acknowledged that there is a trade-off between such discretion for policymakers in the application of the criteria and their credibility. The more room is left for a political interpretation of the convergence criteria, the less effective they are as an anchor for policies and expectations and as a disciplining device.

Availability, reliability and comparability of statistical data

An absolutely crucial issue for GCC convergence criteria is the quality of the statistical data on which the monitoring and assessment of the criteria are based. First, data for all indicators used must be available in a timely manner. Second, the data have to be sufficiently reliable (i.e. the need for major revisions later on should be avoided), although there may be a trade-off between the timely delivery and the reliability of data. Third, data must be comparable between member states, as otherwise no meaningful conclusions can be drawn from the criteria, and comparisons may even be misleading. The European experience shows that even in countries with a generally sound data basis, a major effort is needed to meet the statistical requirements for monetary union, in particular regarding data comparability.[54] The current state of data availability, reliability and comparability in the GCC suggests that further effort is needed in GCC countries to meet the statistical requirements for a meaningful assessment of convergence criteria – in particular in the fiscal area – and the operation of a monetary union.

5.4 MULTILATERAL SURVEILLANCE OF CONVERGENCE CRITERIA AND INSTITUTIONAL UNDERPINNINGS

The monitoring and assessment of convergence criteria needs frequent and effective multilateral surveillance, which in turn requires suitable institutions and fora to

[52] See Buti, Franco and Ongena (1997).

[53] The rationale for using reference values for convergence criteria, despite some unavoidable arbitrariness, can be compared to the rationale behind a speed limit on roads. Few will doubt that a speed limit is a useful and necessary tool to control traffic and to avoid accidents. However, there is no theoretical or empirical case to limit speed to a specific threshold. The 50 km/h speed limit imposed in cities in most European countries, for example, is completely arbitrary, and it could indeed be argued that 40 km/h or 60 km/h would do just as well. No one could plausibly argue that driving 60 km/h is always and on any inner-city road endangering traffic, whereas 40 km/h is always safe. However, the 50 km/h value can be seen as broadly reasonable. By contrast, a limit of 10 km/h would obviously choke traffic, and 100 km/h would represent no effective restriction at all, making them unreasonable choices. It is also logical that despite the arbitrariness of any concrete speed limit, violations have to result in sanctions, and that exceptions must be made under special circumstances, e.g. for ambulances/the fire brigade.

[54] See EMI (1996a) on the statistical requirements for monetary union in the EU.

exchange information and discuss the relevant economic developments and policies. Prior to monetary union and the establishment of a supranational monetary authority, it is crucial that the national central banks participating in the monetary integration process closely cooperate and develop intensive working relationships as well as an institutionalised framework for the exchange of information and for policy discussions. The need for close interaction between central banks applies not only to Governors but also to senior management and experts. In the European context, the Committee of Governors of European Community (EC) central banks, which was established in 1964 (including its substructures and secretariat), was decisive in laying the groundwork for European monetary integration. It was the core body for monetary cooperation and policy dialogue and was instrumental in developing a policy consensus, and formed the nucleus of later European monetary institutions (the European Monetary Institute (EMI), founded in 1994, and subsequently the European System of Central Banks (ESCB) and the Eurosystem in 1998, with the ECB at its core).

As well as having the necessary institutions in place for central bank cooperation, it is crucial to establish appropriate institutions and fora for the exchange of views and policy discussions among finance ministers and senior finance ministry officials. In the European context, the EU Council of Ministers of Economic Affairs and Finance (ECOFIN) (and, since the introduction of the euro, the Eurogroup) is the platform for such interaction.[55] Furthermore, given the wide number of issues in a process of monetary integration (and later on in a monetary union) that are of mutual interest to central banks and finance ministries, appropriate institutions for a confidential exchange of views between central banks and finance ministries are of great importance. In the EU, the role of a platform for an exchange of views between high-level representatives of central banks and finance ministries is primarily fulfilled by the Monetary Committee and, since the introduction of the euro, by the Economic and Financial Committee (EFC).

The necessary structures for central bank cooperation can be replaced by a supranational monetary authority, at the latest when the single currency is introduced (see Chapter 6). The institutions for cooperation between finance ministries and for an exchange of views between finance ministries and central banks have an important role to play in the run-up to monetary union in monitoring the convergence process, but must also remain in place, and might even have to be strengthened, after the introduction of a single currency.

With regard to the institutional underpinnings of multilateral surveillance, a key issue relates to enforcement mechanisms in case national policies deviate from commonly agreed convergence criteria. Peer pressure is an important instrument for disciplining national policies, and for ensuring that national policymakers refrain from actions which may be detrimental to objectives pursued at the community level. Peer pressure can be reinforced by public pressure ("name and shame"). This requires the process of multilateral surveillance to be transparent to the public, as well as the commonly agreed convergence criteria. This is a precondition for the public to be able to monitor the compliance of national policies with the supranational community's interests. Apart from peer pressure, further enforcement mechanisms may be contemplated to ensure compliance with commonly agreed objectives, rules and standards, such as fines. If such financial or legal sanctions are deemed useful, it is crucial to clarify the exact nature of a sanction, the circumstances under which it would be imposed, and the process leading to the imposition of a specific sanction.

[55] See ECB (2001) for an overview of the economic policy framework of EMU.

In the context of the GCC, the nucleus for appropriate institutions to be assigned the task of multilateral surveillance and policy coordination is already in place. The Committee of Governors of Monetary Agencies and Central Banks is, with its substructures, the natural body to supervise monetary and exchange rate policies in the run-up to a GCC monetary union and the necessary harmonisation of legislation on banking supervision and financial markets, given the responsibility of GCC monetary agencies and central banks for banking supervision and the oversight of financial markets in the respective member states. The task of monitoring and coordinating national fiscal policies and other areas of economic policy where surveillance and coordination is required would naturally fall to the Committee for Financial and Economic Cooperation, which is composed of ministers of finance and economics.

So far there is no permanently established institution comparable to the EU's EFC that would allow senior central bank and finance ministry officials from all GCC member states to exchange views on issues of mutual interest. The GCC's Technical Committee, which was formed in 2001 to prepare for monetary union at the technical level, is a forum which brings together officials from central banks and finance ministries of GCC member states, and competent officials from the GCC Secretariat General. Given this composition, it could provide a forum for an exchange of views between central banks and finance ministries on all monetary and financial issues in the run-up to monetary union, including surveillance of the convergence process and policy coordination. Furthermore, it seems sensible that such a Committee should be transformed into a permanent forum after the establishment of monetary union, which would then include representatives of a new supranational monetary authority.

For multilateral surveillance to be effective, it is also essential to have sufficient staff at the supranational level to prepare the meetings of the competent bodies and to conduct the necessary background analytical work, such as analysing economic developments in member states and, in particular, monitoring budgetary policies. Assigning the staff involved in this work to a supranational institution at the GCC level is crucial to guarantee that analysis and assessments are conducted from the angle of the Council as a whole and not impeded by national points of view. Simply entrusting staff working for the national authorities with these tasks and trying to foster cooperation in committees and working groups may not be sufficient to ensure that the necessary supranational perspective is given due consideration.

5.5 APPROPRIATE FISCAL CRITERIA AS A SPECIFIC CHALLENGE FOR THE GCC

As pointed out in Section 5.2, fiscal convergence on the basis of sound public finances prior to monetary union is a key indicator of a country's willingness and ability to implement disciplined fiscal policies, and thus will allow tentative conclusions regarding the sustainability of fiscal convergence after the introduction of a single currency in the GCC. Defining appropriate criteria for fiscal policy is thus crucial for assessing fiscal convergence based on sound public finances. A binding framework regarding fiscal policy might not only be beneficial in the run-up to GCC monetary union, but may prove to be even more important once the union has been established. This could secure permanent fiscal convergence with the objective of preventing potential conflicts between national fiscal policies and a single monetary policy, as well as any negative spillovers between member states of the union. Designing appropriate fiscal criteria is a specific challenge for the GCC as (i) in contrast to the monetary sphere, fiscal convergence among member states is less pronounced (Chapter 4); and (ii) the oil dependence of government budgets in combination with the volatility of oil revenues has to be taken into account.

Against this background, general reflections on fiscal convergence criteria and fiscal rules with a view to a supranational monetary union must be complemented by a clear acknowledgement of the specific challenges for fiscal policy in oil economies such as those of the GCC, as well as their implications with regard to potential fiscal convergence criteria.

5.5.1 GENERAL REFLECTIONS ON FISCAL CONVERGENCE CRITERIA/FISCAL RULES

The case for fiscal rules in general, or, more specifically, for fiscal convergence criteria in the context of a supranational monetary union[56], is primarily based on political economy considerations. Governments tend to have a tendency to finance public expenditure via debt issuance to a greater extent than is warranted from a purely economic point of view.[57] This leaning towards excessive public deficits is due to the intertemporal redistribution involved in deficit financing, which shifts part of the fiscal burden from present to future generations. A large body of economic literature provides theoretical and empirical evidence for this bias in favour of deficit financing.[58] Most of this literature concerns countries with democratic political systems, where elections, and the efforts of competing parties to win electoral support through expenditure-enhancing or revenue-reducing fiscal measures, are the driving force behind the deficit bias. Much less is known about the political economy with regard to public deficits in political systems where there are no elections, or where elections are not the ultimate source of political power and legitimacy. While this topic is not analysed here in detail, there is sufficient evidence, not least from GCC countries over the past two decades, to suggest that persistent and high fiscal deficits and an accumulation of public debt are by no means phenomena confined to Western-style democratic political systems. As persistent deficits lead to an accumulation of public debt, the deficit bias is intrinsically linked to the issue of debt sustainability.[59]

Fiscal rules can be seen as a tool to contain the deficit bias of governments by limiting their discretion with regard to specific parameters of fiscal policy. They can act as a commitment device to prevent short-sighted political considerations leading to excessive spending and deficits. Thus, there is a general case for the adoption of fiscal rules to limit the scope for discretion with regard to fiscal policy even in the absence of a monetary integration process. This case is enhanced in the specific circumstances of a supranational monetary union as envisaged by the GCC, where fiscal policy remains the prerogative of member states, as undisciplined national fiscal policies may impede a stability-oriented single monetary policy and have negative spillover effects on the other members of the union. Against this background, fiscal rules constitute an institutionalised coordination mechanism intended to oblige countries to act responsibly with regard to the impact of their fiscal stance on area-wide economic variables.

A number of requirements for fiscal rules have been formulated:[60]

[56] The term “fiscal rule” is used synonymously here with “fiscal convergence criteria”, as the latter, particularly if they are permanent criteria in a monetary union, have the same effect and fulfil similar functions as fiscal rules in a purely national context.

[57] Financing public investment, tax smoothing and smoothing business cycles are the major normative arguments proposed by economic theory in favour of budget deficits.

[58] The seminal contribution on the deficit bias from a political economy point of view is that of Buchanan and Wagner (1977). Later literature has increasingly looked at specific features of democratic systems that are particularly conducive to excessive deficits, such as individual election systems and the degree of political polarisation, etc. (see, for instance, Roubini and Sachs (1989), Grilli, Masciandaro and Tabellini (1991), Corsetti and Roubini (1993) and Alesina and Perotti (1995)). For a recent overview of the literature, see Schuknecht (2004).

[59] See Chalk and Hemming (2000) for concepts in debt sustainability and an overview of the issues involved.

[60] See Kopits and Symansky (1998), who provide a comprehensive overview of fiscal policy rules and the major policy issues involved. This overview, as well as the deliberations in this section, are limited to quantitative rules – i.e. rules constraining one or several parameters of fiscal policy. As an alternative or complement to such quantitative rules, procedural and institutional rules may also help to foster fiscal discipline. Such procedural and institutional rules are for example often implemented to enhance the control of the treasury over the budgetary process or to strengthen the role of the Minister of Finance within the government.

- A fiscal rule should be *well defined* with regard to the indicators to be constrained, the institutional coverage and potential escape clauses.

- A fiscal rule has to be *transparent*, including accounting, forecasting and institutional arrangements.

- A fiscal rule should be *adequate* with respect to the specified proximate goal.

- If there is a set of fiscal or other macroeconomic rules, these rules have to be mutually *consistent*.

- A fiscal rule should be *simple* and understood by policymakers and the wider public.

- A fiscal rule should be sufficiently *flexible* to accommodate exogenous shocks beyond the control of the authorities.

- A fiscal rule should be *enforceable* and should clarify the consequences of non-compliance.

The extent to which these requirements are met will determine the overall credibility of the fiscal rule and its disciplining effects on fiscal policy. There are however some inevitable trade-offs between the different requirements, most notably between simplicity and transparency on the one hand, and flexibility on the other. The more flexibly a rule is designed in order to accommodate for specific situations (i.e. the more room for interpretation and discretion is left open to policymakers – for instance, via wide and open escape clauses), the less simple and transparent and, ultimately, the less credible the rule tends to be.[61] From a political economy point of view, simplicity and transparency stand out as the most crucial attributes to be fulfilled by an effective fiscal policy rule.[62] However, there is also a case for flexibility in order, for instance, to accommodate business cycles, which is reinforced under the particular circumstance of a monetary union. As member states are deprived of using monetary policy and nominal exchange rate adjustments as a policy tool to accommodate asymmetric shocks, fiscal policy is one of the few tools left in their hands to counter such shocks. A temporary increase in the deficit may therefore be warranted to limit the fallout from a negative demand shock hitting a member state.

Furthermore, it has to be decided in a monetary union how far a single rule should be applied to all member states, or how far the rule itself or its application should be differentiated according to specific features of the public finances in individual countries. A single "one size fits all" rule, such as the same deficit-to-GDP ratio threshold for all member states, is clearly preferable from the point of view of simplicity and transparency, whereas a more differentiated approach may have economic merit in view of different fiscal positions and features. In the GCC context, for example, the issue arises of whether the same rule can be applied to countries whose oil reserves will become exhausted over very different time horizons. The design of a rule which is as simple and transparent as possible and sufficiently flexible at the same time is certainly one of the crucial challenges facing policymakers in the GCC in view of the inevitable trade-off.

[61] This trade-off between credibility and flexibility is not one-dimensional, however. An extremely rigid rule leaving no flexibility at all, such as one stipulating that a balanced budget must be maintained under any circumstances, would clearly also lack credibility.

[62] Buchanan and Wagner (1977) postulate that: "First of all, it [the fiscal rule] must be relatively simple and straightforward, capable of being understood by members of the public. Highly sophisticated rules that might be fully understood only by an economists' priesthood can hardly qualify on this account alone. Secondly, an effective rule must be capable of offering clear criteria of adherence and for violation. Both the politicians and the public must be able readily to discern when the rule is being broken." Kopits and Symansky also identify transparency as the most outstanding requirement of a useful fiscal rule. Schuknecht (2004) makes the point that clarity and simplicity of fiscal rules are particularly important in a supranational context, in which formal enforcement is limited and the ability of the public and financial markets to monitor compliance with the rules is even more important than in a national context.

Apart from fiscal rules addressing deficits, debt or expenditure, placing an explicit obligation on national governments not to bail each other out in the event of financial distress in a member state may contribute to fiscal discipline in a monetary union. Such a "no-bailout" clause would have to stipulate that participating countries (and the supranational union) will not be held responsible for the public debt of any government should funding difficulties manifest themselves.[63] If a bailout among members of the monetary union is explicitly ruled out, this will tend to enhance fiscal discipline and avoid moral hazard problems. It has sometimes been argued that a credible no-bailout clause in combination with an independent central bank might be a sufficient institutional provision to ensure fiscal discipline in a monetary union through market mechanisms.[64] According to this view, unsound fiscal policies would result in higher national risk premia which, in the absence of exchange rate risk in a monetary union and in the presence of a credible no-bail out clause, would reflect the credit risk. Such risk premia would discourage deviation from fiscal discipline by individual governments and provide them with incentives to conduct sustainable policies. While such market discipline may definitely be helpful, it seems imprudent to rely entirely on this mechanism to ensure fiscal discipline. First, it is uncertain whether financial markets are always in a position to fully assess the country-specific credit risk, and thus whether risk premia are appropriate. Second, a no-bailout clause may not be fully credible in the eyes of the market, depending on the perceived political cohesion of a monetary union, and thus risk premia differentiation may remain limited. Third, even if the risk premia are appropriate and the no-bailout clause is credible, it is far from certain that governments will react to increasing risk premia by reducing deficits, in particular if they have a short time horizon and face significant political pressure, such as an upcoming election. Thus a no-bailout clause is an additional tool to foster fiscal discipline, but should not be relied upon entirely. Such a provision may be useful as a complement to fiscal rules directly addressing deficits, debt or expenditure, but cannot substitute them.

5.5.2 FISCAL POLICY CHALLENGES IN OIL ECONOMIES AND IMPLICATIONS FOR GCC CONVERGENCE CRITERIA

Fiscal policy in oil-producing countries faces specific challenges related to the fact that oil revenues are exhaustible, volatile, uncertain and largely originate from abroad.[65] The challenges will tend to be greater the larger the share of oil revenues is in the government's overall revenues and the larger the oil sector is in the economy. Given the dominance of oil in the GCC's economies and public revenues, it is obvious that the specific features of oil revenues must be taken into account in the design of any fiscal rule/convergence criteria for these countries. The specific features of oil revenues pose challenges in both the long and the short term.

In the long term the challenge stems from the exhaustibility of oil reserves and concerns the complex issues of sustainability and intergenerational resource allocation. To avoid a sharp adjustment of fiscal policy once oil reserves are exhausted, and to secure national wealth for future generations, oil-producing countries have to accumulate financial assets during the periods in which they produce oil. After the end of oil production, the revenues from these assets can be used to replace oil income and to maintain levels of expenditure. Oil wealth is thus gradually transformed into financial wealth, leaving the country's overall

[63] The EC Treaty contains such a no-bailout clause in Article 103, which stipulates that "The Community shall not be liable for or assume the commitments of central governments, regional or local or other public authorities, other bodies governed by public law, or public undertakings of any Member State […]. A Member State shall not be liable for or assume the commitments of central governments, regional or local or other public authorities, other bodies governed by public law, or public undertakings of another Member State […]."

[64] See for example Bishop, Damrau and Miller (1989) in the context of the establishment of EMU.

[65] See Barnett and Ossowski (2002). The following considerations are mainly based on their comprehensive overview and analysis of operational aspects of fiscal policy in oil-producing countries.

wealth unchanged and preserving it for future generations. Intuitively, this reasoning is straightforward and makes a strong case for persistent overall fiscal surpluses to accumulate assets.[66] However, the challenge of deriving concrete policy conclusions from this way of reasoning and making them operational must not be underestimated. For example, estimating the oil wealth of a country, defined as the present discounted value of future oil revenues, is surrounded by significant uncertainty regarding the underlying assumptions, which supports a generally conservative approach to fiscal policy.[67] Uncertainty also prevails regarding the role of the government's capital expenditure in preserving overall wealth. In principle, it could be argued that capital expenditure and the accumulation of physical assets could at least partially represent an alternative to the accumulation of financial assets, thereby reducing the need for persistent fiscal surpluses. However, the uncertainties surrounding the effects of capital expenditure on productivity, future output and government revenues, and the well-known difficulties in distinguishing between capital expenditure and current expenditure, are too great to draw any clear-cut conclusions.[68]

The short-term challenge for fiscal policy in oil-producing countries stems from the volatility and unpredictability of oil prices. Public finances are dependent on a volatile variable that is largely beyond the authorities' control. This poses a challenge to both macroeconomic management and fiscal planning. The volatility of oil prices, and hence government revenues, tends to contribute to a pro-cyclical pattern of government expenditure and abrupt changes in government spending, which may translate into macroeconomic volatility and reduced growth prospects. Thus, there is a case for smoothing public expenditure in oil-producing countries, which is further reinforced by the other potential fiscal costs of volatile expenditure policies.[69] In general, the planning of a fiscal stance by targeting a particular level of the overall budget balance is rendered difficult by oil price volatility.

Several countries which derive substantial export and fiscal revenue from oil (or other non-renewable resources) have set up stabilisation and savings funds to deal with both the long-term and short-term challenges for fiscal policy. The savings function of such funds is meant to address the long-term issue of intergenerational equity and fiscal sustainability by accumulating assets, while the stabilisation function addresses the short-term issues of fiscal planning and macroeconomic stability by absorbing and injecting revenue from/into the budget.[70] More

[66] See Alier and Kaufman (1999) who, based on an extension of the non-stochastic overlapping generation model, make the case for persistent fiscal surpluses in an economy with non-renewable resources on intergenerational equity grounds.

[67] There is uncertainty about the future path of oil prices, about oil reserves, and about the costs of extracting them. In the long run, an extreme case to be considered could be technical innovations largely replacing oil as a primary energy source, or significantly enhancing efficiency in the use of oil, which would greatly reduce the value of oil reserves or even make them obsolete. Given such uncertainties, prudence in the design of fiscal policies is important, in particular from the point of view of long-term considerations. See, for instance, Bjerkholt (2003), who suggests a very conservative approach (a "bird-in-the-hand rule") to counter the uncertainty of a country's oil wealth by limiting non-oil deficits to the return on accumulated assets.

[68] Instead of classifying capital expenditure as productive spending, whose effect on future revenues is indeed highly uncertain and may therefore not theoretically underpin its deficit financing, capital expenditure may also be regarded as more akin to spending on durable consumption. According to this view, governments undertake capital spending not because capital is productive, but because government capital provides social benefits for many years. Barnett and Ossowski (2002) suggest that this view of capital spending may provide a rationale for higher non-oil deficits.

[69] During a period of rapidly rising expenditure, for example, these costs involve a reduction in the quality and efficiency of spending due to constraints in the administrative capacity or the realisation of projects with little marginal value added and difficulties in containing and streamlining expenditure following an expansion. In periods of rapidly declining expenditure, moreover, viable investment projects may be interrupted.

[70] See Fasano (2000) and Davis, Ossowski, Daniel and Barnett (2001) for a review of experiences with oil stabilisation and savings funds. The latter stress that such funds, while posing a number of problems in themselves, are not a substitute for explicit fiscal policy decisions and a fiscal rule both to smooth expenditure and to ensure long-term fiscal sustainability. Therefore, this section focuses on fiscal rules, rather than discussing whether, in addition to a rule, the establishment of stabilisation and savings funds would be warranted.

recently, it has been suggested that the unpredictability of oil prices and revenues should be dealt with by using market instruments to hedge oil market risks.[71]

In a monetary union among oil-producing countries, as is the case with the GCC, both the short-term and long-term challenges for fiscal policy need to be addressed through fiscal rules. The specific arguments for fiscal rules in a supranational monetary union as identified above – avoiding negative spillovers and the potential impediment of a single monetary policy – are relevant even in the short term, and not only over a longer time horizon. At the same time, it is obvious that any rule addressing short-term issues must be compatible with long-term sustainability. A fiscal rule which may be sufficient to contain pressures from deficits in the short term, but would nevertheless lead to deteriorating public finances in the long term, would not be plausible from the point of view of sustainability.

The specific challenges for fiscal policy in oil-dominated economies have implications for the choice of the appropriate fiscal indicators that have to be taken into account in the design of convergence criteria. For instance, in the GCC context the overall nominal deficit, and accordingly also the deficit-to-GDP ratio, has to be interpreted with even greater caution than in industrialised economies, and cannot be considered a reliable indicator of the course of fiscal policy.[72] In a period of rising oil prices, for example, the deficit-to-GDP ratio may decline in spite of expansionary fiscal policies featuring expenditure increases or a reduction in non-oil revenue. Higher oil revenues (and thus higher oil GDP) would mask the fiscal expansion. Conversely, in a period of falling oil prices, the deficit-to-GDP ratio may rise in spite of budgetary consolidation in the form of expenditure reductions and an increase in non-oil revenue. An assessment of the underlying fiscal policy stance on the basis of the overall deficit could therefore be misleading. As the debt-to-GDP ratio is strongly influenced by the overall deficit as well as by the impact of oil prices on GDP, this indicator is also affected by oil price developments, which may obscure the effects of the underlying course of fiscal policy on the debt level. Thus, the two fiscal indicators laid down in the Maastricht Treaty, while providing important information, cannot be deemed sufficient to monitor and assess fiscal developments in the GCC member states. Accordingly, basing quantitative targets/reference values on an unqualified deficit-to-GDP ratio would be highly problematic, and could even exacerbate and institutionally enshrine a major problem of public finances in oil economies, namely pro-cyclical behaviour.

Oil price-related deficit-to-GDP ratio

Relating the overall balance-to-GDP ratio to specific oil price levels might point a way out of this dilemma. Such a link could be established by identifying a reference range for the overall balance-to-GDP ratio to be achieved if the oil price is within a specified reference range or close to a specified reference price. In view of the long-term considerations of fiscal sustainability in oil-producing economies as outlined above, the target overall balance-to-GDP ratio under "normal" oil price conditions should be positive to allow for the required accumulation of assets. Accordingly, a common reference oil price or a reference oil price range would also need to be defined. This could for instance be a long-term equilibrium oil price derived from past developments. If the oil price is below the specified reference range, budget balance-to-GDP ratios below the targeted reference range could be tolerated. Conversely, if the oil price is above the specified reference range, budget balance-to-GDP ratios above the reference range would be expected.

[71] See Daniel (2001), who acknowledges, however, that the institutional framework for such markets is not yet fully developed and that it does not represent a solution for large oil producers.

[72] In GCC countries, developed tax systems and unemployment insurance schemes do not exist so far. Therefore automatic stabilisers do not at present play a role in GCC economies, and accordingly do not deserve specific attention, unless their impact on the overall balance increases in the process of economic diversification.

An oil price-related overall budget balance-to-GDP ratio would be a relatively simple and transparent indicator and would at the same time eliminate the main weakness in oil economies of an unqualified overall balance-to-GDP ratio. Nevertheless, several caveats have to be taken into account:

– It is difficult to identify an appropriate reference range for the overall balance-to-GDP ratio that is consistent with an oil price reference range. In the same vein, defining and agreeing an appropriate common reference oil price or even a reference range for oil prices is not a simple task given the significant uncertainties surrounding oil price developments. Thus, the framework may have to be reviewed frequently, in particular when developments in oil markets change rapidly.

– Oil revenues not only depend on oil prices, but also on production levels. Therefore, the overall balance-to-GDP ratio is not only influenced by oil price fluctuations, but also by variations in oil production in a country. This could be taken into account when assessing the development of the overall balance-to-GDP ratio, but would at the same time make interpretation more complex and thus reduce the indicator's appeal.

– If automatic stabilisers were to develop in the process of economic diversification, their impact on the overall balance would have to be taken into account.

The primary non-oil balance/non-oil GDP ratio

Alternatively, an indicator which insulates the budget balance from oil price developments is the non-oil deficit/surplus. This is defined as government revenue excluding oil revenue minus government expenditure, from which oil-related expenditure is deducted (assuming such expenditure exists, is significant and can be clearly delineated). The non-oil deficit is not affected by changes in oil revenues resulting from movements in oil prices (or in oil production), but is influenced by variations in expenditure or in non-oil revenues. Therefore, it could be an indicator of the underlying course of fiscal policy in oil-producing countries. Information may for instance be extracted from year-on-year percentage changes in the non-oil deficit. The non-oil deficit-to-GDP ratio is also an important source of information, but with one crucial caveat. Total GDP movements in oil-producing countries are usually heavily influenced by oil price developments (and variations in oil production). The non-oil deficit-to-GDP ratio may therefore decline, signalling a consolidation effort, even though expenditure has been increased or non-oil revenue lowered. Such a decline in the non-oil deficit-to-GDP ratio may be triggered by a significant increase in total GDP due to an increase in oil GDP following an oil price hike. This could mask the relaxation of fiscal policy, and thus may send a misleading signal. It may therefore be preferable to look at the non-oil deficit/non-oil GDP ratio to obtain information on the course of fiscal policy, and to compare fiscal developments in different countries. Furthermore, if a stock of debt or financial assets exist and generate interest payments or revenues, the primary non-oil balance/non-oil GDP is a more refined indicator of fiscal policy to determine whether or not a fiscal consolidation or expansion has taken place. The primary non-oil balance is then more appropriate, as declining interest payments or rising asset revenues could for example mask a fiscal relaxation.[73]

[73] See Barnett and Ossowski (2002). They illustrate, using the example of a hypothetical oil-producing country, how the overall balance and the non-oil balance and their respective ratios vis-à-vis total GDP and non-oil GDP react in the event of a stylised oil price variation. Barnett and Ossowski also give reasons why the primary non-oil balance is the most appropriate indicator of fiscal policy from the long-term perspective of sustainability and intergenerational equity. In principle, these issues boil down to choosing a primary non-oil deficit that is consistent with fiscal sustainability.

Notwithstanding the benefits of this indicator outlined above, some caveats also have to be taken into account:

- It is far from easy to identify an appropriate reference level for the (primary) non-oil balance/non-oil GDP ratio, and at the outset defining a realistic path to achieve that level.

- The share of non-oil revenues in the budgets of GCC countries is small. A sub-balance excluding oil revenues (and oil GDP) may be seen as a highly "artificial" indicator, given the importance of oil in GCC economies. Furthermore, the non-oil deficit/non-oil GDP ratio is inevitably high, and the disclosure of such a high deficit ratio may have unwarranted effects from a psychological and confidence point of view. In this context, it would be necessary to explain that this is primarily a technical, auxiliary measure to capture the discretionary fiscal impulse.

- It might be technically difficult to differentiate non-oil revenues from oil revenues, and oil GDP from non-oil GDP in a meaningful way. However, it should be kept in mind that in industrialised countries, cyclically adjusted deficits serve a similar purpose as the non-oil balance in oil-dominated economies. They are aimed at insulating the overall deficit measure from purely cyclical influences and indicating the underlying fiscal policy stance. Calculating cyclically adjusted deficits is complex and entails a high degree of methodological uncertainty, but nevertheless does serve the useful purpose of assisting in the interpretation of overall deficit developments. In a similar vein, it may be useful to make an effort to overcome possible difficulties in deriving a meaningful non-oil balance.

Combining several indicators

A fiscal framework in the GCC could also be based on more than one indicator, in particular given the intricacy of fiscal policy in oil economies. For instance, developments in an oil-price-related overall balance-to-GDP ratio as outlined above could be combined with and cross-checked by the primary non-oil balance. Thus, the framework would not rely on just one indicator, thereby reducing the uncertainties which may appear, for instance, with regard to the calculation of the primary non-oil balance/non-oil GDP ratio or in interpreting oil-price-related developments in the overall balance. A further element could be a close monitoring of and target for debt (asset)-to-GDP ratios. Identifying a target for this indicator and a path to achieve the target could be beneficial, given the importance of debt (asset)-to-GDP ratios for the long-term sustainability of fiscal policy in GCC countries.

The advantage of the explicit use of a combination of indicators is that fiscal developments can be cross-checked before any conclusions are drawn regarding the stance of fiscal policy. However, this advantage comes at the expense of simplicity and transparency, pointing to the inevitable trade-off mentioned above. Furthermore, the consistency of quantitative targets and reference values, if set for more than one indicator, must be ensured.

6 ISSUES RELATING TO THE ESTABLISHMENT OF A SUPRANATIONAL GCC MONETARY INSTITUTION

There are several key institutional issues that have to be addressed prior to the introduction of a single currency in the GCC. The first section of this chapter briefly explains that monetary union requires a single monetary and exchange rate policy, which has to be underpinned by a supranational monetary institution at the GCC level. The following section discusses potential degrees of centralisation/ decentralisation in such an institution with regard to crucial aspects of monetary policymaking. The final section reviews a number of further key issues which have to be taken into account in the design of a GCC monetary institution.

The main finding of this chapter is that a single GCC currency inevitably requires the establishment of a supranational monetary institution, in which decision-making on a single monetary and exchange rate policy is centralised. As far as other crucial aspects of monetary policymaking – analysis, implementation and communication – are concerned, a division of labour between the supranational institution and the national monetary agencies and central banks is possible, while taking into account certain requirements regarding centralisation in these areas as well.

6.1 THE NEED FOR A SINGLE MONETARY AND EXCHANGE RATE POLICY AND CENTRALISED DECISION-MAKING IN A SUPRANATIONAL INSTITUTION

A GCC monetary union with a single currency requires a single monetary policy and a single exchange rate policy. A mere coordination of national monetary policies by national central banks is not sufficient to sustain a monetary union with a single currency, given the indivisibility of monetary policy and the fact that a monetary union is more than just a tight exchange rate arrangement. A single monetary policy must be guided by economic, monetary and financial conditions in the monetary union as a whole. This implies that decisions on monetary policy will be based on objectives for the monetary union as a whole and on data for the single currency area, such as the average inflation rate, and that they will be reflected in a single set of interest rates that influence a single money market. A single monetary policy cannot address national or regional developments. If economic developments in one member state diverge from the union average, such divergent developments have to be addressed by policies that remain in the competence of national governments, such as fiscal policy or structural policies.

The requirement of a single monetary policy has far-reaching consequences for the institutional framework in which monetary policy is formulated and implemented. Conceptually it is important to distinguish between four crucial dimensions of monetary policymaking: the *analysis* of economic, monetary and financial developments as a basis for monetary policy decisions, the *decision-making* itself, the *implementation* of monetary policy decisions, and their *communication* to the public. Monetary policy decisions have to be centralised at the supranational level, which requires the establishment of a supranational decision-making framework. Supranationality implies that in such a decision-making body, members act in their personal capacity rather than as representatives of their respective member states. By contrast, the analysis, implementation and communication of monetary policy leave some room for decentralisation, and the appropriate degree of centralisation/decentralisation has to be identified in view of regional circumstances. Accordingly, the key issues arising for the GCC regarding the institutional design of the monetary policy framework are (i) the appropriate format for taking supranational monetary policy decisions in a centralised framework, plus the shape of the supranational monetary institution; and (ii) its relationship with national monetary authorities, including the degree of centralisation/decentralisation in monetary policy analysis, implementation and communication.

While there are different options with regard to the composition of the decision-making body concerning the level at which its members are appointed – i.e. the supranational or national level – a single GCC monetary policy will inevitably require centralised decision-making in a supranational body. An effective institutional framework for monetary policy must permit swift decision-taking if circumstances so require. Such decisions may have to be taken by majority vote if unanimity cannot be reached. The search for a broad consensus has its merits in decision-making on monetary policy, and thus the decision-making process may, in essence, be consensus-driven. However, it is crucial that formal procedures are in place in order to reach timely and efficient decisions in situations which would otherwise result in deadlock. It would therefore not be appropriate for monetary policy decisions to require unanimity. This implies a willingness to accept majority decisions that goes considerably beyond the typical intergovernmental approach to integration.

Therefore, a GCC monetary union and the establishment of a supranational monetary institution will require a significant transfer of national sovereignty to the supranational level in the area of central banking, notwithstanding the variety of approaches that can be followed concerning the division of labour between a supranational monetary institution and national central banks in other areas, such as the analysis, implementation and communication of monetary and exchange rate policy (see next section). This implies that full monetary integration – with the ultimate goal of introducing and managing a single currency – cannot be achieved and sustained effectively by a purely intergovernmental approach to integration, in which national monetary authorities still have the ultimate say on the formulation of policies.

6.2 CENTRALISATION AND DECENTRALISATION OF THE ANALYSIS, IMPLEMENTATION AND COMMUNICATION OF MONETARY AND EXCHANGE RATE POLICY

The degree of centralisation or decentralisation in the design of a future GCC monetary institution is discussed here in relation to those crucial dimensions of monetary policymaking to which differing degrees of centralisation/decentralisation can be applied: analysis, implementation and communication.

6.2.1 ANALYSIS

Monetary policy decisions have to be based on thorough economic, monetary and financial analysis. The degree of centralisation/decentralisation corresponds to the role of the supranational monetary institution in providing analysis for the members of the decision-making body to prepare the ground for monetary policy decisions. A policy geared to the requirements of the monetary union as a whole can only be devised if decision-makers are provided with thorough analysis focusing on the single currency area as a whole. This cannot be achieved without a coherent source of analysis. A coherent view of the single currency area requires a "bird's eye view" and is more than purely a compilation and addition of analyses of national developments. Such a bird's eye view free from national bias requires a supranational monetary institution that is entrusted with the analysis of union-wide developments and endowed with the necessary resources. At the same time, a complementary, decentralised provision of some analysis may entail benefits, including, for instance, competition between several centres of competence, a variety of different analytical perspectives and a better understanding at the national level of local developments and circumstances, which is particularly valuable in a supranational monetary union in which there is significant heterogeneity between member states.

6.2.2 IMPLEMENTATION

Monetary policy decisions can be implemented either by the supranational monetary institution alone or by the national central banks, or there can be a division of labour between them regarding different aspects of policy implementation. The greater the role of the national central banks in policy implementation, the higher the degree of decentralisation. The scope for decentralised implementation is however limited by the inevitable requirement of having a single money market with identical liquidity conditions throughout the monetary area. This implies that monetary operations are executed on uniform terms and conditions in all member states of the monetary union. This uniformity of monetary operations and thereby the singleness of the money market must be ensured by clear instructions on monetary operations from the supranational level.

6.2.3 COMMUNICATION

As with policy implementation, the task of communicating monetary policy to public authorities, financial markets and the general public can be assigned to the supranational monetary authority alone, or shared between the supranational and national levels, or left to the latter. In any case, it is crucial to ensure that a coherent and consistent policy message is sent throughout the single currency area, avoiding conflicting signals from different national central banks and their representatives. The need to ensure the consistency of policy messages has to be balanced by comparative advantages at the national level with regard to communication. Notably, national central banks tend to be closer to their respective publics and therefore could contribute to an effective communication.

In a GCC-wide monetary framework, the appropriate degree of centralisation/ decentralisation would also depend to some extent on the type of monetary and exchange rate policy the GCC intends to pursue once the single currency has been introduced. A fixed exchange rate peg as an external anchor for monetary policy, for instance, is less demanding, in particular with regard to the analysis and communication of monetary policy, than an autonomous monetary policy with an internal anchor. Accordingly, if it is intended to peg the new GCC single currency to the US dollar (or any other currency), and thus to continue the exchange rate regime in place prior to monetary union, a more decentralised institutional framework would be conceivable. Nevertheless, even in such a case, the minimum institutional requirements for a functioning single currency would have to be met from the beginning of monetary union by sufficiently centralising competencies in a new supranational institution. In particular, the institutional centralisation of decision-making is inevitable. The historical experience with highly decentralised central banks, which have typically undergone some centralisation process in the course of their history, quite clearly points to the potential problems of overly decentralised frameworks in the area of monetary policy.[74]

Two specific aspects of the GCC facilitate the institutional design of a supranational monetary institution as compared with the EU, for example. First, the relatively small number of monetary agencies and central banks does not pose a problem regarding the potential size of a decision-making body even if it were to comprise, for instance, all six Governors of the GCC monetary agencies and central banks plus an approximately equal number of members appointed in a supranational context. Similarly, cooperation among only six monetary agencies and central banks can be implemented relatively easily. Second, the fact that the GCC member states share a common

[74] Past examples of such highly decentralised central banks are the early Federal Reserve System in the US, from its establishment in 1913 until the Banking Act of 1935, and the Federal Republic of Germany's *Bank deutscher Länder* (Bank of German Federal States). The latter was the predecessor of the Bundesbank, which was not established until 1957, eight years after the foundation of the Federal Republic. See Meltzer (2003) and Goodfriend (1999) on the history of the early Federal Reserve System, and Buchheim (1998) on the *Bank deutscher Länder*.

language will greatly facilitate the communication of a single monetary policy, making it easier for the supranational monetary authority to directly communicate with the respective publics.

6.3 OVERVIEW OF FURTHER KEY ISSUES TO BE CONSIDERED IN THE DESIGN OF A GCC MONETARY INSTITUTION

A number of additional issues have to be addressed regarding the institutional design of a new GCC monetary institution. The following list is far from exhaustive, but aims to highlight key issues.

6.3.1 MANDATE

It is crucial that a GCC supranational monetary institution is provided with a clear, unambiguous mandate that clarifies the primary objective of the institution, and avoids the institution being overburdened with objectives which it either cannot sufficiently accomplish with the tools at the disposal of a central bank, or which may at times be conflicting.[75] Furthermore, the mandates of the monetary agencies and central banks of GCC member states need to be compatible with that of the supranational institution to avoid differing mandates becoming a source of confusion and friction.

6.3.2 INDEPENDENCE

Both central bank practice and academic research provide ample evidence that central bank independence is essential for monetary stability.[76] Against this background, a trend towards granting central banks independence from political authorities can be observed worldwide in recent decades.[77] The decision on the degree of independence granted to the central bank is ultimately a political one to be taken by the relevant authorities in the GCC, against the background of their historic experience and their political systems. A broad consensus on the status of a GCC monetary institution and its relations with political authorities at the GCC level and the national level prior to the establishment of a monetary union would reduce the risk of conflicts later on. Furthermore, the agreed level of independence is to be granted to all central banks in order to provide monetary stability, and to avoid institutional incompatibilities between a supranational institution and national monetary agencies and central banks.

6.3.3 PROVISIONS ON MONETARY FINANCING

The prohibition on monetary financing prevents public bodies from funding themselves in a potentially inflationary, non-market-oriented manner.[78] As a central bank can only be truly independent if it cannot be obliged to extend credit to the government, this may be referred to as “economic independence”. Given that provisions with regard to monetary financing currently differ between GCC monetary agencies and central banks, these would have to be harmonised.

6.3.4 LEGAL ISSUES CONCERNING THE ORGANISATIONAL STRUCTURE

A number of legal issues have to be addressed concerning the organisational structure of a GCC monetary institution, including (i) the tasks of the supranational institution (which would have to be clearly defined and delineated

[75] The ECB’s mandate, which singles out one overriding objective, to maintain price stability, is an example that is clear and unambiguous in this respect. Art. 105 of the Treaty stipulates: “The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community […]”.

[76] See for example Parkin (1987), Grilli, Masciandaro and Tabellini (1991), and Alesina and Summers (1993).

[77] The predecessor of the ECB, the EMI, established a number of criteria against which the concept of central bank independence can be assessed in concrete terms. These criteria apply to functional independence, institutional independence, personal independence and financial independence. See EMI (1996b).

[78] To prevent the ECB or national central banks extending credit to the government, which would undermine their ability to achieve the primary objective of price stability, Article 101 of the Treaty stipulates: “Overdraft facilities or any type of credit facility with the ECB or with the central banks of Member States […] in favour of Community institutions or bodies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the ECB or national central banks of debt instruments.”

from those of the national central banks); (ii) the ownership of the supranational institution (whether it is owned by the national central banks or vice versa, or whether another option is available); (iii) the determination of the institution's budget (whether the supranational institution's budget is determined by the national central banks, or it has control over the budgets of the national central banks); and (iv) the legal personality of the supranational institution. However, the answer to these questions does to a great extent depend on the preferred degree of centralisation/decentralisation as outlined above, as well as the legal traditions in the region.

6.3.5 DISTRIBUTION OF SEIGNIORAGE

A decision has to be taken on how to distribute the seigniorage generated by the performance of the monetary policy function. The two principal options are (i) to assign revenue to the supranational level (assuming a single legal issuer of the currency), or (ii) to distribute it to national monetary agencies and central banks according to a key that would have to be agreed by member states (assuming the national monetary agencies and central banks are to remain legal issuers of the single currency). Any provision in this regard may have redistributive effects between member states and could affect their national budgets.

6.3.6 MONETARY POLICY INSTRUMENTS AND PROCEDURES

A single monetary policy requires monetary policy operations to be executed on uniform terms and conditions in all member states of the monetary union. Therefore, GCC member states have to agree on a common set of monetary policy instruments and procedures, which together would form the operational framework of the GCC monetary institution. It is crucial that these instruments are designed and agreed upon prior to the start of monetary union, to ensure that they can be applied smoothly from day one of the single currency. While there has been a general trend in GCC countries away from direct and towards indirect, market-based instruments, differences between monetary policy instruments applied by the GCC monetary agencies and central banks still exist. A starting point for work on a common set of monetary policy instruments could be a thorough review of instruments used by GCC monetary agencies and central banks today, including an assessment of experiences made with different instruments so far.

6.3.7 FOREIGN EXCHANGE RESERVES

An agreement has to be reached about control over and management of foreign exchange reserves. Reserves can be transferred either totally or partially to the supranational institution, or left in the hands of the national central banks. The extent to which reserves are transferred to the GCC monetary institution or left with the national central banks will mainly depend on the desired degree of centralisation/decentralisation as described above, in particular with regard to policy implementation. If, for instance, the supranational monetary institution is assigned the task of executing interventions on the foreign exchange market, it might be preferable for it to command part of the reserves directly. While the question of who manages and administers foreign exchange reserves is of a more technical nature, it is of great importance that the GCC monetary institution and its decision-making body have effective control over the use of foreign exchange reserves if they remain with the national central banks, and that the supranational institution is in a position to influence large foreign exchange transactions undertaken by other public bodies in the member states, which might impact the single exchange rate policy. Only by exercising effective control over the use of reserves of all member states can the supranational institution pursue a coherent exchange rate policy and prevent transactions by individual national central banks or other public bodies contravening its exchange rate policy.

6.3.8 PAYMENT SYSTEMS

Monetary union requires the provision of safe and reliable monetary area-wide mechanisms for the settlement of payments and securities transactions in the single currency. The existence of such mechanisms is a crucial precondition for a smooth execution of a single monetary policy by ensuring that liquidity conditions are identical throughout the monetary union. In this context, a well-functioning area-wide payment system offering settlement in central bank money is necessary in order to guarantee the singleness of the money market. Area-wide infrastructures for the handling of large-value and retail payments and securities transactions are vital not only for the overall efficiency of the economic system, but also because they facilitate economic and financial integration in a more general sense. A first step towards developing the necessary infrastructures could be to define the requirements to be complied with by these infrastructures and to conduct a thorough review of the payment and securities settlement systems currently in place for the handling of transactions within and between GCC member states.

6.3.9 STATISTICS

The need for high quality statistics has already been highlighted in the context of the discussion on convergence criteria in the run-up to a monetary union (see Chapter 5). In contrast to the statistical work required in the context of the convergence process, which focuses mainly on the availability, reliability and comparability of national data in order to review economic convergence, the statistical work in view of the single monetary policy to be conducted after the single currency has been introduced should be geared towards the provision of area-wide statistics. The conduct of a single monetary policy requires the availability of a rather wide range of statistics covering the monetary union as a single economy, in particular in the areas of the price index, economic developments, money and banking, interest rates, exchange rates, balance of payments, and the international investment position and financial accounts statistics. Steps towards the harmonisation of concepts and the preparation of appropriate aggregation and consolidation methods have to be taken in good time prior to the start of monetary union. Their implementation in all prospective participating countries has to start sufficiently far in advance, as it generally involves a significant lead time.

6.3.10 BANKING AND FINANCIAL MARKET REGULATION AND SUPERVISION

Integrated banking and financial markets are crucial in a monetary union in order to reap the full benefits of a single currency and to facilitate the smooth conduct of a single monetary policy. The European experience suggests that the full integration of banking and financial markets does not follow automatically from the introduction of a single currency, but has to be spurred on by further action based on explicit political decisions. As a minimum requirement for a monetary union, GCC member states need a common set of harmonised legislation on banking and financial market regulation. Furthermore, they have to find solutions to ensure effective supervision of cross-border financial groups in a monetary union. It has to be decided whether the model for banking supervision in the GCC would necessarily be the same as the institutional model to be envisaged for monetary policy, or whether a different institutional set-up is preferable.

In the area of banking and financial market supervision, three issues have to be addressed in principle in the context of the GCC monetary union: (i) whether supervision should be assigned to the national level or the GCC level; (ii) whether supervision should be the task of central banks or specific supervisory institutions; and (iii) whether one institution should be assigned comprehensive supervisory authority over banks and financial markets, or whether there should be specialised supervisory institutions for different financial sectors.

If supervision basically remains a national task, it has to be ensured that effective fora and mechanisms of information exchange and coordination of supervisors in all financial sectors are established. Such arrangements would be necessary to ensure adequate convergence of supervisory practices and to address issues which may impact on the financial stability of the single currency area as a whole. Turning to the role of central banks in banking supervision, there seems to be a case for strong involvement in the GCC context as (i) all GCC monetary agencies and central banks are responsible for banking supervision, and (ii) financial intermediation in the GCC is mainly conducted via banks, with financial markets only playing a secondary role to date. Given the expertise of GCC monetary agencies and central banks in banking supervision, it would seem natural for a GCC monetary institution to play a significant role in the coordination of banking and financial market supervision at the GCC level. In addition, strong involvement on the part of central banks and monetary agencies would acknowledge their specific expertise in the area of financial stability.

6.3.11 INTERNATIONAL REPRESENTATION

An issue to be addressed prior to the establishment of monetary union is the representation of the single currency area at the international level, in particular in organisations and fora dealing with monetary, financial and economic issues, such as the IMF, the G20 (of which Saudi Arabia is a member), and, in the specific case of the GCC countries, the AMF. The respective roles of a GCC monetary institution, the Committee for Financial and Economic Cooperation (and its Chairman) and the GCC Secretariat General in representing the monetary union at the international level would have to be clarified. It has to be taken into account in this context that the statutes of international organisations usually foresee the membership of nation states. The appropriate representation of a supranational monetary union, which is warranted by the nature of the monetary, financial and economic issues dealt with in the respective institutions, may therefore require special arrangements.[79]

6.3.12 TIMING AND SEQUENCING OF THE ESTABLISHMENT OF A GCC MONETARY INSTITUTION

A supranational GCC monetary institution will have to be fully operational as from the day on which the single currency is introduced. Therefore it is crucial to take into account the lead times required to set up the institution, including, for instance, the analytical agenda that has to be addressed and testing the operational framework. The European experience suggests that the preparation for monetary union and the ultimate set-up of a supranational central bank are greatly facilitated if a predecessor institution, such as the EMI in the case of the EU, is set up early on in the process of monetary integration. A predecessor institution can serve as the institutional nucleus out of which the supranational central bank evolves, and play a central role in the analytical and technical preparation for the monetary union. For instance, a predecessor institution could take the lead in making preparations for the issuance of new banknotes, an area which requires careful consideration and sufficient lead times. It can also help to address any credibility concerns, which could arise if the supranational institution faced the task of building itself up from scratch (possibly having to overcome difficulties on the way) before being put in charge of conducting the single monetary and exchange rate policy.

[79] An example of such an arrangement is the ECB observer at the IMF, who, for instance, participates in meetings of the IMF Executive Board concerning Article IV consultations with EU Member States and candidate countries and in a number of meetings concerned with global economic and financial developments.

7 FINAL REMARKS

This paper has looked at key economic and institutional aspects of the envisaged GCC monetary union. Introducing a single currency in the member states of the GCC is an objective which is supported by the region's common history and language, the relative homogeneity of its political systems and traditions and, most importantly, the similarity of economic structures among the member states. Despite differences between member states, these structures remain largely dominated by the production of oil and gas. In their endeavour to achieve a single currency by 2010, GCC countries can also build on a considerable degree of monetary convergence over recent decades, which is reflected in a high degree of exchange rate stability, generally low inflation rates and co-moving interest rates. The process of monetary integration is embedded in a comprehensive project for economic integration which, after the establishment of a free trade area and a customs union in 2003, aims at the completion of a common market by 2007. However, it has to be borne in mind that so far the level of economic integration (as reflected in the level of intra-GCC trade, for example) has been relatively limited. Besides legal and regulatory barriers to closer integration, which should be eliminated in the course of the integration process, the similar factor endowment of the region represents a structural factor that limits economic integration.

Against this background, the macroeconomic costs of introducing a single currency in terms of relinquishing autonomous monetary and exchange rate policies seem to be limited. This view is supported by the fact that GCC member states in recent decades have not had to resort to this adjustment instrument to deal with the consequences of asymmetric shocks. At the same time, the economic benefits of a monetary union in terms of the elimination of transaction costs could be less significant than in the euro area for instance, as intra-regional integration in the GCC is relatively low, and exchange rate risks seem to be small under the present circumstances. Notwithstanding the latter, however, a monetary union could result in significant gains, for example in the area of financial markets, where a single currency could spur the development of more liquid and deeper financial markets. In the same vein, a single currency could facilitate non-oil trade between GCC member states and thereby further the objective of policymakers in the region to diversify their economies. Finally, monetary union could be the catalyst for the design of a multilateral, stability-oriented macroeconomic framework for GCC member states, which maintains monetary stability and promotes the fiscal discipline that is necessary to underpin monetary stability and to ensure fiscal sustainability in the long term.

The analysis in this paper has pointed to some key issues that have to be addressed by the GCC in order to lay the groundwork for a credible and sustainable monetary union:

- Deepened economic integration would increase the potential benefits and minimise the costs of the envisaged single currency. While the agenda that has been set in this regard by the GCC seems to be comprehensive and well-sequenced, the effective and smooth implementation of the planned stages of integration will be key to underpinning a monetary union. Furthermore, the integration process may have to be accompanied by a strengthening of supranational GCC institutions to the extent that it requires not only the coordination of national policies, but also the pursuit of common policies.

- Prior to monetary union, the GCC faces the challenge of designing an appropriate set of convergence criteria, taking into account the specific situation of the region and the inevitable policy choices involved in establishing such criteria. Monetary criteria could be used to monitor whether the high degree of monetary convergence already achieved by GCC member states is maintained up to the introduction of the single currency. Fiscal criteria would be crucial in fostering fiscal convergence among member states on the basis of sound public finances, where significant differences still exist. They would have to take into account the specifics of fiscal policy in oil economies. Fiscal convergence has to be ensured via a permanent framework for fiscal policy even after the single currency has been introduced. Such a framework is necessary to prevent undisciplined national fiscal policies from undermining a stability-oriented monetary policy and having unwarranted spillover effects between member states. For a meaningful monitoring and assessment of convergence criteria, GCC member states will have to improve further their statistical data.

– The similarity of economic structures in the GCC, which is based on the dominance of oil and gas and which in the past reduced the risk of asymmetric shocks and the need to resort to nominal exchange rate adjustments, may diminish in the future, as the pace and direction of economic diversification is likely to differ among member states. As a result, GCC countries might become more prone to asymmetric shocks. To absorb such shocks in a monetary union, alternative adjustment mechanisms need to be in place, which is a strong argument in favour of economic reforms aimed at enhancing price flexibility in product and factor markets in the GCC, in particular in the labour market.

– As monetary union requires a single monetary and exchange rate policy, the GCC has to establish a supranational monetary institution to formulate and conduct such a policy. While different models could be envisaged for the division of labour between such a supranational central bank and the national central banks and monetary agencies, decision-making on monetary and exchange rate policy has to be centralised at the new institution. The single monetary policy has to be geared to economic, monetary and financial conditions in the monetary union as a whole, which requires that the supranational central bank also command sufficient analytical resources. Such a central bank has to be fully operational from day one of monetary union, requiring timely preparation.

Overarching these issues is the need for: (i) a broad consensus in the GCC on the basic orientation of monetary and exchange rate policy and other key areas of economic policy, in particular fiscal policy; and (ii) political commitment to the economic integration process in general, and the monetary union project in particular. Policy consensus is crucial to avoid tensions once the single currency has been introduced as well as to underpin the credibility and sustainability of the monetary union. The political commitment to the process has to be strong and unambiguous at the highest political level in order to overcome obstacles or deadlock on the way to monetary union. At the same time, the political commitment has to be an informed commitment that fully takes into account the inevitable implications of monetary union. In particular, monetary union ultimately results in the transfer of sovereignty from the national to the supranational level in monetary affairs and, to some extent, needs to be accompanied by constraints for government budgets, which are areas widely regarded as being at the core of national sovereignty.

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