REPORT

THE GULF CURRENCY

Lessons from the Euro

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In December 2009, after several years of negotiations, agreement was reached between four countries of the Gulf Cooperation Council, Saudi Arabia, Kuwait, Qatar and Bahrain, to abandon their existing currencies in favour of a new single currency, yet to be named. The other two GCC members, UAE and Oman, may join later. The new currency is projected to be in operation by 2015 and the GCC argues that it will eliminate exchange rate risk between the countries, promote regional competitiveness and enhance intra-GCC trade and investment.

However, there is not much scope for the new currency to improve exchange rate certainty as GCC currencies are already closely aligned – a result of the fact that they have all effectively followed the US dollar, with minor departures, for the best part of three decades.

The Gulf currency may bring a small reduction in transactions costs between the GCC states, but there is much more to be gained from the further removal of trade barriers, the development of capital markets, and the adoption of more uniform subsidies and regulations. It might be argued that that new currency will act as a spur for these other market-improving measures. But these measures do not *need* the new currency and they can be adopted independently.

On the other hand, there may be an economic case for breaking the tie with the US dollar, which will be easier under the joint currency than with separate currencies.

THE EURO AS A MODEL

One motivation for the Gulf currency is the apparent success of the euro. However, there are no claims that the euro has itself been of much help in improving the European Union's 'single market'. The euro is, above all, a political project, designed to promote the ideal of 'ever closer union' in Europe and its 'success' during the past 10 years is hailed in the EU institutions as a major achievement of European integration.

	Nominal GDP US $ billions	Population thousands
Bahrain	19.4	728
Kuwait	114.9	2,691
Qatar	92.5	833
Saudi Arabia	379.5	28,687
GCC MU	**606.3**	**32.687**
Oman	52.3	3,418
UAE	228.6	4,798
GCC total	**887.2**	**42,155**
Eurozone	**12,266.3**	**320,441**

Table 1:

The Gulf region compared with the eurozone; 2009

GCC MU stands for GCC Monetary Union.

Source: IMF World Economic Outlook, October 2009 estimates

Although the Gulf-zone will be much smaller than the eurozone both in population and economic size (table 1), there is no doubt that the Gulf rulers are aware of the symbolic prestige of the euro and they are looking to the euro as the model for their own currency. There will be a single central bank, there are plans for entrance conditions which match the 'convergence criteria' applied to countries joining the euro, and implementation is to follow similar procedures with detailed planning handled by an independent Monetary Council that will later mutate into the central bank.

It is therefore ironic that the decision to proceed with the new Gulf currency has been made at a time when the euro is suffering its severest strains to date – which prompts consideration of whether the Gulf currency might also be vulnerable. The euro-system is currently threatened by doubt about the sustainability of the debts of several Southern eurozone governments and there is speculation that, without financial support from other governments or the IMF, there may be a return to national currencies. The focus at the moment is on Greece where government debt is 115% of GDP (table 2) and the budget deficit is 12.7% of GDP (an upwards revision from the figure in table 2). Comparable problems also exist in Portugal, Ireland, Spain and Italy, generally compounded by large balance of payments deficits.

	Government finances		Balance of payments on current account % GDP
	Government debt % GDP	Fiscal balance % GDP	
Bahrain	24.2	-4.7	3.7
Kuwait	6.9	24.4	29.4
Qatar	12.6	9.0	10.8
S Arabia	14.5	1.2	4.1
GCC MU	**13.1**	**2.4**	**9.9**
Oman	4.4	4.1	-0.5
UAE	10.2	4.0	-1.6
GCC total	**12.3**	**5.3**	**6.3**
Germany	77.4	-4.2	2.9
Greece	114.9	-6.4	-10.0
Ireland	65.8	-12.1	-1.7
Italy	123.6	-5.6	-2.5
Portugal	83.7	-6.9	-9.9
Spain	59.3	-12.3	-6.0
Eurozone	**84.6**	**-6.3**	**-0.1**

Table 2:

Government finances and balance of payments, GCC and some eurozone countries; 2009

Source: IMF and OECD 2009 estimates

The immediate cause of these eurozone debts is, of course, the global financial crisis and the subsequent recession which have together led to appalling government debt positions not just in EU countries but also in others including the US and Britain. But for the eurozone countries, the problems run deeper and euro membership also makes them harder to solve. Government finances in Greece had already been in poor shape for years before it joined the euro, but its penalty for lax fiscal behaviour was a depreciating currency and a corresponding currency risk premium on its debts. When it joined in 2001 (reporting falsely optimistic figures for its budget deficit), it was rewarded with much lower interest costs on its national debt.

Under the implicit guarantee of eurozone 'solidarity', Greece, Italy, and the others effectively imported Germany's reputation for sound fiscal management. But, far from leading the Greeks to mend their ways, euro membership enabled its government to continue spending as before and even made this cheaper. The EU's Stability Pact limit on budget deficits (max 3% of GDP) was supposed to enforce prudent fiscal behaviour, but it has never been a credible deterrent and it has been frequently flouted by large and small euro members.

Euro membership, however, brought with it the new penalty of short-term interest rates set by the European Central Bank and these have generally suited Germany rather better than the Southern eurozone countries. In the first few years, interest rates were too low for the Southerners, which increased inflation and led to a marked decline in competitiveness. Then in 2004-5, euro interest rates rose just when these countries needed it least. In 2008, boom turned to slump, exacerbated by the global economic downturn.

In 2009, all these malign influences – the world recession and financial crisis, previous inappropriate interest rates and continuing fiscal incontinence – combined to bankrupt the Greek government and, in differing degrees, those of Portugal, Spain and Ireland.

WILL THE GULF CURRENCY HAVE SIMILAR PROBLEMS?

At present, government debts in the GCC are small and, apart from Bahrain, all government budgets are in surplus (2009; table 2). The contrast with the troubled eurozone governments could hardly be greater. If the Stability Pact conditions of the eurozone are the relevant criteria (government deficits less than 3% of GDP; debts less than 60% of GDP), these are evidently satisfied with ease.

	Oil billion barrels	Gas billion cubic feet
Bahrain	--	3.0
Kuwait	101.5	62.9
Qatar	27.3	899.3
S Arabia	264.1	267.3
Oman	5.6	34.6
UAE	97.8	227.1
GCC total	**496.3**	**1494.2**

Table 3: Hydrocarbon reserves, end 2008

BP Statistical Review of World Energy, June 09

However, a joint currency is a large commitment and all member countries need to be confident that the other members will continue with responsible fiscal behaviour in the future. In GCC countries, hydrocarbon duties provide the bulk of government revenues and the question has to be raised as to what will replace this when hydrocarbon reserves become depleted. This is a not a concern for Saudi Arabia and Qatar (table 3), provided that oil and gas prices do not fall significantly, but Bahrain and Oman (predicted to join the currency later) are less fortunate.

Diversification into other activities such as tourism and financial services is taking place in all GCC countries and there is discussion about developing new sources of taxation. But, even if sufficient revenue is raised, a potential difficulty arises with monetary policy. In present circumstances, the dollar peg has meant that GCC countries have, for years, been obliged to accept short-term interest rates that are close to the $ rates set by the US Federal Reserve. This has not been an issue so far because the common dependence on oil has meant that the economic cycles of the Gulf states have been roughly in step. As some countries replace oil and gas production with other activities, their economic cycles may no longer coincide so well.

The single interest rate, which becomes locked in under a single currency, may then become a problem as in the eurozone where is has caused price levels to diverge across countries. Unfortunately, a single currency does not imply a single inflation rate, yet it does remove the option of currency deprecation as a means of restoring competitiveness after a country has suffered from inflation. Thus, when prices and wages in a country have become higher than elsewhere, this can only be corrected by relative reduction in those prices and wages, as is now painfully evident in Southern Europe.

THE CHALLENGE IS POLITICAL

In the end – and here the euro comparison is relevant again – the longevity of the Gulf currency will depend crucially on the degree of *political* cohesion between the member states. To state the obvious, the usual arrangement throughout the world is that single currencies coincide with countries run by single governments. When the Soviet Union broke up, for instance, the countries of Eastern Europe that regained political independence were quick to re-establish monetary independence. The euro is clearly anomalous in this respect – its founding fathers believed that economic union would force the pace of political integration. It remains to be seen whether this, or the opposite, will be true.

Currencies tend to be national rather than super-national because there is a common legislature, labour mobility is greater within countries than internationally, governments usually have some power to impose discipline on overspending regions and there is scope for fiscal transfers between regions. In the United States, for example, if California is booming while Michigan is in slump, there is automatically a compensating transfer of resources through the tax system. This works in the US because it has a federal budget of some 20% of GDP, unlike the EU where the common budget is only 1% of GDP.

These caveats aside, current circumstances seem to be favourable for the establishment of a joint Gulf currency – at least as compared to the euro. GCC government finances are generally healthy, their business cycles are approximately in phase, they share a common culture and language, and co-operation between countries is increasing at several levels. But they do not share a government so the new currency could be vulnerable to the same forces that now endanger the euro. There needs to be enough commitment amongst all members both to abide by the rules and to help other members if they need it. As the largest economy and oil exporter, this responsibility will rest disproportionately on Saudi Arabia, although this would be shared with UAE if UAE and Oman join at a later date.

SHOULD THE DOLLAR PEG BE MAINTAINED?

Initially, the new currency is expected to be tied to the US dollar, continuing the arrangement that is largely observed by the individual GCC countries at present.

Once it is established, there is the possibility of breaking the dollar link in order to adopt a more appropriate external exchange rate regime – a change that would be harder for each country to make on its own.

For the most part, the peg to the US dollar has served well, being the currency of the GCC countries' dominant hydrocarbon exports and of most of their large external assets. However, the dollar peg makes Gulf economies unnecessarily exposed to swings in the oil price (measured in dollars), and there are concerns that the recent weakness of the dollar against other major currencies contributed to inflation (this was the motive for Kuwait's recent move to an undisclosed wider basket). This has given rise to a number of suggestions for alternative exchange rate regimes: a peg to a dollar-euro basket or a wider basket of currencies; tying the currency to the oil price; an adjustable dollar peg; a managed float or a free float.

The test of any exchange rate policy other than a free float is its credibility, implying that the managed float and the adjustable peg would be poor choices. In the absence of controls on the movement of foreign capital, any arrangement that builds in discretion for the monetary authority over exchange rates invites destabilising foreign exchange flows whenever there is a hint that the parity could be adjusted. Similarly, fixing the new currency to a wider basket is not ideal as it is vulnerable to expectations that the composition of the basket may be changed. For these reasons, a free float is likely to be the appropriate option and it has the additional advantage that it should partially smooth the flow of foreign earnings as the oil price fluctuates.

In conclusion, whatever exchange rate policy is finally adopted, it is clear that the GCC countries are better suited for a joint currency than the euro countries. And provided that the Gulf states are prepared to group together in forming something that more closely resembles a single government than at present, it should have a longer life expectancy than the euro. However, while the Gulf states might value the apparent prestige of their own joint currency, they should not expect it to be a significant factor in improving trade unless it drives other reforms.

John Whittaker is an economist at Lancaster University with interests in monetary policy, money and banking, macro-economics and financial economics.

The Gulf One Lancaster Centre for Economic Research (GOLCER) was established in May 2008 by Lancaster University Management School and Gulf One Investment Bank. The centre is funded by a donation from Gulf One Bank.

The main purpose of the Centre is to conduct empirical research focused on key economic and financial developments in the Middle East and North Africa (MENA) region, with special emphasis on the Gulf region. This region includes Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and United Arab Emirates, countries that form the Gulf Cooperation Council.

GOLCER's research agenda will include, as primary topics, energy economics, Islamic banking and finance, telecommunication and infrastructure economics. Recent developments in these fields will be assessed in the light of their impact on the economy of the Gulf region.

In addition to its research activities, GOLCER will provide tailored training courses in specialised areas, including quantitative methods and applications of state-of-the-art econometric and statistical software packages to economic and financial phenomena. GOLCER will also provide consultancy services.

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