A common currency area for the Gulf region

Muhammad Al-Jasser and Abdulrahman Al-Hamidy[1]

Creation of a common currency area has been one of the cherished goals of the Gulf Cooperation Council (GCC) countries[2] right from the beginning. This goal was formally declared soon after the foundation of the GCC in 1981 through Article 22 of the Council's Unified Economic Agreement of June 1982, which stipulates that "The member states shall seek to coordinate their financial, monetary and banking policies and enhance cooperation between monetary agencies and central banks, including an endeavour to establish a common currency in order to further their desired economic integration".

The GCC countries have great potential for becoming a viable unified currency area. Beside constituting an almost contiguous area, these countries have many similarities in history, culture and economic characteristics (Table 1). The majority of these countries are highly dependent on the export of oil. They are trying to diversify their economies and increase the participation of the private sector in the development efforts. These countries believe in free enterprise. Barring a few items, imports and exports are free. Capital movements to and from these countries are also unrestricted. Their currencies are fully convertible and there are no taxes or subsidies on the purchase or sale of foreign exchange. Their exchange rate policies have for long been well coordinated, with the cross rates of their currencies showing remarkable stability.

The GCC countries have taken a number of steps to integrate their economic and financial systems. They have made the movement of national goods, labour and capital across their borders completely free. Also, they have adopted a common tariff and harmonised their customs administration and procedures. They have instituted steps to resolve cross-border trade disputes and agreed to accord national treatment for tax to each other's individuals and corporations. They have liberalised land ownership for each other's nationals, both for building a second home and for business purposes. They have also taken measures to promote foreign direct investment and intraregional capital flows, harmonise investment codes and stock exchange regulations, interlink electricity grids and develop a common gas grid. To integrate their financial systems, they have adopted unified bank supervision procedures, as well as allowing each other's banks to open branches in their jurisdictions. They have interlinked their ATM machines. In addition, they have initiated measures to interlink their stock markets so as to allow cross listing and trade in stocks of companies registered in member countries. They have also satisfied certain convergence criteria, including low inflation, stable bilateral exchange rates (as already mentioned) and close nominal interest rates through the implementation of a similar pegged exchange rate regime.

To quicken the pace of economic and financial integration, the GCC heads of state set up, in December 2001, a timetable requiring the GCC countries to establish a customs union by 2003 and integrate their exchange rates by the same date; reach an agreement on convergence criteria to be achieved by 2005; and adopt a common currency by 2010.

The GCC countries have progressed well in implementing the aforementioned timetable. They have already established a customs union, with a common external tariff rate of 5%. They have also agreed to the one entry point system of imports and the distribution of revenue on the basis of the final destination of imports. They have adopted a common customs law and have also agreed to establish a commission to monitor the implementation of the common external tariff.

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[1] Vice Governor and Director General of the Research and Statistics Department, respectively, of the Saudi Arabian Monetary Agency.

[2] The GCC countries are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.

Table 1

Selected economic indicators of GCC countries (as of 2001)

Indicators	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	United Arab Emirates
GDP at current prices (in billions of US dollars)	8	33	20	16	183[1]	47[2]
Per capita income (in thousands of US dollars)	12.2	16.6	8.1	26.9	8.7	16.7[2]
Real GDP index (1995 = 100)	123.6	102.7	129.1	–	112.6	–
Consumer price index (1995 = 100)	99.6[3]	111.3	97.7	119.3	98.1	–
Budget balance (as a percentage to GDP)	–1.0	39.2	–4.8[3]	–	4.0[3]	–0.3[2]
Exports (as a percentage of GDP)	70	49	39[2]	58[4]	36	19[5]
Imports (as a percentage of GDP)	54	24	29	20[4]	16	53[2]
Current account balance (as a percentage to GDP)	2.0	26.1	16.6	–	7.8	–
Foreign exchange reserves (in billions of US dollars)	1.6	9.2	2.3	1.2	14.8	13.9
Nominal effective exchange rate index (1995 = 100)	123.9	–	123.8	128.8	128.2	132.1
Population (in millions)	0.7	2.0	2.5	0.6	21.0	2.7

Note: Flow data are for the year while stock data are for end-year.

[1] National source. [2] 1998. [3] 2000. [4] 1999. [5] 1992.

Source: IMF, *International Financial Statistics*, May 2003.

The exchange rate integration required all the GCC countries to officially peg their currencies to a common denominator, namely the US dollar, in order to maintain stability in the cross exchange rates. This has been achieved by the date set in the timetable. The choice of US dollar to serve as a common denominator was based on two main considerations. First, the US dollar is the intervention currency of all the GCC countries and their foreign reserves for currency cover and balance of payments purposes are largely held in dollars. Moreover, a stable relationship of their currencies with the US dollar is of crucial importance not only for fiscal management but also for the GCC traders in their business planning. Second, the GCC currencies were already effectively pegged to the US dollar for a long time (Table 2). Four out of six GCC currencies were formally pegged to the US dollar - the Omani riyal since 1970s, the Qatari riyal since mid 2001 and the Bahraini dinar and the UAE dirham since early 2002. The Qatari riyal, Bahraini dinar and UAE dirham were previously pegged formally to the special drawing right (SDR) but in effect they have maintained a fixed relationship with the US dollar since around 1980 (other than a slight change in 1997 in the case of the UAE dirham). The Saudi riyal, though pegged to the SDR, had been virtually fixed to the dollar since June 1986. The Kuwaiti dinar was linked to a special basket of currencies, but since the US dollar was assigned a very large weight in this basket, the exchange rate of the Kuwaiti dinar vis-à-vis the dollar has remained broadly stable over time.

Table 2

Official exchange rates of GCC currencies against the US dollar

(per US dollar at year-end)

	1992	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**
Bahrain	0.376	0.376	0.376	0.376	0.376	0.376	0.376	0.376	0.376	0.376	0.376
Kuwait	0.303	0.298	0.300	0.299	0.300	0.305	0.302	0.304	0.305	0.308	0.300
Oman	0.385	0.385	0.385	0.385	0.385	0.385	0.385	0.385	0.385	0.385	0.385
Qatar	3.640	3.640	3.640	3.640	3.640	3.640	3.640	3.640	3.640	3.640	3.640
Saudi Arabia	3.745	3.745	3.745	3.745	3.745	3.745	3.745	3.745	3.745	3.745	3.745
UAE	3.671	3.671	3.671	3.671	3.671	3.671	3.673	3.673	3.673	3.673	3.673

Source: IMF, *International Financial Statistics*, Year Book 2002 and May 2003.

The Council of Ministers of Saudi Arabia ordained in July 2002 that the relevant authorities should undertake necessary measures to implement the timetable set by the GCC heads of state for achieving the goal of monetary union and a unified currency for the region. Kuwait announced in October 2002 that the Kuwaiti dinar would be officially pegged to the US dollar from January 2003.

It may be asked what was the need for formally pegging all the GCC currencies to the US dollar when already these currencies were, in actual practice, maintaining a virtually fixed relationship with the dollar. But the formal pegging of all the GCC currencies was more than a formalisation of the existing arrangements. It has made the GCC countries a completely cohesive group in regard to their exchange rate arrangements. Moreover, in the previous arrangements there was always the possibility that one or more of these countries could unilaterally change their exchange rate peg. This could impair the intraregional trade and investment activities of risk-averse agents. Such an uncertainty has been largely removed by countries entering into an agreement to commit themselves formally to adhere to fixed exchange rates vis-à-vis the dollar.

Exchange rate integration has stabilised the GCC currencies vis-à-vis the US dollar, made them move in unison against other international currencies and generated a grid of bilateral parities between the GCC currencies which will promote intraregional exchange rate stability as well. This arrangement differs from the Exchange Rate Mechanism of the European Monetary System (EMS) that was in place before the adoption of the euro. The sole objective of the EMS was to achieve intra-European exchange rate stability through fixation of parities with the ECU which was a basket of currencies of the EU countries themselves. This arrangement linked the EMS currencies intraregionally but at the same time made them float jointly vis-à-vis the rest of the world. In contrast, the exchange rate integration among the GCC countries seeks to promote exchange rate stability not only intraregionally but also internationally by fixing parities with a non-regional denominator, namely the US dollar.

The transition from the integrated exchange rate system to a common currency by 2010 is expected to be smooth. As mentioned earlier, the GCC countries have already made considerable progress. As a matter of fact, the level of economic coordination achieved by them compares favourably with the state of affairs which existed in Europe at the time of establishing the EMS. They have already established their customs union. Their national economic objectives, growth rates, inflation rates, monetary and fiscal policies, interest rates and banking policies are in broad harmony. They are diversifying their economies to reduce dependence on oil, which has often been a factor in dislocating fiscal sustainability and straining their balance of payments. Encouragement of the private sector is the major plank of their development strategy. They have undertaken privatisation programmes to reduce the role of the government and enlarge the scope of the private sector. It is hoped that in coming years the GCC countries will make more concerted efforts to harmonise their policies and remove whatever structural and macroeconomic imbalances still remain.

The name of the new currency and its exchange rate arrangement has not as yet been decided. The new currency may be linked to the US dollar, the SDR or a special basket of currencies. A decision in this regard will be taken by the GCC authorities on the eve of the launching of the common currency, taking into account the regional and international economic conditions prevailing at that time. Since, in the interim period, all the GCC currencies will be officially linked to the US dollar, the probability is that the new currency would also be linked to the US dollar. This will greatly facilitate the transition. The authorities would simply have to set the initial exchange rate of the common currency to the dollar. This rate could be set at one to one or a multiple thereof. Once a decision in this regard has been taken, the bilateral rates at which national currencies would become convertible into the common currency will be irrevocably fixed. This conversion facility will be available for a limited period of time, say six months, during which the public will be able to get accustomed to the use of the new currency (for the introduction of the euro this facility was available for seven months).

The adoption of a common currency by the GCC countries will bring a number of economic benefits. It will eliminate the currency conversion costs involved in intraregional transactions and remove the disturbances in relative prices arising from nominal exchange rate fluctuations. The lowering of transaction costs and removal of exchange rate uncertainty will contribute to raising intraregional trade, to which GCC countries attach considerable importance. As mentioned earlier, they have already taken a number of measures to that end and a common currency will give an additional boost. Some empirical studies have shown that bilateral trade between two countries that use the same currency tends to be much larger than the bilateral trade between countries that use different currencies. It should, therefore, be reasonable to expect that the increase in the GCC's intraregional trade following the introduction of a common currency would be quite substantial.

In addition, since intraregional trade is mostly non-oil related (Table 3), its enlargement, in turn, will contribute significantly to the development of the non-oil sectors of the regional economies, to which they attach great importance for achieving their diversification objectives. The adoption of a common currency, with the resultant reduction in currency conversion costs and elimination of exchange risks, should promote intraregional investments. It will also be conducive to investment by foreigners in the region.

Moreover, the introduction of a common currency will serve as a catalyst for stronger integration and deepening of GCC financial markets. It will foster the integration of money markets across the region and lead to a uniform short-term interest rate structure. It will also contribute to the integration and development of the region's bond and equity markets and thereby facilitate savings and investments in the region.

The introduction of a common currency will also be associated with the pursuit of a common monetary policy, and more disciplined fiscal policies by the member countries. This will considerably enhance the credibility of the economic policies pursued in the region.

Set against the above benefits, the introduction of a common currency will involve a loss of independence in pursuing monetary and exchange rate policies by the GCC countries individually. However, this will not be of much significance as these countries have already been coordinating their monetary, financial and other policies and their exchange rates have remained almost unchanged for a prolonged period under a similar pegged exchange rate regime.

Table 3

Intraregional and total exports of GCC countries, 1996

In millions of US dollars

	All exports		Non-oil exports[1]	
	Value	**Percentage of total**	**Value**	**Percentage of total**
Bahrain				
Within the GCC	385	8.4	352	24.2
Total exports	4,610		1,453	
Kuwait				
Within the GCC	288	1.9	288	62.4
Total exports	15,367		462	
Oman				
Within the GCC	711	9.9	668	47.3
Total exports	7,221		1,413	
Qatar				
Within the GCC	363	9.0	363	58.9
Total exports	4,055		617	
Saudi Arabia				
Within the GCC	1,571	2.6	1,571	27.0
Total exports	60,108		5,846	
United Arab Emirates[2]				
Within the GCC	610	3.1	581	39.9
Total exports	19,673		1,457	
Total GCC				
Within the GCC	3,931	3.5	3,832	34.1
Total Exports	111,037		11,249	

[1] Refers to all trade and products exported except crude and refined oil products. [2] All export figures for the United Arab Emirates are for 1993.

Source: Table 2 in E Jadresic, "On a common currency for the GCC countries", *IMF Policy Discussion Paper*, no 02/12, December 2002.