Pegging to the Dollar and the Feasibility of the Proposed Currency Area in the GCC

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The aim of this short paper is to examine the trade-offs associated with the move to the planned currency area with special emphasis on the stability of the banking system in Gulf Cooperation Council (GCC) economies.

Introduction

Looking around the world, one sees many examples of movement toward multinational currencies: twelve countries in Europe have adopted a single currency and more are working toward doing the same; another form of currency maneuver, dollarization, is being implemented in Ecuador and El Salvador; and eleven members of the Southern African Development Community are debating whether to adopt the dollar or to create an independent monetary union possibly anchored to the South African rand. Six oil-producing countries (Saudi Arabia, United Arab Emirates, Bahrain, Oman, Qatar, and Kuwait) have declared their intention to form a currency union by 2010. During a summit meeting at the end of 2001, the heads of the GCC countries decided to establish by January 1, 2010, a monetary union with a single currency pegged to the U.S. dollar. Under the proposed strategy, member countries have decided to officially peg their currencies to the U.S. dollar by the end of 2002, and adopt economic performance criteria no later than 2005 for the policy convergence needed to carry the monetary union. Lately, some of these countries have announced individually that they were unprepared for such a move. In this paper, we assume that a new currency will be issued by a new shared central bank in 2010 or thereabout - at least for some of these countries - and that it will also be pegged to the US dollar –as announced in the 2001 agreement- as it is the case currently with most of the currencies of the GCC.[1]

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[1] In view of the long-term forecasted weakness of the US Dollar and the structural economic problems of the US economy including falling real wages, a common GCC currency should not be pegged to the dollar but to a basket of different currencies, because pegging to the Dollar alone would leave the Gulf economies too exposed. With a basket the region's central bank would adjust the weight of various currencies within it which would not cause much of a stir in the currency market. Dr. Ferdinand Lips has advised the GCC in Dubai to peg their currency to gold rather than the dollar or the euro since the gold, the king of money, was a safe and tangible investment option and has been increasing in value recently.

While pegging is a reality in several countries, it is on the agenda for others. Recent world history shows that pegging or a fixed exchange rate system in general, is not always stable or credible because it depends to some extent on the availability of reserves of the pegging government that shall be used to defend the peg. Arrangements short of full pegging, or fixing of the exchange rate to that of the currency of another country, include currency boards, with a rigid link between domestic currency and foreign reserves,[2] and managed floating of the currency. Using external economic ties of this sort are usually sought by countries when they are experiencing extenuating economic circumstances. For example, Ecuador embraced full dollarization in 2000, after the collapse of its financial system in 1998-1999 at the astounding flow-cost of more than 7 percent of GDP.[3]

When currency unions are founded they typically take one of two forms. First, the most common form, client countries (which are usually small) adopt the currency of a large secure country. Second, a group of countries creates a new currency and a new joint central bank. This second arrangement applies to the euro zone and is planned for the GCC countries. As a theoretical background, we use the framework developed by Alesina and Barro [2002], which discusses the trade-off between the costs and benefits of currency unions. We also note[4] that currency unions tend to increase the co-movement of prices but are not methodically tied to the co-movement of outputs.

Comparing GCC Countries

Economic and social indicators vary throughout the Gulf. (2001 est.)[5]

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[2] A currency board is typically defined by a legislative commitment to exchange domestic currency for the reserve currency at a fixed rate and by the requirement that (a major proportion of) monetary liabilities be backed by the reserve currency. It is an arrangement that falls half way between a fixed exchange rate and a currency union.

[3] The flow cost may be measured as the change in reserve money in a given year, expressed as percent of GDP. Bogetic (1999) calculates that cost alone to have exceeded 7 percent in Ecuador. Other costs of dollarization include losing a domestic central bank as the lender of last resort , losing flexibility in monetary and exchange rate policy, cost of linking business cycles, cost of converting prices from domestic currency to the foreign currency chosen , etc..

[4] Alberto Alesina, Robert J. Barro, and Silvana Tenreyro, Optimal Currency Areas, NBER Macroeconomics Annal 2002.

[5] Fasano, Ugo and Iqbal, Zubair, (2002) Common Currency, Finance and Development, December, vol. 39, No. 4.

Country	Nominal GDP (million dollars)	Nominal GDP (per capita dollars)	Pop-ulation (millions)[1]	Overall fiscal balance (% of GDP)[2]	Total government debt (% of GDP)	Proven oil reserves (years)[3]	Central bank foreign assets (mths of imports)[4]	Life expectancy at birth (years)[5]	Illiteracy (percent of population 15+)[5]
Bahrain	7,9330	11,1620	0.70	0.20	31.10	15.00	3.00	73	12
Kuwait	33,8070	14,6260	2.20	22.70	33.80	134.00	10.10	77	17
Oman	19,8960	8,0500	2.50	4.00	20.30	16.00	4.90	74	28
Qatar	16,5530	27,9170	0.60	0.10	55.60	15.00	2.70	75	19
S.Arabia	186,4890	8,8680	21.00	-3.90	92.10	87.00	11.00	73	24
U.A.E.	69,8710	20,0320	3.50	-3.90	4.00	124.00	4.90	75	25
GCC	334,5490	12,708[6]	30.50	-0.4[6]	60.7[6]	89.7[6]	8.8[6]	75	21

1.Includes expatriates.

2.Includes investment income of government foreign assets.

3.Based on current production.

4.These figures are not an accurate reflection of the country's foreign asset position because data on government reserves are partial in some GCC countries.

5.Latest available information.

6.Weighted average.

Sources: National authorities; IMF staff estimates; and World Bank, World Development Indicators, 2001.

Despite the GCC progress toward integration evidenced in 2003 with their establishment of a customs union, the six countries continued to exhibit differences in economic performance and policy preferences during the 1990s, particularly in the second half. Though inflation has traditionally been low in the area, it has picked up recently (some countries like UAE and Qatar displaying double-digit inflation) and it differs across countries, leading to diverging paths for the real effective exchange rates. Real GDP growth disparities have also been observed, particularly of non-oil GDP. Some GCC countries have recorded fiscal deficits, reflecting volatile global oil prices and relatively high levels of expenditure.[6] In the meantime, government debt has increased

[6] See Laabas and Limam (2002). Table 10 Tests of Equal Mean and Variance of GCC Macroeconomic Fundamentals and the ensuing analysis of the correlation of GDP growth rates between member countries.

significantly in a few GCC countries. The structure of the banking system differs across GCC countries, particularly regarding entry restrictions, liquidity requirements, loan classification and provisioning, as well as ownership. In this paper we study the benefits and costs of the currency area in general with a special emphasis on providing market discipline for the banking and financial systems. The benefits of a currency union are long-term while its costs tend to be immediate. In the long-run, the creation of a single currency may boost intra-regional trade and investment and may help eventually to decrease country differences plus achieve convergence with respect to economic policy. However, the realization of these long-term gains relies on features and characteristics of the individual countries in the GCC.

The planned monetary union of the GCC countries should reinforce the beneficial effects of capital and labor market reforms in addition to sound macroeconomic policies and help them address the two main challenges, namely, reducing vulnerability to oil price fluctuations as well as accelerating non-oil growth to generate employment opportunities for the rapidly growing domestic workforce.[7] The monetary union is also likely to promote policy coordination, reduce transaction costs, and increase price transparency, resulting in a more stable environment for business and facilitating investment decisions. However, although direct gains (such as increased intra-regional trade) from the union might be relatively small for these countries, indirect gains could be more important. In particular, the introduction of a common currency may enhance growth prospects by contributing to the unification and development of the region's bond and equity markets and by improving the efficiency of financial services. In contrast, the costs of a monetary union to individual countries—such as giving up the ability to set an independent monetary policy and adjust the nominal exchange rate—should not be high because GCC countries have not relied on these tools for quite some time under their pegged exchange rate regimes. Although most GCC currencies have been formally pegged to the IMF's Special Drawing Right (SDR), in practice they have maintained a stable long-term relationship with the U.S. dollar (except for the Kuwaiti dinar, which is pegged to a special weighted basket of currencies of the country's trade and financial partners). Nevertheless, the monetary union will need to be sustained by a range of structural reforms to be fully effective.

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[7] Ibid. Page 32. The opinion presented in this reference argues that countries are more likely to verify the optimality criteria of currency union ex-post rather than ex-ante and that expansion of trade and increasingly correlated business cycles should be the outcome rather than the prerequisites of currency unions.

Trade Benefits

Country borders matter for trade flows mainly because they tend to be associated with different currencies. The elimination of one source of border costs—the change of currencies— might have a large effect on trade. Alesina and Barro [2002] investigate the relationship between currency unions and trade flows. They find that, in general, countries that trade more with each other benefit more from unified currencies. Despite the signing of a free trade area agreement, inter-GCC trade remains weak. The share of intra-GCC commodity exports in the total exports of each country remains very limited.[8] The degree of intra-GCC trade integration (around 8% of the GCC exports in 1999) is still relatively weak in comparison with other economic blocs in the world. Also, the limited diversification of the GCC exports allows for a limited expansion of inter-industry trade. A single currency might reinforce intra-industry trade if the GCC countries achieve concerted efforts at increasing specialization and improving the technical style of their industrial sectors even in the oil by-products industries. Alesina, Barro and Tenreyro [2002] suggest that it is likely that the adoption of another country's currency increases bilateral trade and raises the co-movement of prices. These responses suggest that our examination of the trade patterns and co-movements that applied before the adoption of a common currency would underestimate the potential benefits from joining a currency union.

The Benefits And Costs Of Commitment

A fixed exchange rate system or a peg against a high inflation currency is costly to maintain in the long-run. Consequently, fixed exchange rates can create instability in the financial markets. To the extent that a currency union is more costly to break than a promise to maintain a fixed exchange rate, the currency union is more credible. Therefore, the countries that stand to gain the most from giving up their currencies are those that have a history of high and volatile inflation. This kind of recent history in the GCC is a symptom of a lack of internal discipline for monetary policy. Hence, to the extent that this lack of discipline tends to persist, these countries would benefit the most from the introduction of external discipline, given that the peg is to a basket of currencies not to a weak dollar, as currently observed. A currency union represents a commitment precisely because it is costly to reverse. Once the domestic currency has been replaced by the new unified currency, to go back to a domestic currency may be very costly. This would imply a legislative change that usually does not happen suddenly or unilaterally.

[8] Laabas and Limam (2002) found that the average for these shares during the period 1989-1999 were 21.3% for Bahrain, 1.6% for Kuwait, 17.1% for Oman, 6.3% for Qatar, 6.6% for Saudi Arabia and 4.6% for U.A.E. Further, these shares were stagnant which is worrisome.

The adoption of a common currency reduces the transaction costs of trade (see, for example, Rose [2000]). Additionally, if the country adopts a stable currency it consigns to a stable monetary policy. This may be particularly important in GCC countries at the current phase of their economic growth and development. However, pegging has the potential cost of abandoning monetary policy and the exchange rate as policy instruments. Since 2002, the GCC currencies were all pegged to the US dollar, therefore their monetary policy has not been independent for quite a while. A new currency which is pegged against the dollar will not cost the union additional forgone monetary policy instruments.

Similarly, a new currency could be costly to adopt. The transition to a new currency is not being considered in this paper but may prove significantly expensive. The new currency may bring the banking and financial systems down if put into practice in a crisis environment (like hyperinflation circumstances, or a falling price of oil). To properly analyze this issue, a dynamic model would be required.[9] The new currency is assumed to be issued by a new independent central bank. This approach involves relinquishing political sovereignty. Many questions revolve around this important requirement. The concerned Gulf countries should form an optimal currency area. Moreover, the issue of building an independent central bank is particularly challenging since most of the central banks of the countries involved have not had a reputation of setting independent monetary policy. To take an example, the European Monetary Union would not have formed if the Bundesbank had not been so hawkish in fighting inflation. In addition, judging by the recent European experience, the establishment of a joint central bank in the region from an institutional viewpoint is probably controversial.

Stabilization Policies

The abandonment of a separate currency implies the loss of an independent monetary policy. To the extent that monetary policy would have contributed to business-cycle stabilization, the loss of monetary independence implies costs in the form of wider cyclical fluctuations of output. The higher the association of shocks between the client and the remaining clients in the union, the lower are the costs of giving up monetary independence. The more the shocks are related, the more the policy selected by the new currency will be appropriate for the clients. Since the GCC are almost uniformly affected by terms of trade shocks (i.e., stemming from changes in the price of oil), the costs involved with monetary independence will be lower for the group. The costs implied by the loss of an independent currency depend also on the explicit or

[9] The author is working on a paper at the time of writing this one where this model is displayed to explain such a case.

implicit contract that can be arranged between the members of the currency union, which currently remains to be drafted.

In the discussion leading up to the formation of the European Monetary Union, concerns about the degree of association among business cycles across potential members were critical. In practice, the institutional arrangements within the European Union are much more complex than a seignorage compensation scheme. However, the point is, that the ECB does not target the shocks of any particular country, but rather the average European shocks.[10] Similar agreements should be worked between the GCC members to ensure the proper stabilization of shocks in the proposed currency union. The costs of abandoning a domestic monetary policy in GCC countries may not be that high because stabilization policies are typically not well used when exchange rates are fixed. To the extent that monetary policy is not properly used as a stabilization device, the loss of monetary independence is not a substantial cost (and may actually be a benefit) for developing countries. To summarize, the countries that have the largest co-movements of outputs and prices with potential anchors, are those with the lowest costs of abandoning monetary independence.

Trade, Geography and Co-Movements

Countries that trade more can benefit more from currency unions for the reasons already discussed. Increased trade may also raise the co-movements of outputs and prices. In this case, there is a second reason why countries that trade more would have a greater net benefit from adopting a currency union. Despite diversification efforts, the oil sector still contributes on average about one-third of GDP and accounts for three-fourths of annual government revenue and export receipts, making the GCC countries vulnerable to oil price fluctuations. In addition, growth of non-oil GDP has been slow in some of these countries, while strains in the employment market for nationals have emerged, with the GCC labor markets remaining segmented between nationals and expatriates. GCC countries are currently at various stages of implementing structural and institutional reforms, including lifting impediments to foreign direct investment, streamlining business regulations, expanding private investment opportunities in key sectors, and improving corporate governance.

10 The European Union also has specific prescriptions about the allocation of seignorage. The amounts are divided according to the share of GDP of the various member countries. For a discussion of the European Central Bank policy objectives and how this policy relates to individual country shocks, see Alesina et al. (2001).

An established literature on the gravity model of trade shows that bilateral trade volumes are well explained by a set of geographical and economic variables, such as the distance between the countries and the sizes and incomes of the countries. Note that the term "distance" has to be interpreted broadly to include not only literal geographical distance, but also whether the countries share a common language, legal system, and so on. In addition, some geographical variables may influence co-movements of outputs and prices beyond their effects through trade. For example, regional proximity and weather patterns may relate to the nature of underlying shocks, which in turn influence the co-movements.

Whether more trade always means more co-movements of outputs and prices, is not a settled issue. On the theoretical side, the answer depends largely on whether trade is inter-industry or intra-industry. In the latter case, more trade likely leads to more co-movements. However, in the former case, increased trade may stimulate sectoral specialization across countries. This heightened specialization likely lowers the co-movements of outputs and prices, because industry-specific shocks become country specific shocks.[11] The type of trade between two countries is also likely to be influenced by the levels of per capita GDP: For example, intra-industry trade tends to be much more important for rich countries. GCC economies seem to be driven by terms-of-trade and domestic shocks; this implies a potential increase in intra-industry trade provided co-ordination and specialization take place in different member countries.[12] Therefore a peg to a basket of currencies where the dollar and the euro take major parts is appropriate.

In summary, geographical or gravity variables affect bilateral trade and, as a result, the costs and benefits of currency unions. Some geographical variables may have an effect on the attractiveness of currency unions beyond those operating through the trade channel. This choice of pegged exchange rate regime must be maintained by a strong fiscal situation and a solid banking system. In addition, it must be accompanied by structural reforms and human capital development to boost the economies' elasticity, particularly the labor market for nationals, in order to enhance the chances of developing non-oil activities. Moreover, given the volatility in oil prices and, in turn, nominal GDP, GCC countries need to carefully review how these criteria should be measured. But, for operational reasons, they will eventually have to agree on a common indicator that reflects these criteria for fiscal convergence. A coordinated fiscal policy reaction to shocks might also

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11 See Frankel and Rose (1998) for the argument that more trade favors more correlated business cycles. See Krugman (1993) for the opposite argument. For an extensive theoretical and empirical discussion of these issues, see Ozcan, Sorensen, and Yosha (2001,2002) and Imbs (2000).

12 See Conclusions section in Eisa Aleisa and Hammoudeh, Shawkat. [2004]. A common currency peg in the GCC area: The Optimal Choice of Exchange Rate Regime. MEEA Vol. 9.

be needed to avoid jeopardizing the solidity of the union. To achieve the full assimilation and expansion of financial markets, a monetary union needs to be assisted by a number of regulatory and legislative adjustments The experience with European monetary union shows that the introduction of the euro, while nurturing more liquid bond and equity markets, has not eliminated all obstacles to financial market assimilation. This is because of differences in tax, accounting, and legal structures, and a lack of fully integrated clearing and settlement systems.

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