1. Introduction

Ronald MacDonald and Abdulrazak Al Faris

ABOUT THIS BOOK

The Gulf Cooperation Council (GCC) – the United Arab Emirates, the State of Bahrain, the Kingdom of Saudi Arabia, the Sultanate of Oman, the State of Qatar and the State of Kuwait – has as an objective the formation of a monetary union in 2010. This proposed monetary union raises clear issues in terms of the appropriateness of such a regime for these countries and whether, for example, the necessary institutional mechanisms are in place in the run up to the proposed union. Furthermore, in the run up to the monetary union most of the GCC countries have pegged their currencies rigidly to the US dollar, but the relatively dramatic movements in the US dollar in the recent past, and also in the early 1990s, have called this practice into question for a group of countries that predominantly rely on hydrocarbons as their primary export. This book brings together a selection of papers that focus on these important issues for the United Arab Emirates and other Gulf State countries. Specifically, the papers by Warren Coats, Zubair Iqbal, Mohsin Khan and Ronald MacDonald focus on exchange rate regime issues for either the UAE dirham or for the proposed GCC currency, while the primary focus of the papers by Abdulrazak Al Faris, Willem Buiter and Paul De Grauwe is on monetary union issues for the Gulf States.

Abdulrazak Al Faris provides in Chapter 2 a historical perspective of the main developments in the GCC integration process that led to the decision to adopt the single currency. The literature on the subject is reviewed, and the costs and benefits of a monetary union are critically evaluated before moving on to an analysis of the criteria required for a successful integration, followed by an investigation into the implications of such a union on the political and economic landscape of the region. Al Faris reviews the steps taken thus far in the process of achieving a currency union within the framework of wider regional integration. Moving on, the author then provides a critical analysis of the fundamental criteria necessary for successful integration, particularly their relevance, consistency and compatibility.
Currency union and exchange rate issues with the Gulf region. The author stresses that convergence criteria should reflect ‘the particular circumstances of the region, level of development and the degree of sophistication the members have in terms of fiscal and monetary management’. Moreover, since reliable and timely statistics on key macroeconomic indicators are absent from most of these countries, the emphasis should be put now on transparency, a mandatory deadline for the provision of data and an independent international and regional surveillance on the observance of standards and codes and convergence criteria.

Using both technical economic arguments and political economy considerations, Willem Buiter in Chapter 3 reviews the arguments for and against monetary union among the six members of the Gulf Cooperation Council. He concludes that although there is an economic case for GCC monetary union, that case is not overwhelming. This follows from the lack of economic integration (displayed in the lack of free movement of goods, services, capital and persons) among the GCC members, which Buiter finds striking. Given this lack of economic integration, the case for monetary union is mainly based on the small size of all GCC member countries, other than Saudi Arabia, and their high degree of openness. Buiter argues that even without the creation of a monetary union, there could be significant advantages to all GCC members, from both an economic and a security perspective, from greater economic integration, through the creation of a true common market for goods, services, capital and labor and from deeper political integration.

Furthermore, Buiter argues that the political arguments against a GCC monetary union appear overwhelming: the absence of effective supranational political institutions encompassing the six GCC members means that there could be no effective political accountability of the GCC central bank and the surrender of political sovereignty inherent in joining a monetary union would therefore not be perceived as legitimate by an increasingly politically sophisticated citizenry. He argues that monetary union among the GCC members will occur only as part of a broad and broadly-based movement towards far-reaching political integration and there is little evidence of that as yet.

Paul De Grauwe uses the historical experience of the European countries’ move to full monetary union (EMU) to draw lessons for the Gulf States and their planned monetary union. He argues that the overriding lesson from the European experience is that a monetary union is not created in a political and institutional desert and that monetary union was made possible in Europe because of at least 40 years of preparatory work in terms of institution building. For example, the creation of the European Central Bank was made possible by the pre-existence of numerous European institutions (the European Commission, the Council,
the European Parliament, the European Court of Justice) to which the member states of the EU gradually transferred part of their national sovereignty. Once the process of institutional building started, an endogenous dynamic took over, whereby limited first steps called for other steps towards further institutional cooperation.

Second, Paul De Grauwe’s discussion of the EMU convergence criteria leads him to conclude that these criteria can in fact be dispensed with and the candidate countries of the GCC currency union have nothing useful to learn from them. He argues that these convergence criteria are either useless and harmless, in terms of the interest rate convergence criterion, or useless and harmful, in terms of the fixed exchange rate requirement. He argues that the latter can be seen as a rite of passage in which countries show to the others that they are capable of sustaining pain and the inflation convergence requirement has the same quality of a rite of passage, whereby high-inflation countries show to the low-inflation countries how serious they are in keeping a low inflation rate. Finally, De Grauwe notes that the numerical precision, as given in the Maastricht Treaty, appears to be unhelpful in imposing budgetary discipline.

Exchange rate policy in the UAE, and other Gulf States, has been driven by the need to ensure external stability, market credibility and – in conjunction with fiscal and structural policies – to facilitate development of the non-oil sector in order to reduce excessive dependence on oil exports. For this purpose, the UAE and other Gulf State authorities have adopted an exchange rate regime that pegs their currency to the US dollar. As Zubair Iqbal, Mohsin Khan and Ronald MacDonald point out in their chapters, such regimes have a number of advantages, such as providing a credible nominal anchor for private expectations about the behavior of the exchange rate and the appropriate supporting monetary policy; it is a relatively straightforward system and avoids many of the complexities and institutional requirements for establishing an alternative anchor, such as an inflation target; pegged exchange rates would seem to be suitable for small open economies with a dominant trading partner that maintains a reasonably stable monetary policy, thus obviating the need for managing an independent and perhaps costly monetary policy. Finally, a fixed exchange rate is thought to better insulate a country against monetary shocks, regardless of the degree of capital mobility.

However, and as recent history shows, fixity can have a number of disadvantages. Crucially, failure to provide adjustment to changing economic conditions affecting the underlying equilibrium real exchange rate, including temporary real shocks (such as temporary oil price shocks), means adjustment has to be made by other means, particularly changes in the level of domestic prices and costs, which in turn lead to changes in
the level of economic activity – growth – and employment. In particular, adjustment to negative real shocks will have to be effected through a contractionary fiscal policy since a fixed rate implies monetary policy is assigned primarily to maintenance of the exchange rate, which could make it more difficult to simultaneously achieve internal and external objectives. Moreover, greater terms-of-trade volatility implies higher costs associated with a pegged exchange rate. Also, if the pegged regime is adopted when conditions are favorable, but without adequate policy commitment and institutional foundations to withstand the potential strains on the peg, it can entail a costly crisis when conditions turn unfavorable, particularly in an environment of capital mobility.

The most recent IMF Article IV statements for the Gulf States that have chosen to peg to the US dollar, make clear that pegging to the US dollar has served these countries well, allowing them to ‘import’ US monetary policy credibility and relatively low inflation, and until 2004/05 inflation remained relatively low and broadly aligned to that in the US. However, in the post-2004 period, up until the financial crises of 2008, the rapid increase in private sector demand, particularly in the non-tradable sector, increase in the cost of imports from non-dollar areas and the emerging supply constraints have intensified inflationary pressures in these countries and for many brought into question the suitability of the pegged exchange rate regime. The alternative regimes to pegging to the dollar are set out in some detail in the chapters by Zubair Iqbal, Mohsin Khan and Ronald MacDonald and range from a rigid peg against the US dollar, a managed float against the dollar, pegs with wider bands, currency basket pegs, crawling peg against a basket of currencies, pegging exchange rate to the price of oil to a freely floating regime.

Mohsin Khan in Chapter 5, considers the exchange rate regime issues facing the unified GCC currency and although he has a preference for pegging to the US dollar recognizes that the decision for a particular exchange rate regime depends ultimately on the policy objectives and common preferences of the authorities involved. He also notes that the choice of an exchange rate regime under the monetary union is not necessarily a permanent one. For example, the GCC countries could initially peg the single currency to the US dollar and then move to a more flexible regime, such as a dollar-euro peg, as circumstances dictate. This would allow for a smoother transition for the monetary union to a new exchange rate system. Khan also emphasizes that in a fast-changing environment, a forward-looking monitoring framework will be essential for the monetary union and that the exchange rate regime is only one element of the overall policy framework and, as such, should not be assessed in isolation. Hence, it must be compatible with the other elements of the framework, such as
monetary, fiscal and structural policies (that is, policies related to price formation in labor and product markets), and the broader institutional development of the GCC region.

In Chapter 6 Ronald MacDonald examines exchange rate regime issues for the UAE, although his discussion has wider applicability for other hydrocarbon-based economies and therefore his proposals would also apply for the proposed unified GCC currency. MacDonald argues that although pegging to the US dollar has served the UAE, and many of the other Gulf States well, recent events and especially the asymmetric nature of the US and UAE economies has to be recognized in the design of an appropriate exchange rate regime for the UAE (this asymmetry shows up in two ways: the UAE is predominantly a hydrocarbon exporter while the US is predominantly a hydrocarbon importer; the monetary policy needs of the two countries are often very different). MacDonald argues that this would involve moving away from the current regime of pegging to the US dollar to one in which the dirham is pegged to an appropriate basket of currencies, thereby providing the non-hydrocarbon sector with the stability and credibility it needs to flourish while at the same time allowing the price of oil to influence the external value of the currency. He envisages the latter being achieved by either including the price of oil directly into the basket of currencies or by adjusting the basket – along the lines of a crawling peg, as the price of oil changes.

As the title of Chapter 7 indicates, Warren Oates’ chapter nicely complements those concerning alternative exchange rate regimes in that it looks at the operational implications of moving to the alternative regimes. As he points out, one of the key aspects in moving from fixed to flexible exchange rates, for a country with no prior experience of flexibility, is the necessity of developing an interbank market in foreign exchange trade. Oates then examines the operational issues surrounding exchange rate targeting, monetary aggregate targeting and inflation targeting. For exchange rate targeting, the key operational aspects are: data analysis of factors effecting equilibrium balance of payments used to determine the exchange rate target; a clear explanation to the market of the factors guiding the choice of exchange rate targets and what would lead to a change in target; and contingency plans for how to deal with a speculative attack on the exchange rate. For monetary aggregate targeting the key elements are, inter alia: the determination of which monetary aggregate has the most predictable relationship with inflation; a target for the growth of this aggregate must be chosen, periodically reviewed and adjusted as necessary in light of the behavior of the real economy and the desired inflation; central bank instruments need to be developed for controlling the size of its balance sheet, in particular its monetary liabilities and the central bank
must estimate and forecast the relationship between its monetary liabilities (the monetary base) and its chosen monetary aggregate.

For inflation targeting the key aspects are, inter alia: the central bank and government must credibly commit to an inflation target, preferably in legislation; a suitable price index to target must be chosen, along with the horizon over which the target is to be achieved; and a forecasting team must be established to develop inflation forecasting models and to maintain and update them.

Zubair Iqbal in Chapter 8 recommends moving to much more exchange rate flexibility for the UAE dirham, but that the move to such flexibility should be ‘a gradual step-by-step approach’, which initially involves a shift to a currency basket peg to allow flexibility, widening of margins to permit a greater role of the market in the determination of the rate, followed by the introduction of nominal exchange rate targeting as a nominal anchor. Iqbal demonstrates using a simulation analysis for the past ten years or so that a relatively small currency basket would have been characterized by moderate exchange rate volatility while allowing an appropriate movement in the Dh/USD rate. Furthermore, during the initial phase of rate flexibility, steps could be taken to establish the needed institutional infrastructure for managing a more flexible exchange rate system. These include a deep and liquid foreign exchange market, central bank intervention policy, establishment of mechanisms to ensure effective management of exchange risk and strengthened regulation.