

The GCC Monetary Union: Choice of Exchange Rate Regime

Mohsin S. Khan

Abstract

The creation of a monetary union has been the primary objective of the Gulf Cooperation Council (GCC) members since the early 1980s. Significant progress has already been made in regional economic integration: The GCC countries have largely unrestricted intraregional mobility of goods, labor, and capital; regulation of the banking sector is being harmonized; and in 2008 the countries established a common market. Further, most of the convergence criteria established for entry into a monetary union have already been achieved. In establishing a monetary union, however, the GCC countries must decide on the exchange rate regime for the single currency. The countries' use of a US dollar peg as an external anchor for monetary policy has so far served them well, but rising inflation and differing economic cycles from the United States in recent years have raised the question of whether the dollar peg remains the best policy.

Mohsin Khan considers the costs and benefits of alternative exchange rate regimes for the GCC. These include continued use of a dollar peg, a peg to a basket of currencies such as the special drawing rights (SDR) or simply the dollar and euro, a peg to the export price of oil, and a managed floating exchange rate. In light of the structural characteristics of the GCC countries, Khan considers the dollar peg the best option following the establishment of a GCC monetary union. The peg has proved credible and is easy to administer. If further international integration in trade, services, and asset markets makes a higher degree of exchange rate flexibility desirable in the future, implementing a basket peg could provide this flexibility. Regardless, the choice of exchange rate regime for the GCC countries need not be permanent: The countries could initially peg the single GCC currency to the US dollar and then move to a more flexible regime as their policy needs and institutions develop.

Keywords: Exchange rate regimes, monetary unions, Gulf Cooperation Council

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INTRODUCTION

The creation of a monetary union has been an overriding objective of the regional economic integration process among Gulf Cooperation Council (GCC) members since the early 1980s.¹ Since then, the GCC member countries have come a long way on the road to economic integration. When established, the GCC monetary union would be the second most important supranational monetary union in the world in GDP terms, second only to the European Monetary Union (EMU).²

The experience of monetary unions elsewhere in the world can provide useful insights into the challenges that the planned GCC monetary union faces. Presently there are five monetary unions in the world. Three of these unions are in Africa, one in the Caribbean, and one in Europe. In all of them, a new common currency was created, except in the Southern African Common Monetary Area (CMA), in which the South African rand is the common currency in circulation. The GCC countries are probably the most homogeneous among the unions, sharing a common history, language, and culture.³ They are mainly oil exporters (with the exception of Bahrain), are very open to trade and imported labor, have very flexible labor markets in which even nominal wages can adjust, and have complete factor mobility within the group. Further, they all have full convertibility. One could argue that the GCC countries have already fulfilled many of the preconditions for a currency union. Overall the GCC meets the generally accepted criteria for a single currency among its members, namely proximity, size, fluctuations of output, trade structure, and inflation performance (Berengaut and Elborgh-Woytek 2006). Much progress has been made toward achieving the goal of a full-fledged GCC monetary union. GCC countries have achieved virtually unrestricted intraregional mobility of goods, national labor, and capital, and prudential regulations and supervision of the banking sector are being gradually harmonized. All members except Kuwait have pegged their currencies to the US dollar since 2003, and a common external tariff was introduced in 2003. Although the GCC currencies have been de facto pegged to the US dollar for decades,⁴ a single GCC currency is expected to encourage trade and financial integration, facilitate foreign direct investment, and foster the development of the GCC into an “optimum currency area” ex post even if, as has been argued by some, the GCC grouping may not constitute one ex ante (Rose 2000; Frankel and Rose 1998 and 2000; Buiters 2008).

A common external tariff was introduced in 2003, and on January 1, 2008, the GCC launched the

1. The GCC includes Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates (UAE). A useful description of the GCC is contained in a recent study by the European Central Bank; see Sturm et al. (2008).

2. In 2008 total GDP of the GCC was over \$1 trillion, and the average per capita income was about \$25,000.

3. Edmund O’Sullivan (2008) has a very interesting and detailed account of the history of the Gulf states.

4. During 1980–2002 Bahrain, Qatar, Saudi Arabia, and the UAE were de facto pegged to the US dollar, but de jure pegged with horizontal bands to the special drawing rights (SDR). Oman was pegged to the US dollar and Kuwait to an undisclosed basket.

common market. The common market provides GCC citizens equal treatment in all economic activities, especially freedom of movement and residence; work in private and government jobs; pension and social security; engagement in all professions and crafts as well as all economic, investment, and service activities; real estate ownership; capital movements; tax treatment; stock ownership and formation of corporations; and education, health, and social services. The common market is expected to result in increased production efficiencies and an improved negotiating position in international economic fora. Full implementation of the common market will require the adoption of national laws and regulations, a process that is underway at the GCC Secretariat based in Riyadh, Saudi Arabia. So far, the GCC Secretariat has developed dispute resolution mechanisms, including a common market committee, a ministerial level committee, and an arbitration center in Bahrain, and plans are underway to create a supranational court.

The European Central Bank (ECB) has provided the GCC with a draft Monetary Union Agreement (MUA) and statutes on the Gulf Monetary Council (GMC) and the Gulf Central Bank (GCB). It is expected that a monetary council will be established by the end of 2009 to serve as a transition body in preparation for the single currency and the GCC Central Bank. A set of five convergence criteria (on inflation, interest rates, reserves, fiscal balance, and public debt), similar to those used in the run-up to the European Monetary Union, has been agreed in principle (table 1). Although they are not preconditions for entry, by the end of 2006 the GCC countries had met almost all of the convergence criteria and exhibited a high degree of convergence on many macroeconomic indicators. With inflation across the GCC (except in Bahrain) rising to similar rates, inflation convergence (which has been lagging) is being achieved, although at a level that is obviously too high from the standpoint of macroeconomic stability.

But there have also been some unanticipated setbacks to achieving the monetary union. In October 2006 Oman announced that it would not join the union by 2010, and in May 2007 Kuwait declared that it was moving from the dollar peg to an undisclosed currency basket, although it reaffirmed its commitment to join the union. There have also been delays in establishing harmonized systems and in institution building. In terms of preparedness for the common currency and the creation of a common, independent central bank, the monetary policy frameworks, payment and settlement systems, regulatory and supervisory structures, macroeconomic statistics, and other specific central bank functions have yet to be fully harmonized. The management of reserves and nonreserve assets has also not yet been agreed. In addition, on the fiscal side, setting up a common accounting framework and adequate budgetary procedures are a high priority in the period leading up to the introduction of a common currency. As a result, the 2010 deadline for the single GCC currency appears increasingly unachievable, a fact that is now acknowledged by several of the countries as well as by the GCC Secretariat.

Looking ahead, one very important decision in the formation of a monetary union is the choice of

Table 1 GCC countries: Compliance with the convergence criteria, end-2006

Country	Budget deficit lower than 3 percent of GDP, or 5 percent when oil prices are weak	Public debt to GDP ratio lower than 60 percent	Foreign exchange reserves in excess of four months' imports	Interest rates not higher than two percentage points above the average of the lowest three countries' rates	Inflation not higher than 2 percent above the average rate of the six states^a
Bahrain	✓	✓	—	✓	✓
Kuwait	✓	✓	✓	✓	✓
Oman	✓	✓	✓	✓	✓
Qatar	✓	✓	✓	✓	—
Saudi Arabia	✓	✓	✓	✓	✓
UAE	✓	✓	✓	✓	—

✓ = criterion has been met

— = criterion has not been met

a. A weighted average based on US dollar nominal GDP of the six states.

Source: Country authorities and author.

an appropriate exchange rate regime. The countries' choice of a US dollar peg as the external anchor for monetary policy has obviously been credible and has served them well so far. In fact, one can argue that the generally low inflation rate in the GCC until recently has been due to the pegging of their currencies to the US dollar. At the same time, rising inflationary pressures in the last couple of years, increasing integration with global markets, and differing economic cycles and policy needs from that of the anchor country, the United States, have raised questions about whether the peg to the dollar remains appropriate.

The choice of the exchange rate regime has to be seen in the context of the structural characteristics of the GCC economies, in particular the importance of the oil sector in GDP, exports, and government revenue, as well as the emerging economic challenges for these countries in the near future. The primary challenge for them is to further develop the non-oil private sector in order to create employment opportunities for the rapidly growing national labor force.

The objective of this paper is to outline the main alternative exchange rate regimes for the unified GCC currency and to discuss their advantages and disadvantages. To start with, this paper will discuss general considerations in determining exchange rate regimes. It will then consider GCC-specific issues.

GENERAL CONSIDERATIONS IN DETERMINING THE EXCHANGE RATE REGIME

The most common criterion suggested by the theoretical literature for determining the optimal exchange rate regime is macroeconomic and financial stability in the face of real or nominal shocks. The conventional view on the choice of exchange rate regime has been that exchange rate flexibility

allows for macroeconomic and financial stability in the face of real domestic or external shocks (such as terms-of-trade fluctuations) or foreign nominal shocks (such as an increase in trading partner inflation). Fixed exchange rates are more effective in achieving macroeconomic and financial stability in reaction to domestic nominal shocks (such as shifts in money demand). Ideally, the exchange rate regime chosen should yield external stability, internal stability (low inflation), balance sheet stability, international competitiveness, credibility of monetary policy, and low transaction costs (Husain 2006).

External stability is defined as a balance of payments position that is not likely to give rise to disruptive adjustments in exchange rates. A balance of payments position consistent with external stability is one in which both the underlying current account is broadly in line with its equilibrium and the capital and financial account does not create risks of abrupt shifts in capital flows.⁵ Balance sheet stability deals with the impact of exchange rate volatility on the net open position of the financial and public sectors. International competitiveness of the non-oil tradable goods sector is related to how well the real exchange rate supports external trade, and changes (actual and expected) in the nominal exchange rate can be an important indicator of the credibility of the domestic monetary policy stance. Similarly, exchange rate volatility can raise transaction costs in international trade and finance by increasing uncertainty and information needs. In applying these criteria, trade offs are usually necessary and political-economy considerations in the choice of regime may become relevant.

The main argument for an exchange rate regime other than the dollar peg for the GCC countries is that these countries could better pursue an internal goal of low inflation if they had monetary policy independence. The merit of this argument, however, depends on the effectiveness of the channels of the monetary transmission mechanism. For example, the independence argument has less force in GCC countries where, like other developing countries, the lack of sensitivity to changes in policy interest rates weakens the interest rate transmission mechanism channel and thus the efficiency of an independent monetary policy. Also, the impact of the exchange rate channel on inflation is more limited in an environment where the scope for expenditure switching between traded and nontraded goods is very limited and where administrative price controls exist, as in many of the GCC countries.

Exchange rate arrangements other than the dollar peg could be considered in light of emerging changes in trade and investment patterns. However, the insulating properties of exchange rate regimes are strongly affected by the structural characteristics of the GCC economies, such as the dominating influence of the oil sector in GDP, exports, and government revenue. These countries jointly account for over 40 percent of global oil reserves and 25 percent of natural gas reserves. Currently, oil and gas production contributes about half of GDP and three quarters of exports and government revenues. Given different levels of hydrocarbon endowments, countries such as Bahrain and Oman are accelerating the development of their non-oil sectors. Although the diversification process involves a mix of hydrocarbon-based

5. This concept is comprehensively discussed in IMF (2007).

industries, such as petrochemicals and energy-intensive aluminum smelting, the GCC countries are also developing their services sectors, including financial services, tourism, and education. However, in all GCC countries except Oman and Bahrain, hydrocarbons will continue to play a major role for a very long time.

As countries diversify in the future, it has been argued that greater exchange rate flexibility may be warranted. Countries with expanded manufacturing and service sectors will also have to be internationally competitive in the non-oil tradables sector, highlighting the importance of price flexibility in their factor and product markets. In that regard, efforts to nationalize the GCC countries' labor force, by increasing the number of nationals in the non-oil private sector and raising the costs of employing expatriate workers, could reduce the flexibility of the GCC countries' labor markets in the future and constrain their ability to adjust to terms-of-trade shocks.

External financial assets, which have primarily been in US dollars, may also become progressively more diversified as a consequence of globalization, growth prospects in emerging economies, and the rise of the euro as a reserve currency.⁶ With increased capital mobility, trade openness, and foreign direct investment, the attractiveness of maintaining the peg to the US dollar could decrease, especially if increased openness leads to greater volatility. In that regard, a more flexible exchange rate regime would have the advantage that it could provide another tool for adjusting to shocks and managing oil price-related volatility.

GCC member countries officially pegged their national currencies to the US dollar on January 1, 2003, as an explicit step toward monetary integration. Although at that time the countries (except Kuwait) were already pegged to the US dollar, the decision was based on the expectation that the dollar peg would maintain stability and strengthen confidence in the economies, and therefore the countries would go into the monetary union at those parities. As such, GCC countries have pursued economic policies consistent with exchange rate pegs. For instance, they have implemented appropriate fiscal policies and have flexible labor and product markets.⁷ GCC members have also accumulated significant foreign exchange reserves, underpinning the credibility of the peg and discouraging speculation against their currencies.

GCC governments have stated that they remain open to the choice of the exchange rate arrangement under the planned GCC currency union. Ultimately, the choice of a specific exchange rate regime will depend on the preferences of the GCC member countries, and will presumably be based on both economic and political considerations. The next section examines the main costs and benefits of the following exchange rate regimes: a US dollar peg, managed floating, pegging to a basket of currencies, and pegging to the export price of oil.

6. This could lessen the risk of balance sheet effects from exchange rate changes.

7. Under the peg regime, fiscal policy is the main instrument used to promote domestic and external stability.

ALTERNATIVE EXCHANGE RATE REGIMES FOR THE GCC MONETARY UNION

US Dollar Peg

A strong case can be made for the monetary union to continue pegging to the dollar. Macroeconomic conditions in the GCC countries have been stable for the last two decades even during periods of dollar fluctuations, and over the long run cyclical synchronicity between the GCC and the United States has been increasing despite some recent divergence (box 1). The peg to the US dollar has helped the region avoid nominal shocks from geopolitical risks feeding into the economy. These risks are likely to continue, placing a premium on a credible US dollar peg. Furthermore, from a historical perspective, the recent fluctuations in the US dollar are not fundamentally different from previous fluctuations.

The dollar peg provides a credible and easily understood anchor for monetary policy (Abed, Nuri, Erbas, and Guerami 2003). The dollar peg has clearly anchored inflationary expectations at low levels and provided certainty about future exchange rates. For example, the recent uptick in inflation notwithstanding, forward markets continue to reflect confidence in the dollar peg. The peg is easy to administer and does not require the institutions necessary for implementing an independent monetary policy. Such institutions would need to be built, become effective, and establish credibility. Since the monetary transmission mechanism is weak, given the absence of domestic capital markets, the shallow size of credit markets, and the limited role of interest rates, a peg rather than a float is a realistic option for the first few years of a GCC monetary union.

The exchange rate peg simplifies trade and financial transactions, accounting and business planning, as well as monetary coordination among the member countries. Exchange rate risk can be easily hedged, even in the absence of a well-developed domestic private market in forward exchange, as it is possible to work through US dollar markets. With cross-rates constant, intra-GCC transactions benefit,⁸ as traders and investors do not have to take on any exchange rate risk, thereby encouraging further integration of the members. Absent developed financial markets, and particularly forward markets in which to hedge, the central banks would probably have to take on the task of providing forward cover.

Labor market flexibility can support international competitiveness under a fixed exchange rate regime. At present GCC countries face a relatively elastic supply of labor (mostly unskilled) coming from low-income countries in the Middle East and South Asia. GCC countries have also been applying their policy of nationalization of the labor force in a very flexible manner so as to avoid labor shortages and minimize output disruptions.

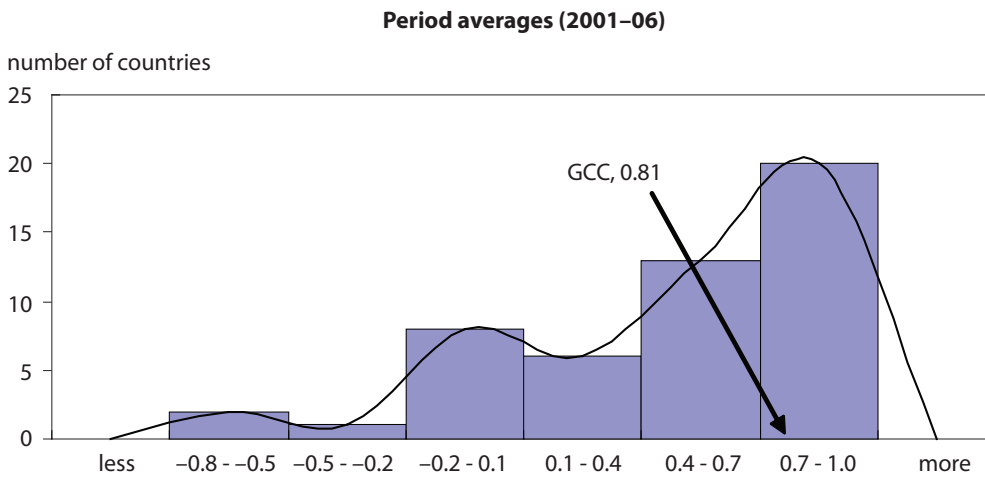
Pegged exchange rate regimes are preferred by major oil exporters. Of the 26 countries whose oil exports account for over 50 percent of total exports, 18 have conventional fixed pegs, including the GCC

8. Intra-GCC trade would benefit from any regime that fixes cross-rates, including a common basket peg or a narrow currency trading band.

Box 1 The synchronization of business cycles and output volatility

The cyclical synchronicity between GCC and US business cycles has been positive and has strengthened over time, notwithstanding recent divergence (box 1 figure 1). Cyclical synchronicity could play an important role in assessing the appropriateness of the exchange rate peg (Husain 2006). Strong, positively correlated business-cycle dynamics of output and consumption minimize the costs associated with a loss of flexibility arising from the inability to use monetary policy to smooth business cycles under a pegged regime.

Box 1 Figure 1 Correlation between US and selected countries' GDP growth



Source: Author's calculations.

The data through 2006 show that the peg has not been costly to the GCC countries. One way to assess the degree of cyclical synchronicity is to measure the correlation between GCC GDP growth and US GDP growth. For the period of 1980–2006, correlation between the growth rates in the GCC and the United States was 0.16; during 2001–06, the correlation was 0.81, one of the highest among a group of 50 countries that included developed and emerging-market economies as well as mature stabilizers.

Two key factors could explain this strengthening of cyclical synchronicity. Globalization has increased significantly the synchronization of many countries' business cycles with those of the US economy, due to its dominant size. While the correlation between US GDP growth and GDP growth for the 20 highest-ranked countries averaged 51 percent during 1980–99, it increased to 87 percent during 2001–06. The second factor is limited global spare oil production capacity, which has meant procyclicality of GCC oil production and international oil prices with global growth. Both trends are likely to continue in the medium term, given current tight oil supply conditions and because an important part of future additions to production capacity will come from the GCC region.¹

Finally, output volatility has been low in recent years. While pegged regimes limit the use of monetary

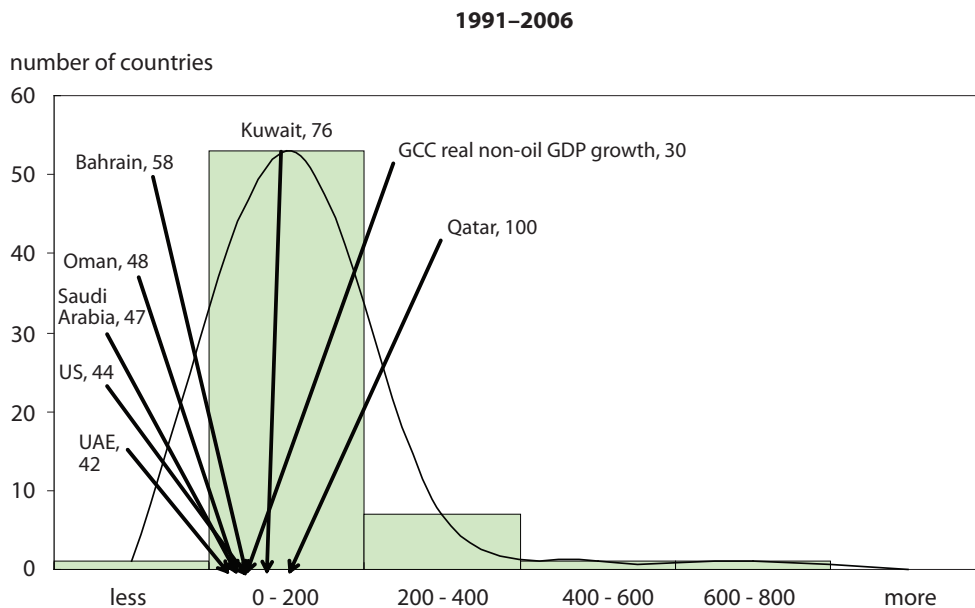
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1. The common stance of monetary policy under the dollar peg may also have strengthened, in part, cyclical synchronicity between the GCC and the United States.

Box 1 The synchronization of business cycles and output volatility (continued)

policy to smooth the business cycle, this did not translate into higher output volatility in the case of the GCC. In general, output volatility, measured by the coefficient of variation of real non-oil GDP growth, was low in the GCC region. With the exception of Kuwait and Qatar,² output volatility in the GCC was comparable to that in the United States during 1991–2006 (box 1 figure 2). In addition to cyclical synchronicity, the authorities' policy of saving oil revenues during positive terms-of-trade shocks and using these savings to smooth domestic demand during negative terms-of-trade shocks helped stabilize domestic demand and hence real non-oil GDP growth. The stabilizing role of fiscal policy reflects the direct impact of government consumption on domestic demand, its indirect impact through creating business opportunities for the private sector to service public-sector consumption and investment demand, and its effect on private-sector income and consumption through salaries, transfers, and subsidies.

Box 1 Figure 2 Coefficient of variation for US GDP growth and GCC real non-oil GDP growth, percent



Source: Author's calculations.

2. The relatively high volatility in Kuwait was due to the Iraqi invasion in 1990 and the war in 1991 and their impact on the oil industry and investors' and consumers' confidence. The recent large projects to develop the liquefied natural gas (LNG) industry and infrastructure have contributed to the relatively high volatility in Qatar.

countries and members of the Central African Economic and Monetary Community (CEMAC).⁹ Other countries with a peg include Brunei (a currency board) and Ecuador (a dollarized economy). Algeria, Kazakhstan, and Russia have managed floats, but the volatility of their exchange rates has been contained within a tight band. This points to the commonality of features among the large, oil-exporting economies. In particular, with foreign exchange receipts provided predominantly by the dominant export commodity and subject to significant price volatility, it is relatively more difficult to operate a free foreign exchange market, particularly if the institutions needed to support it are not well developed.

The familiarity of GCC authorities and private economic agents with the US dollar peg as well as the similar preferences the GCC countries have shown for a fixed exchange rate both speak in favor of maintaining the current arrangement after the implementation of the planned monetary union. In fact, in 2003 GCC member countries opted to fix their bilateral parities and to peg their currencies to the dollar in the run-up to the GCC monetary union in 2010 to benefit from greater certainty about the parities at which they would enter the monetary union. Keeping the single GCC currency peg to the dollar would leave the public and policymakers on already familiar ground.

The dollar peg does have a number of disadvantages. First, it imports monetary policy from the United States, which at times may not be appropriate for local needs (Setser 2007).¹⁰ With an open capital account, the dollar peg requires the GCC countries to follow US interest rate policy, which has the potential to result in policies unsuited to the needs of the GCC countries' business cycles. When the divergences between the business cycles are likely to be temporary, policy tools other than interest rates or exchange rates would have to be used to influence domestic activity. In particular, fiscal policy and, to a lesser extent, quantitative credit restrictions and tighter prudential regulations would need to be used to curb aggregate demand and credit expansion. The peg also means that GCC countries cannot defend against imported inflation, although in the long run, higher inflation in trading partners would tend to be offset by depreciation of their currencies against the US dollar. Further, the peg forces any adjustment of the real exchange rate to a new equilibrium to take place through inflation rather than through adjustment in the nominal exchange rate. Adjustment through inflation is slower than that through the exchange rate and may trigger price-wage spirals, generate low real interest rates, and increase the risk of asset bubbles as investors switch into real estate and equity assets. It also reduces the real value of financial savings.

9. In contrast, Mexico and Norway, where oil exports are less than 50 percent of total exports and the non-oil sectors are more diversified, have relatively free-floating currencies.

10. This can also happen with a basket peg, if, in the case of an SDR peg, the dollar, euro, and yen zones are all easing while the GCC needs tightening.

Managed Floating

Letting the single GCC currency float against other currencies would have the advantage of allowing the GCC countries to use monetary policy to smooth business cycles. A more flexible exchange rate regime would also allow the countries to absorb large adverse real shocks more easily than a fixed exchange rate regime. As the GCC economies, their exports, and their international asset portfolios become more diversified, the flexibility of the labor market may decrease because of increased participation by nationals, the exposure to shocks (including to capital movements) may increase, and greater flexibility of the exchange rate would become more desirable. It could also be argued that if current trends continue, the GCC would be sufficiently large economically to have its own currency unattached to another major currency.

In light of the current structural characteristics of the GCC economies, however, it is questionable whether active monetary and exchange rate policies would achieve domestic and external stability. This is because the interest rate channel of the monetary transmission mechanism may be ineffective in an environment where economic agents' decisions are highly insensitive to changes in the interest rate. Corporate-sector investment and spending decisions (investment and consumption) depend to a large extent on actual and projected government spending, limiting the role of the interest rate. Thus fiscal policy has to bear the burden of smoothing the effect of shocks on domestic activity.¹¹ In addition, the exchange rate channel is weak because of the insensitivity of exports to changes in the exchange rate.

A further issue relates to the choice of the nominal anchor under a float. The two main alternatives would be inflation targeting and monetary targeting. Inflation targeting must be based on a good understanding of the inflationary process and its determinants, in addition to institutional and technical requirements, such as sophisticated market-based monetary operations, central bank independence, and transparency of policy to build accountability and credibility. The new GCC central bank would be untested, and it would likely take some time to develop these institutional requirements. Monetary targeting would require a stable and predictable money demand function and the development of instruments and adequate forecasting ability to undertake efficient liquidity management. Given the structural changes that are ongoing in these economies, the stability of the money demand function is uncertain. To have an alternative anchor to the exchange rate, GCC countries would need to improve the measurement of inflation, develop inflation forecasting capacity and instruments to manage liquidity, and enhance communication strategies.

11. Countries like Kuwait, the UAE, and to some extent Oman were able to use countercyclical and expansionary fiscal policy to overcome the prolonged weakness in oil prices since the mid-1980s through the 1990s by utilizing a part of their sovereign wealth fund (SWF) resources. However, Saudi Arabia had to rely on increasing domestic debt and drawing down its international reserves to finance its countercyclical fiscal stance during that period.

There are also risks of high exchange rate volatility associated with a floating regime. Given the open capital account, the dominance of oil as the main export commodity, the inherent difficulty of distinguishing between temporary and permanent terms-of-trade shocks, and thin foreign exchange markets that are dominated by a relatively small number of agents, large swings in oil prices could lead to volatile exchange rates (Cashin and McDermott 2001), which could lead to larger fluctuations in non-oil output and higher and more volatile inflation. In this case, the central bank would need to intervene heavily in order to stabilize the exchange rate in line with fundamentals. More generally, there is evidence that greater nominal exchange rate volatility is associated with greater real exchange rate volatility (Taylor 2002), potentially affecting non-oil sectors adversely. To illustrate, suppose that in the case of Saudi Arabia the price of oil in Riyals is kept constant (the same result as under an oil peg) by dollar/Riyal fluctuations that offset any dollar oil price changes. Even with perfectly stabilized fiscal revenues in Riyals (allowing perfect expenditure planning), changes in oil prices would induce massive swings in the dollar/Riyal rate that may be beyond the capacity of the financial system to handle. At the same time, the large relative price volatility would make investment planning in the non-oil sector extremely difficult.

Letting the exchange rate of the GCC currency float would also introduce a new and different type of uncertainty and risk into international transactions, as well as complicate budgetary accounting and business planning. At the same time, underdeveloped and incomplete financial markets would make hedging against exchange rate risk costly and sometimes impossible. Much will depend on the extent of the development of financial instruments and markets by the time of the establishment of the monetary union. In fact, experience suggests that in switching exchange rate regimes, the timing of exits and the extent of institutional development are critical.

Basket Peg

Adopting a basket peg may be a useful way to introduce some flexibility in the exchange rate. With a basket peg, the main anchor properties of an exchange rate peg could be retained, while at the same time gaining some adaptability to the adverse effects of swings among the values of the major reserve currencies. For example, with oil priced in US dollars, under a dollar peg volatility in the price of oil results in volatility in oil export receipts. Under an SDR peg the volatility of oil export receipts would be much less than under the dollar peg. The volatility of the nominal effective exchange rate would be reduced, benefiting external trade, investment, and balance sheet stability. In the short run, a basket peg can help contain imported inflation by sheltering the exchange rate against cross-rate movements such as the recent dollar slide.

Basket pegs may, however, reduce the microeconomic and informational benefits of maintaining one constant bilateral exchange rate relevant for price comparisons and economic transactions. They also tend to be less transparent, more difficult to explain to the public, and less credible than single

pegs, especially when the currency weights are not known.¹² A failure to disclose the relative weights and composition of the currencies used in the basket could complicate the assessment of exchange rate risk and lead to unanticipated behavior. In Kuwait speculation after the move to an undisclosed basket resulted in strong demand for the dinar, large capital inflows, and an increase in liquidity.

Pegging to a basket of currencies, however, rules out active monetary policy, much as in the case of a single currency peg. Under capital convertibility, interest rates would likewise have to follow a “basket” of interest rates. This would reduce the likelihood of a recurrence of extreme desynchronization between the monetary policy needs of the GCC countries and the policy of the anchor currency.¹³ However, the central bank would have to actively manage foreign exchange operations and foreign exchange risk. Relatively low levels of financial intermediation and breadth of financial instruments would limit the scope and effectiveness of these operations (Roger, Restrepo, and Garcia 2008). And pegging to a basket of currencies would not fully address the management of oil price volatility or the rise in liquidity from high oil prices. A basket that included the price of oil (see below) would also mirror the relatively higher volatility of oil prices.

One option could be a transparent basket consisting only of the US dollar and the euro.¹⁴ It would be simple to interpret, would reduce monetary dependence of the GCC on the US Federal Reserve, account for the bulk of transactions in goods, services, and financial instruments (now in the US dollar and the euro area), and allow for the use of dollar or euro hedging instruments to efficiently manage financial risks given the considerable depth in euro financial instruments. The timing of a move to a basket peg would, however, need careful deliberation. Furthermore, exchange rate stability would likely be highest if repegging to a basket occurred when the currencies in the basket were broadly in equilibrium, which is difficult to determine.

Pegging to the Export Price of Oil

Pegging the domestic currency to the export price of the main export product (PEP) has sometimes been suggested for small open economies that are relatively specialized in the production and export of a particular mineral or agricultural commodity.¹⁵ The argument for PEP is that it simultaneously delivers automatic accommodation to terms-of-trade shocks, as floating exchange rates are supposed to do, while

12. This effect is minimized in the case of a peg to a basket where the composition and weights are known, such as the SDR.

13. However, the potential difference between the interest rate of an anchor currency and that of a basket of currencies will depend on the relative movements of the interest rates of these currencies over time. In the case of Saudi Arabia, for example, a peg to the SDR would have raised current domestic interest rates by only 1 percentage point in 2008.

14. For a discussion of pegging to a dollar-euro basket, see Khan (2009).

15. A variant of this approach is pegging to a basket of commodities and currencies.

retaining the credibility-enhancing advantages of a nominal anchor, as dollar pegs are supposed to do (Frankel and Saiki 2002). A peg to the price of oil would allow the real exchange rate to move in line with the real price of the main export commodity. Essentially, it would decouple oil exporters' monetary policies from those of oil importers.

But there are several important qualifications and drawbacks attached to this type of exchange rate policy. First, the GCC countries taken together account for a sizeable part of total world output and exports. Therefore, the small economy assumption is not applicable in the case of the GCC, as the price of oil cannot be regarded as exogenous. Indeed oil can be seen as a major international currency in itself, and pegging their national (fiat) currencies to their own (commodity) currency would not anchor the GCC countries' currencies to something truly exogenous.

Second, it is questionable whether an automatic adjustment to terms-of-trade shocks would be effective under a PEP system. For example, an adverse terms-of-trade shock (a decline in oil prices) would, under PEP, result in a real depreciation. However, with oil production in most GCC countries constrained by capacity and extraction limits, as well as by the OPEC quota system, all adjustment would have to come through expanding non-oil exports or cutting imports. However, in the GCC, non-oil exports depend on hydrocarbon production for inputs, and are therefore not independent from the level of oil and gas production.

Third, pegging to the price of oil would introduce greater volatility in the exchange rate. This could lead to lower government revenues and expenditures and higher government debt.

Fourth, pegging to the price of oil would create significant volatility for other sectors of the economy. For example, a consequence of high oil prices would be a real appreciation, which would raise the cost of other exports and dampen the diversification effort. In the event of a decline in oil prices, it is unclear whether the oil peg would permit sufficient depreciation of the national currency to accommodate the adverse change in the terms of trade and stabilize export earnings. Further, it can be argued that a gradual adjustment in the real exchange rate may be preferable until the terms-of-trade shift appears permanent. In any event, with daily fixing of the exchange rate, PEP requires transparency and credibility that may take time to establish.

CONCLUSIONS

To sum up, the dollar peg seems to be the best option in the short run after the establishment of the monetary union and the single currency. The longstanding de facto peg of the GCC currencies to the US dollar has contributed to a strong track record of macroeconomic stability. The dollar peg has provided a credible nominal anchor for monetary policy and is easy to administer. It has simplified trade and financial transactions, accounting, and business planning and has provided clarity about the parities at

which the GCC member countries will enter the GCC monetary union. High labor market flexibility in the private sector has also helped international competitiveness and quick adjustment to shocks. The jump in inflation in 2007–08 is viewed as temporary and is expected to come down as large infrastructure projects are completed and the absorptive capacity of the GCC economies expands.

If individual exchange rate parities, however, were considered out of line with fundamentals at the time of the GCC monetary union's establishment, which would be signaled by continued high domestic inflation, the GCC could retain the dollar peg but effect a one-off coordinated adjustment of the current parities at the establishment of the common currency. A revaluation could allow a temporary dampening of imported inflation and help bring real exchange rates closer to equilibrium. However, a revaluation would impose significant and immediate valuation losses on the large official foreign assets of the GCC countries¹⁶ and would reduce international competitiveness for those countries that have embarked on economic diversification. If large, a revaluation could generate sharply lower fiscal revenues in domestic currency and entail a significant adverse impact on the balance sheets of both the government and private sectors, including banks. There is also a risk that as soon as the signal is given that the exchange rate is a policy instrument available to tackle inflation, this could increase market expectations of further revaluations and encourage speculation, even if fundamentals are unchanged.¹⁷ In fact, this was observed when Kuwait moved to a basket peg and again in late 2007 when investors reacted to statements of GCC officials by transferring substantial deposits into the region, betting on an imminent currency revaluation.

Further, it would be important to estimate the needed adjustment accurately. Debate continues on how to determine the equilibrium real exchange rate and hence the appropriate level of the nominal exchange rate for oil exporters. This is an extremely difficult exercise that yields a wide range of results (box 2). Ideally, the exchange rate should be set at a level that would be consistent with sustaining the current account at some desired equilibrium level (or "norm"). But the equilibrium real exchange rate will depend on both the level and volatility of oil prices over the medium term. In fact, any change in current or future oil prices will alter the equilibrium exchange rate and the current account norm. While evidence suggests some undervaluation for the GCC countries, the available estimates are typically prone to large errors, and quantification of the degree of undervaluation is difficult.

On the other hand, with increasing integration in international trade, services, and asset markets, the GCC countries could be more prone to external shocks, and a higher degree of exchange rate flexibility may become more desirable to ensure external stability and international competitiveness. In particular, as oil reserves are depleted in some member countries and the non-oil tradable sectors

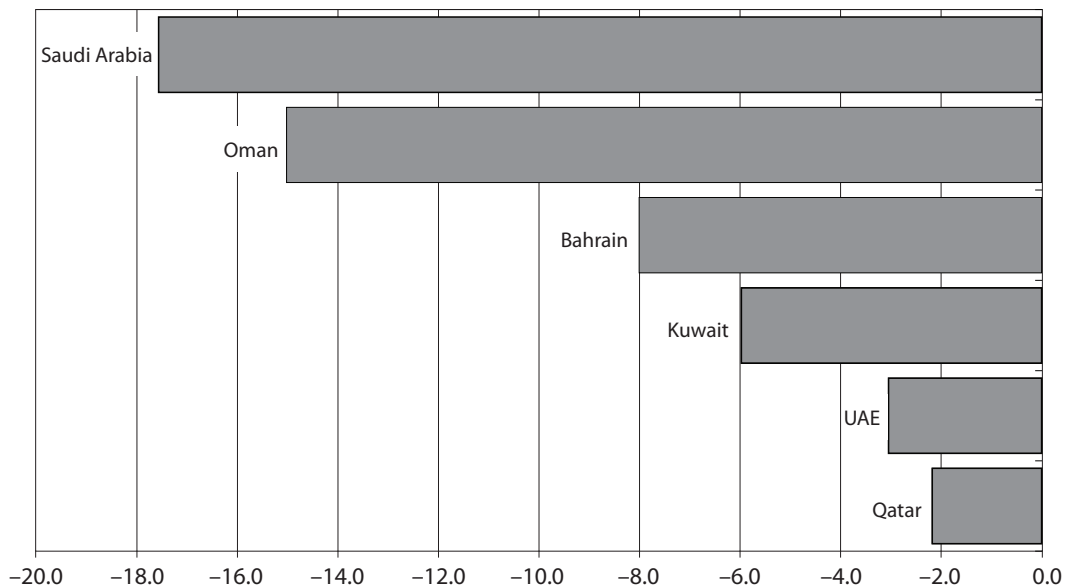
16. Domestic inflation imposes the same losses but more gradually, allowing economic agents time to adjust.

17. Instead of a large revaluation, the authorities could consider incremental revaluations (a crawling peg). While similar to a revaluation, the announcement of the crawling peg would leave the currency more exposed to speculation ("one-way bets") and to large and frequent interventions by the central bank.

Box 2 Exchange rate assessment in GCC countries

GCC countries' real effective exchange rates (REERs) appear undervalued. While there is no generally accepted methodology to assess the level of the exchange rate for oil producers, the positive terms-of-trade shock experienced during 2003–07 likely resulted in an appreciation of the equilibrium REER. Utilizing a set of variables suggested by the Consultative Group on Exchange Rate Issues (CGER), preliminary panel-based estimates show that the average deviation of the actual REER from the estimated equilibrium REER ranged from 2 percent in Qatar to nearly 18 percent in Saudi Arabia (box 2 figure 1). The recent increase in inflation in GCC countries, primarily due to domestic demand pressures, supply constraints, and imported inflation, should lead to a narrowing of the differential between the REER and the equilibrium REER.

Box 2 Figure 1 Real exchange rate assessments, 2000–07, average misalignment percent



Source: Author's calculations.

The macrobalance approach for assessing equilibrium exchange rates likewise suggests that the current accounts of the GCC countries are presently above their medium-term current account norms (box 2 table 1). This suggests some undervaluation of the exchange rate. However, the current account surpluses are expected to narrow over the medium term, reflecting government spending and higher imports associated with investment projects. There is strong evidence that current account balances in the GCC are determined mostly by fiscal policy and only to a limited extent by the exchange rate.

A third approach for assessing the level of exchange rates, the external sustainability approach, can be adapted to reflect the intergenerational equity concerns of depletable resource-based economies. It involves using fiscal rules for converting oil wealth into financial assets, calculating the net present value of the stock of

box continues on next page

Box 2 Exchange rate assessment in GCC countries (continued)

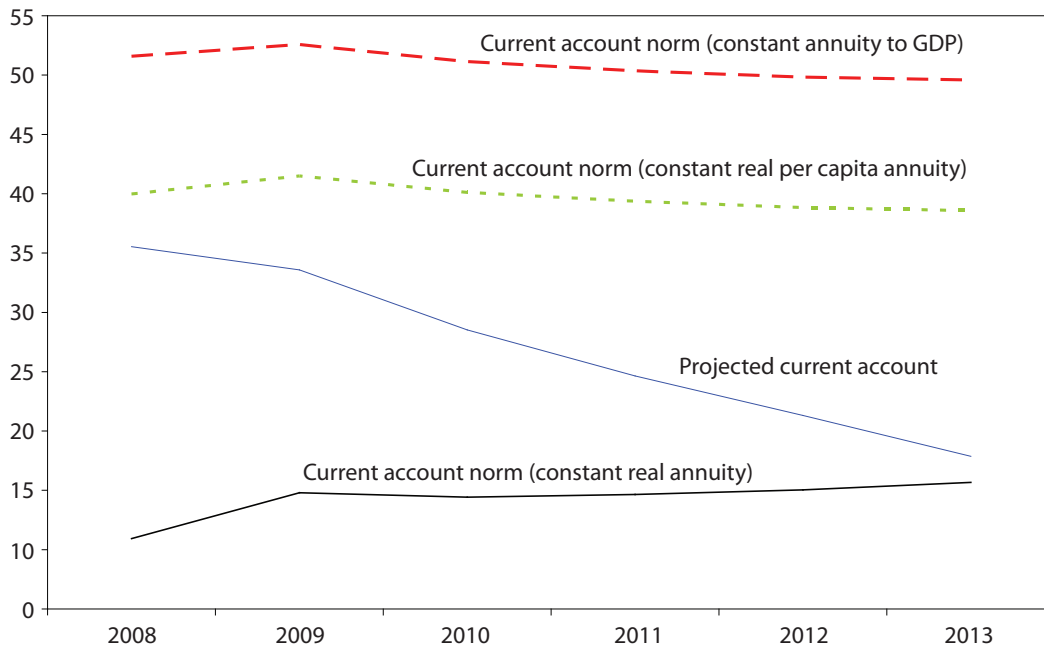
oil wealth, and making assumptions on rates of oil extraction, future oil prices, and the discount rate. To ensure fiscal sustainability, the primary non-oil fiscal deficit should be equal to an “optimal” annuity. This annuity could be a constant share of GDP, constant in real per capita terms, or constant in real terms. These estimated annuities are illustrated for Saudi Arabia assuming 264 billion barrels of reserves, a 78 percent recovery rate, depletion by 2085, a real GDP growth rate of 3.5 percent, and a discount rate of 8 percent for future oil revenue (box 2 figure 2). Each of these annuity definitions yields significantly different current account norms and therefore different degrees of misalignment. In fact, in two cases it would appear the Saudi Riyal is overvalued.

Box 2 Table 1 Current account norms, percent of GDP

Country	Current account		
	Observed	Medium-Term	Norm
	2006	2012	
Bahrain	13.3	5.6	6.5
Kuwait	50	33.5	41
Oman	12.2	2.6	4
Qatar	30.5	26.8	30.5
Saudi Arabia	20.3	8.1	20.3
UAE	22	15	21.1

Source: Author’s calculations.

Box 2 Figure 2 Saudi Arabia: Current account norms vs. projected estimates, 2008–13, percent of GDP



expand, the non-oil private sector will need to remain competitive to function as the main source of new employment opportunities for the rapidly growing national labor forces. And policies aimed at higher participation rates by nationals in GCC labor markets could erode over time the partial offset provided to the peg regime by flexible labor markets.

Implementing a basket peg would be one way to introduce some flexibility in the exchange rate. While capable of dampening volatility from swings among the values of major currencies and avoiding a monetary policy tied exclusively to one country, a basket peg would not eliminate the effects of imported inflation nor would it allow the countries to operate an independent monetary policy. On the other hand, pegging to the export price of oil could deliver automatic accommodation to terms-of-trade shocks but would be likely to transmit significant volatility to the non-oil sectors.

The nature, extent, and timing of any departure from the current regime would need to reflect projected medium- and long-term developments in the GCC economies. For instance, a common monetary and exchange rate policy would require the setting of appropriate initial parities and creating compensating and incentive mechanisms (e.g., a fiscal transfer system) to reflect evolving differences among the economies in both natural resource endowments and financial wealth. Further, the execution of exchange rate flexibility would require efficient decision-making processes and market-based monetary operations. Because these institutional factors take time to be fully established, exchange rate flexibility is feasible only as a longer-term option.

The decision for a particular exchange rate regime depends ultimately on the policy objectives and common preferences of the authorities involved. It is important to note also that the choice of an exchange rate regime under the monetary union is not necessarily a permanent one. For example, the GCC 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. In a fast-changing environment, a forward-looking monitoring framework will be essential for the monetary union. It should be emphasized, however, 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 (i.e., policies related to price formation in labor and product markets), and the broader institutional development of the GCC region.

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