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An economic analysis of potential GCC economic and monetary union for sustainable development — Drawing from the European experience

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ABSTRACT

Purpose: Gulf Cooperation Council (GCC) has been set up in 1980s for strengthening cooperation and economic development of the region. However, the progress has been slow and the oil price plunge recently has led to concerns regarding sustainable development primarily due to the region's dependence on oil and lack of diversification. The paper analyses the scope for Economic and Monetary Union (EMU) of the GCC in the current backdrop of oil crisis and examines potential implication of a union for sustainable development of the GCC through price transparency, free trade, movement of labour and resources.

Design/Methodology/Approach: The paper draws its theoretical and practical approach from the experience of the Economic Union of Europe (using convergence criteria and growth and stability pact) in 1999. The paper analyses time series data of macro-economic variables (e.g. GDP, budget deficits, debt and others) for GCC during 2005–2014 from United Nations Conference on Trade and Development (UNCTAD), World Bank and International Monetary Fund (IMF) databases.

Findings: The paper concludes that GCC economies are very similar in terms of their structural and economic fundamentals. The paper shows convergence of the countries in terms of macroeconomic variables and concludes that EMU will contribute towards sustainable development of the region.

Originality/Value: The study is useful to policy makers, central banks, industry and researchers as it relates sustainable development in GCC to the EMU following the experience of the EMU.

Keywords: Economic and Monetary Union; EMU; sustainable development; Gulf Cooperation Council; GCC; European Union; convergence criteria; GDP; debt; budget deficits.

INTRODUCTION

Over the past decade (2005–2014), Gulf Cooperation Council (GCC) member states (Bahrain, Kuwait, Qatar, Oman, United Arab Emirates (UAE) and Saudi Arabia) have been the focus of considerable attention since they were viewed as direct beneficiaries of high oil prices. During this time, oil prices climbed steadily (except for a brief period during 2008 recession), leading to prosperous government coffers and large fiscal surpluses, but have subsequently also fallen sharply. Since 2001, GCC economies have formed a Common Market and forged a Customs Union. They had also laid down plans of introducing a single, common currency but that has been harder to implement due to political hurdles.

This paper constructs convergence factors, based on those used by countries joining the European Union in the 1990s, to explore underlying areas of convergence among GCC member states and examines the sustainability of a potential GCC Economic and Monetary Union (EMU) (Note: 1).

Section 2 of the paper summarises the features of the potential GCC EMU; Section 3 provides the literature review; Section 4 summarises Maastricht criteria of the Eurozone EMU; Section 5 presents empirical analysis of data exploring GCC EMU; Section 6 provides the conclusions.

THE GCC AS AN EMU – PAST, PRESENT AND THE FUTURE

The GCC was formed in 1981 for the purpose of improving cooperation and accelerating economic development in the region. The stated objectives of the group included formulating uniform regulations in areas such as religion, finance, trade, customs, tourism, legislation and administration; fostering scientific and technical progress in industry, mining, agriculture, water and animal resources; establishing scientific research centers; setting up joint ventures; building a unified military (Peninsula Shield Force); encouraging cooperation in the private sector; strengthening ties between their peoples and finally, establishing a common currency (GCC Secretariat General, 2012).

The GCC Common Market was launched on 1 January 2008 with the objective of forming an integrated common market for seamless movement of labour, capital, goods and services. The process of creating a Customs Union started in 2003 and operations finally commenced on 1 January 2015. Features of the Customs Union include a free trade bloc with a common external tariff, extended labour market and free capital movement. Additionally, every GCC citizen will also be eligible for government and private sector employment plus insurance and retirement benefits. This also includes real estate ownership, access to education, health and other social services. Unfortunately, transition to the next stage of creating an EMU has been delayed due to certain global and regional phenomena.

The original 2001 GCC plan also included transitioning to a common currency in 2010 which would be pegged to the USD ('Khaleeji'). The roadmap to realise this strategic vision was initiated in 2002 when all GCC countries officially pegged their currencies to the USD. Until then, most of the regional currencies were pegged to the SDR (Note: 2). Subsequently, political differences between the GCC states and the 2008 financial crisis led to uncertainties around accession of GCC countries to the potential EMU.

There have been other smaller 'victories' for GCC – a GCC Supreme Council, GCC Ministerial Council and a GCC Secretariat Council have been set up. A GCC patent office has been created in Saudi Arabia. The 'Peninsular Shield Force' (United military force of the GCC), although largely ineffective during the 1990 Iraqi invasion of Kuwait, played a significant role during the 2011 social disruptions in Bahrain.

GCC VITAL ECONOMIC STATISTICS

The combined GDP of the GCC stands at approximately USD 1.1 trillion (at 2005 prices). The largest share of $540 billion is attributable to Saudi Arabia, followed by UAE at $246 billion and Qatar at $138 billion. The total population of GCC members comprise of about 50 million including 52% natives and 48% expatriates. 2013 per capita GDP was estimated to be $33,500 with foreign exchange reserves at $1 trillion. 2015 growth had been projected at a modest 3% for the region. Debt-to-GDP levels are within manageable limits for most of the GCC states (at less than 50% of GDP as compared to G7 countries (IMF, Regional Economic Outlook, Middle East & Central Asia, October 2015).

IMPORTANCE OF OIL TO GCC

Oil plays a vital role in the functioning of GCC members. It is the largest source of revenue and is routinely used as a benchmark for preparing annual budgets. A constant and flourishing revenue stream provided by oil exports has benefited GCC nationals and residents in the form of subsidies in key areas – fuel, water, electricity and staple food products. Oil is also the other reason why this region has enjoyed low taxation levels (both corporate and personal) although that may soon be reversed due to the prolonged price slump in international oil markets. A protracted period of low oil prices, combined with the lack of clarity of a price rebound anytime soon, has compelled GCC members to review their fiscal strategies.

GCC states hold approximately 30% of the world reserves of oil (approximately 1.7 trillion barrels) and their daily contribution to worldwide oil production is 22%. Oil continues to be a significant source of government revenue – approximately 81% for Saudi Arabia, 71% for Kuwait and 25% for Qatar (2015 estimate, IMF Article IV releases).

Kuwait and Qatar are also the most resilient as far as oil prices are concerned. They have a fiscal break-even price of $56/barrel followed by UAE at $78/barrel and Saudi Arabia at $106/barrel. Bahrain and Oman are fiscally most exposed to oil price shocks having a break-even oil price for balancing their budget at $123/barrel and $108/barrel, respectively (Figure 1) (2014 estimate, IMF Regional Economic Outlook, Middle East & Central Asia, October 2015).

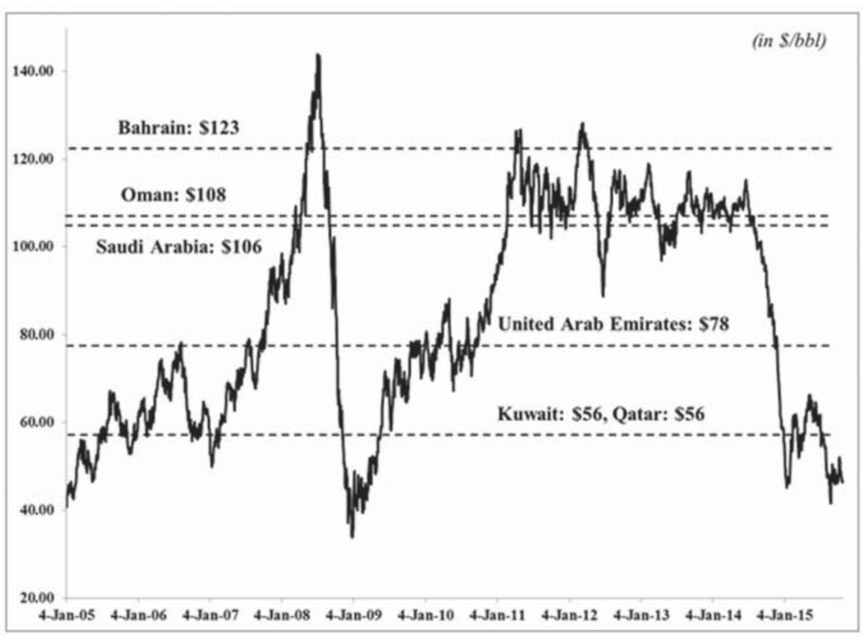

Figure 1 Historical Oil Prices versus Fiscal Break-even Levels

Source(s): US. Energy Information Administration, IMF Regional Economic Outlook October 2015.

GCC member states have maneuvered fiscal policy tools to combat medium-term impact of lower oil prices. These include the gradual withdrawal of subsidies, introduction of taxes and greater fiscal discipline by lowering government expenditure. However, medium to long term strategies to ensure sustainability will include diversification of GCC economies so that there is less dependence on hydrocarbon-related revenues. These economies are also heavily reliant on the government or public sector with a comparable lack of private sector participation in GDP. With limited domestic production and hence intra-regional trade, the economies look structurally very similar with same religion, language, cultures and customs.

This paper answers the question that apart from long-term diversification strategies, can the GCC economies create a sustainable EMU and reap benefits of resource mobilisation, uniform rules, regulations, trade and investment related opportunities?

MONETARY AND FISCAL POLICIES IN THE GCC

GCC countries pegged their currencies to the USD in 2002 after announcing their intention to move to a single currency ('Khaleeji') by 2010. Subsequently, Kuwait pegged itself to a basket of currencies with USD weighing the highest in the basket. GCC members have limited leeway to independently change interest rates or money supply and influence domestic monetary policy due to their pegged exchange rate regimes. External trade exposure necessitates the USD peg for easing effects of fluctuations and volatility of oil prices on the external account.

The GCC states also have limited fiscal policy tools available due to low or insignificant taxation levels. The annual government budget is based on forecasted oil prices and hence faces severe maneuverability constraints when oil prices are down.

LITERATURE REVIEW

Fasano (2003) examines the steps such as the structural changes needed for fiscal convergence, institutional requirements and common policies needed for successful monetary union of the GCC economies.

Willett (2010) have argued that from the standpoint of traditional Optimum Currency Area (OCA) and have concluded that though the GCC countries have successfully maintained their peg to the anchor currencies, yet they do not exhibit the characteristics of the OCA countries to move to an EMU due to the large public sector, significant foreign labour force, small intra-regional trade and limited wage – price flexibility.

Khan (2009) examines Maastricht convergence criteria for GCC countries and concludes that the GCC countries should first move to a single currency pegged to the USD and then to a floating currency regime in the long run with more developed institutions.

Kamar and Naceur (2007) use econometric analysis to conclude that though commonality are observed in government consumption, monetary and fiscal policies among GCC states, yet there is need for further integration of macroeconomic activity across the GCC for the single currency to be introduced.

Buiter (2008) is of the opinion that there is no overwhelming case for monetary union and even if there was, it would be in the long run with political integration between the GCC states.

AlKholifey and Alreshan (2010) study the feasibility of the monetary union in the GCC and estimate the costs and benefits of the potential union.

Laabas and Limam (2002) use both quantitative and qualitative analysis to conclude that GCC economies do not fulfil OCA criteria like the Eurozone for creating EMU. However, political will, greater coordination and building of supranational institutions with integrated approach will be able to create the right background for the introduction of the single currency by keeping regional interests on priority over national interests.

EMU AND MAASTRICHT CONVERGENCE CRITERIA

Prior to the creation of the European Union, a treaty was signed in Maastricht in 1992 that proposed five convergence criteria (Note 3) to be met by countries planning to adopt the Euro. Those conditions included limits on inflation, national budget deficit, public debt, long-term interest rate and exchange rate volatility (through participation in ERM II) (Note 4). The Maastricht guidelines were translated to measurable factors namely Harmonised Index of Consumer Prices (HICP) Inflation, Government Budget Deficit, Government Debt-to-GDP ratio, Exchange Rate Stability and long term interest rate. Growth and Stability Pact identified the Government Budget Deficit to be less than or equal to 3% of GDP and Government debt-to-GDP ratio to be less than or equal to 60%. Table 1a shows the Eurozone EMU convergence criteria.

This paper examines the degree of convergence achieved amongst GCC members based on proposed convergence criteria customised to the GCC and determines whether sustainable economic integration is feasible. Table 1b shows proposed GCC convergence criteria.

Table 1a The Five Convergence Criteria of EMU

Key Metric	*Measured Using*	*Convergence Criteria*
Price Stability	Consumer price inflation rate	<=1.5% above rate of the three best performing Member States
Sound Public Finances	Government deficit as % of GDP	<=3%
Sustainable Public Finances	Government debt as % of GDP	<=60%
Durability of Convergence	Long-term interest rate	<=2% above the rate of three best performing Member States in terms of price stability
Exchange Rate Stability	Deviation from a central rate	Participation in ERM II for at least two years without severe tensions

Table 1b GCC convergence criteria

Key Metric	*Measured Using*	*Convergence Criteria*
Sustainable Growth	Real GDP growth rates	<=1.5% above the rate of the three best performing Member States
Price Stability	Consumer Price Inflation (CPI) Rate	<=1.5% above the rate of the three best performing Member States
Sound Public Finances	Government deficit as % of GDP	<=3%
Sustainable Public Finances	Government debt as % of GDP	<=60%
Exchange Rate Stability	Deviation from the pegged rates of individual currencies to the USD	Participation in the pegged exchange rate regime for at least two years without severe tensions

EMPIRICAL ANALYSIS OF THE DATA

For the purposes of this analysis, I consider time-series data for ten years (2005—2014) for the six GCC states and assess whether they satisfy the convergence criteria in Table 1b. The data is publicly available and has been sourced from the International Monetary Fund (IMF), The World Bank and United Nations Conference on Trade and Development (UNCTAD) databases.

Table 1b lists five separate components which are proposed as GCC convergence criteria for accession of member states to potential EMU. These are namely, real GDP growth rate, budget deficit-to-GDP ratio, debt-to-GDP ratio, inflation rate and exchange rate. The interest rate has not been used as a convergence criterion as each of the GCC states lack independent monetary policy.

ANALYSIS OF GCC EMU CONVERGENCE CRITERIA

Figure 2 confirms that real GDP growth is influenced by oil prices for GCC countries. Rising oil prices over the past decade have resulted in strong GDP growth and heavy government spending on infrastructure and services (the latter mainly through subsidies) (Figure 3). As expected, a decline in oil price is reflected in muted GDP growth for GCC economies. Figure 2 shows a strong pattern of convergence between countries at lower oil prices during 2011—2014, irrespective of their oil reserves, break-even prices of oil and degree of dependence on oil.

The GCC is prone to imported inflation due to high dependence on the rest of the world. The main driver of imported inflation is food which is also highly inelastic in nature with respect to prices and income (Salisu and Bousrih, 2013). Figure 4 shows the Comparative Inflation (CPI) rate against the oil price trend during the period 2005—2014. There is a positive relationship between the rise in oil prices and inflation rates. Before the sudden plunge in September 2008, oil prices had enjoyed steady growth since 2003. Inflation in the oil-driven economies were led by heavy government spending which in-turn fueled demand in the economy and led to demand-pull inflation (Figure 3). Added to this were the supply constraints related to labour and other resources which increased costs, leading to cost-push inflation. Credit creation, particularly in the real estate sector, and money supply growth have all fueled inflation during 2005—2007 (Salisu and Bousrih, 2013). The 2008 financial crisis and subsequent oil price plunge led to lower global food prices and helped reduce inflation. As oil prices started to show signs of

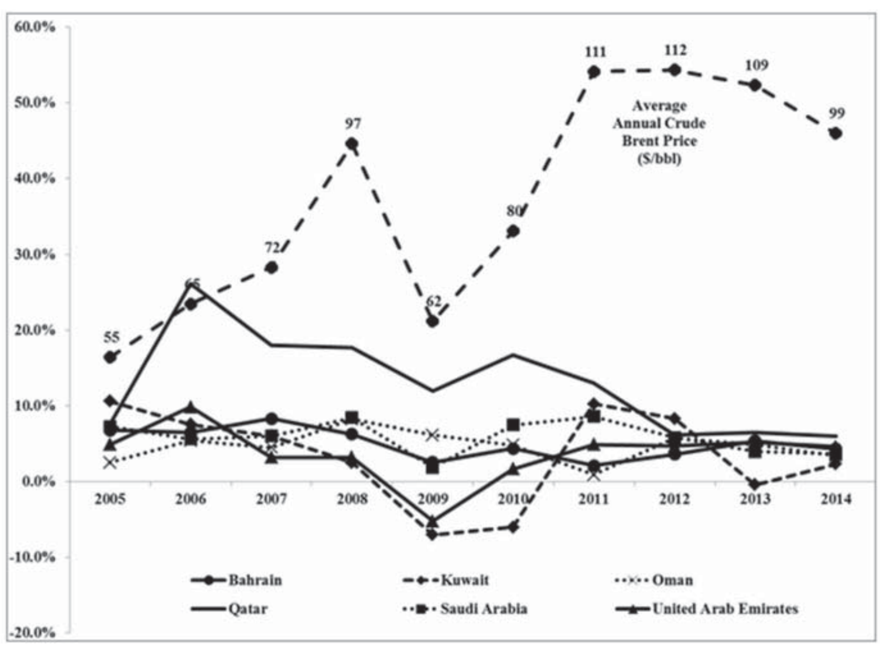

Figure 2 Comparative GDP Growth versus Oil Price ($/bbl)

Source(s): IMF Regional Economic Outlook: Middle East and Central Asia (October 2015), UNCTADstat, US. Energy Information Administration.

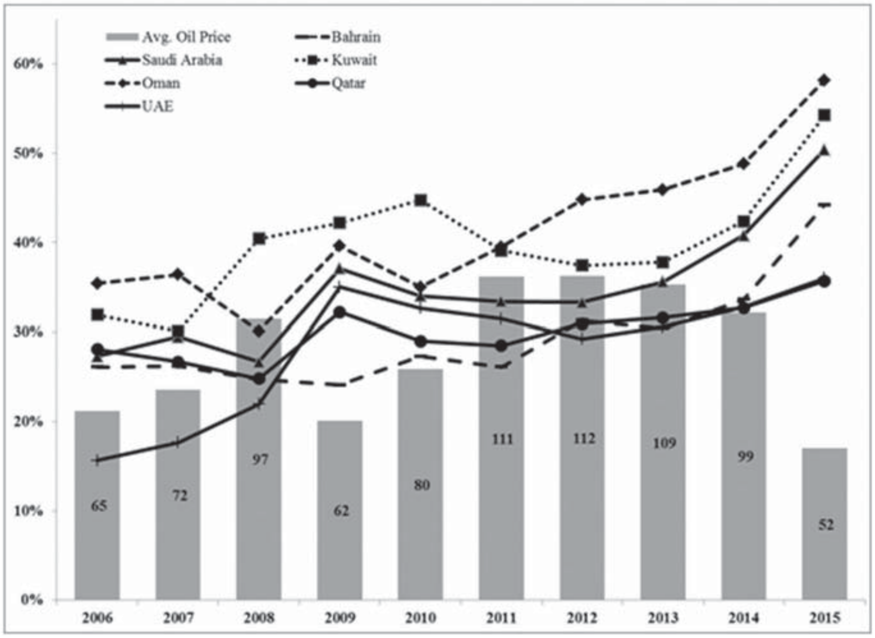

Figure 3 Government Expenditure (as %age of GDP) versus Average annual oil price

Note: 2015 expenditure numbers are IMF estimates.
Source(s): IMF Article IV releases, IMF Fiscal Monitor October 2015, US. Energy Information Administration.

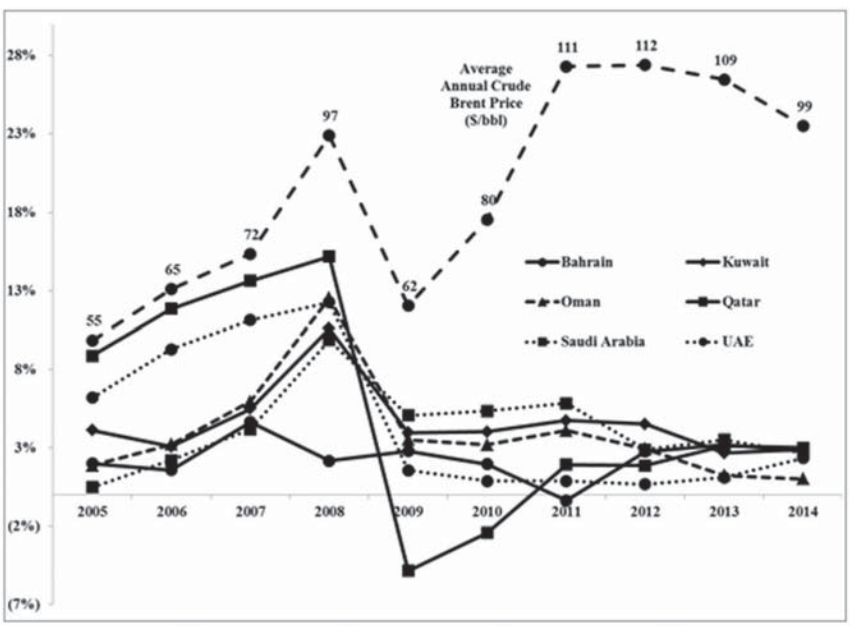

Figure 4 Comparative Inflation Rate versus Oil Price ($/bbl)

Note: 2015 expenditure numbers are IMF estimates.
Source: Based on IMF, Regional Economic Outlook: Middle East and Central Asia (October 2015), UNCTADstat, US. Energy Information Administration.

volatility from 2010, the inflation rates have remained moderate and showed signs of convergence during 2011–2014.

The fiscal deficit-to-GDP ratio (Table 2) shows that as oil prices have continued to decline it is only Kuwait and Qatar who meet the convergence criteria during 2013–2015 on forecasted levels as their fiscal deficit-to-GDP ratios are less than the required 3%. Hence in times of high and moderately high oil prices the fiscal deficit criterion is satisfied by almost all GCC states but during periods of low oil prices, it raises concerns over sustainability of the potential GCC EMU. It is evident from Table 2 that while governments may increase spending during high oil prices to foster economic growth, such levels of spending is difficult to curtail during the period of lower prices, especially when different economies have different break-even prices (Figure 1). The most challenging obstacle towards sustainability of a potential GCC EMU is the combination of high fiscal break-event points for some countries (e.g. Bahrain, Oman) combined with high dependence on oil (Saudi Arabia, Qatar and Kuwait) for others (Hanna, 2006).

Though the GCC states fulfil the debt-to-GDP ratio criterion even under the continuously falling oil prices, yet Bahrain has exhibited rising debt-to-GDP ratios in recent years followed by Qatar (Table 3). Qatar has invested in a number of sectors for diversification including banking, real estate and education. The 2020 World Football championships are also the reason for very heavy public spending in Qatar. In Bahrain, public expenditure is high due to socio-political pressure after 2011. Government revenue is dependent on a low available supply of oil (Devaux, 2014). Kuwait, Qatar and Saudi Arabia widely meet the convergence criterion for debt-to-GDP ratio; however, it poses serious risks for specific countries like Qatar and Bahrain as oil prices have continued to dip in 2015 and beyond. The sustainability of the potential EMU is at stake with Bahrain and Qatar at much higher debt to GDP ratios with 44% and 32%, respectively in 2014 than the rest of the GCC. The risk can get higher for the region if oil prices continue to dip even in the medium term.

Table 2 Fiscal Surplus/Deficit to GDP Ratio

(%)	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*	*2014*	*2015*
Bahrain	4	3	2	5	−6	−6	−2	−3	−4	−6	−14
Saudi Arabia	18	21	12	30	−5	4	11	12	6	−3	−22
Kuwait	37	32	37	20	27	26	33	35	34	26	1
Oman	12	14	12	17	0	6	9	5	3	−1	−18
Qatar	9	9	10	11	16	6	10	14	21	15	5
UAE	20	25	22	20	−4	2	6	11	10	5	−6

Note: 2015 numbers are IMF estimates.
Source: IMF Fiscal Monitor October 2015, IMF Article IV releases.

Table 3 Debt to GDP Ratio

(%)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Bahrain	24	20	16	13	21	30	32	36	43	44	67
Saudi Arabia	37	26	17	12	14	8	5	4	2	2	7
Kuwait	14	11	12	10	11	11	9	7	6	7	10
Oman	10	9	7	5	7	6	5	5	5	5	9
Qatar	18	12	8	12	34	38	35	36	32	32	30
UAE	7	7	8	13	24	22	18	17	16	16	19

Note: 2015 numbers are IMF estimates.
Source: Based on IMF, Regional Economic Outlook: Middle East and Central Asia (October 2015).

The exchange rate stability convergence condition (Table 1b) is satisfied by all GCC members as their currencies are pegged to an anchor currency or a basket of currencies (in case of Kuwait only) and there have not been any serious deviations from the respective pegs since 2002. There have not been any devaluations or crisis in terms of foreign exchange in any of the GCC economies. The GCC states have pledged to continue to peg their individual currencies to the USD/other currencies.

CONCLUSION

After considering the GCC EMU convergence factors, based on the EMU Maastricht criteria, I conclude that almost all of the conditions for convergence are satisfied by the GCC economies in recent times (2011–2014) particularly GDP growth rates, inflation rates and exchange rates relative to oil price changes during 2005–2014. However, fiscal deficit-to-GDP ratios, for most member states, are a source of significant concern for the sustainability of the potential GCC EMU during a period of low oil prices. This fiscal vulnerability, primarily due to oil dependence and lack of diversification, also trickles down to the debt-to-GDP ratios where Bahrain and Qatar exhibit higher but stable ratios, compared to the rest.

The paper concludes that GCC member states should diversify their economies away from hydrocarbons and hydrocarbon related products to alleviate their current fiscal vulnerability to low oil prices before they consider accession to a GCC EMU. Due to lack of convergence of the GCC states on the fiscal deficit-to-GDP ratios, the sustainability of the potential EMU may be threatened in the short to medium term.

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Notes

1. *EMU*: In June 1988 the European Council confirmed the objective of the progressive realisation of EMU where member countries would reap advantages of a common currency through free trade, labour and capital movement, price transparency and other benefits. It also means a common central bank and a common monetary policy that is, (European Central Bank (ECB) in EMU of Europe).

2. *SDRs*: The Special Drawing Rights (SDRs) is an international reserve asset, created by the IMF in 1969 to supplement the existing official reserves of member countries.

3. *Convergence Criteria*: This is considered a pre-requisite for entering the EMU where specific economic and monetary variables of different countries need to show signs of similar movements within acceptable range.

4. *ERM II*: Also called the Exchange Rate Mechanism II, it was set up to ensure minimal disruption between Euro and non-Euro currency for a possible accession of a non-Euro country to EMU. Prospective non-Euro member countries can fix their currencies against the Euro. Permissible fluctuation limit is only within a band of +/−15% for a period of two years and also maintain other convergence criteria as in Table 1a before they can be a part of the EMU.

BIOGRAPHICAL NOTE

Dr. Subhadra Ganguli is an Associate Professor of Economics in Ahlia University, Kingdom of Bahrain. She holds a PhD in Economics from University of California in Riverside, USA. She has experience in academic teaching, research, quality assurance and consulting for the last 20 years in India, USA and Bahrain.