An economic analysis of sustainability of a potential GCC economic and monetary union during 2005-2014

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Abstract

Purpose – Gulf Cooperation Council (GCC) was set up in 1981 between Bahrain, Oman, Qatar, Saudi Arabia, United Arab Emirates and Kuwait for strengthening cooperation and economic development in the region. The GCC has made strides towards economic consolidation by forming a customs union and a common market. The long-term vision is to create an Economic and Monetary Union (EMU) with a single currency. Progress towards the EMU has been slow and the recent oil price plunge has led to concerns regarding sustainable growth of member countries due to their significant dependence on oil and lack of diversification. The purpose of this paper is to analyse the scope of an EMU in the GCC against the backdrop of current oil crisis and examine sustainability of such a union. The paper studies convergence criteria similar to the ones followed by the accession countries of the European EMU in the 1990s preceding the introduction of the single currency Euro.

Design/methodology/approach – The paper draws its practical approach from the experience of the European Monetary Union, though the original idea of the single currency in Optimum Currency Areas was conceived by Mundell (1961). The present paper analyses macroeconomic time-series variables (e.g. GDP, budget deficits, debt, growth rates, inflation rates, exchange rates) for GCC during the period 2005-2014. Data has been sourced from United Nations Conference on Trade and Development (UNCTAD), The World Bank and International Monetary Fund (IMF) databases to study the convergence criteria adopted by the EMU countries for the introduction of the Euro.

Findings – The paper concludes that GCC economies are similar in terms of their structural and economic fundamentals. Most elements of the convergence criteria that were followed by the accession countries in Europe are fulfilled by the GCC member states, particularly during 2011-2014. The GCC states look similar in terms of sustainable growth, price stability and exchange rate stability – three aspects of convergence met by the European Union states. However, heavy dependence on oil and lack of diversification from oil and hydrocarbon-related products in the gross domestic product (GDP) composition of GCC states pose severe risks to the potential union. Fiscal vulnerabilities of these economies to oil price shocks, such as the current oil price crisis, create concerns for such a union during oil price lows. Widely divergent fiscal deficit-to-GDP ratios and rising debt-to-GDP ratios during periods of low oil prices imply the lack of sound and unsustainable public finances for some of the GCC states. The divergence has stemmed from widely different break-even oil prices for government budgets within the GCC and also due to varying degrees of oil dependencies between the member states. The scope of a successful and more sustainable EMU can be further explored once the GCC economics have achieved adequate diversity from oil.

Originality/value – The study is useful to policy makers, central banks, businesses and researchers since it highlights the EMU as a feasible option for the GCC states. The sustainability of the EMU is contingent on diversification of these economies in the future from oil and oil-related products. The study can be utilized by policy makers as a strategy to further restructure GCC economies towards greater resilience and integration prior to accession to the GCC EMU.

Keywords Sustainable development, GCC, GDP, EMU, Convergence criteria

Paper type Research paper

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1. 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 period, 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 for introducing single, common currency but that has been harder to implement due to political hurdles within the GCC.

This paper constructs convergence factors, based on those used by countries joining the European Monetary 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).

Section 2 of the paper summarizes the characteristics of the potential GCC and its efforts in creating an integrated monetary union. Section 3 provides literature review of the previous work in this area of study and related results along with the scope, merits and demerits of the potential GCC EMU; Section 4 explains the research methodology used in the paper for studying the convergence criteria of the European Monetary Union states for adopting single currency Euro; Section 5 presents empirical analysis of data exploring GCC EMU; Section 6 provides the conclusions of the analysis of the data, limitations of the research as well as recommendations following the findings of the study for policy makers and researchers.

2. 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 centres; 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 – www.gcc-sg.org/eng/).

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 across GCC states. 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 road map to realize 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[1]. Subsequently, political differences between 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 has 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.

2.1 GCC vital economic statistics

The combined gross domestic product (GDP) of the GCC stands at approximately USD1.1 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 per cent natives and 48 per cent 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 per cent for the region. Debt-to-GDP levels are within manageable limits for most of the GCC states (at less than 50 per cent of GDP as compared to G7 countries) (IMF, Regional Economic Outlook, Middle East and Central Asia, October 2015).

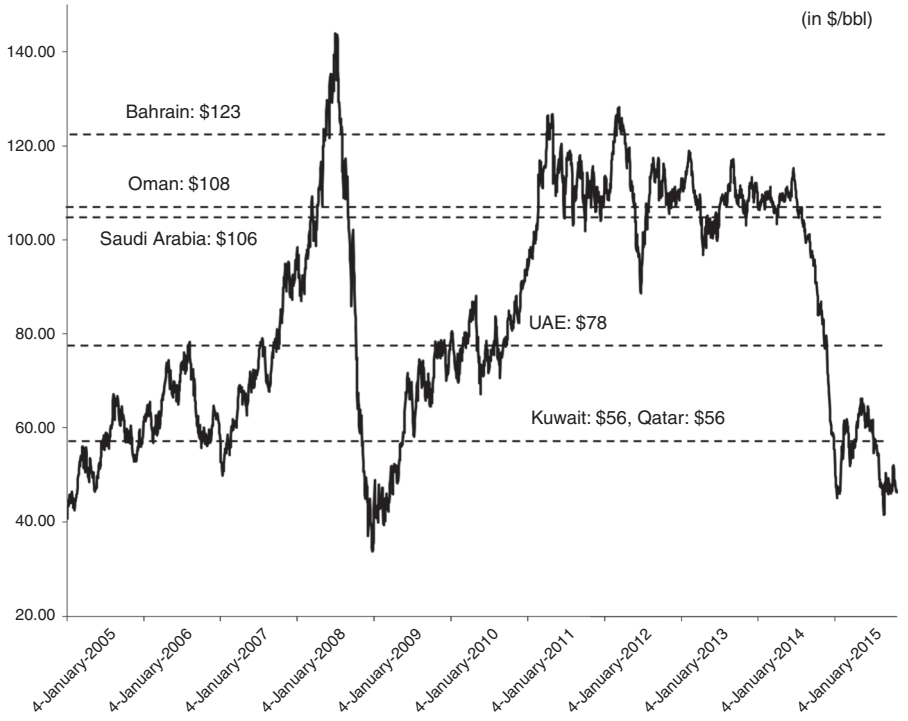
2.2 Importance of oil to GCC

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 benefitted 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 per cent of the world reserves of oil (approximately 1.7 trillion barrels) and their daily contribution to worldwide oil production is 22 per cent. Oil continues to be a significant source of government revenue – approximately 81 per cent for Saudi Arabia, 71 per cent for Kuwait and 25 per cent 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 and Central Asia, October 2015).

GCC member states have manoeuvred 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 and cultures and customs.



Sources: US Energy Information Administration; IMF Regional Economic Outlook October 2015

Figure 1.
Historical oil prices vs fiscal break-even levels

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 mobilization, uniform rules, regulations, trade and investment related opportunities that an EMU entails?

2.3 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 manoeuvrability constraints when oil prices are down.

3. Literature review

The conditions for economic integration and the idea of an "Optimum Currency Area (OCAs)" were first laid out by Robert Mundell (1961) in a classic paper titled "A Theory

of Optimum Currency Areas". An "OCA" is a geographical region in which economic efficiency is maximized due to the use of a single, common currency. The arguments in favour of a "Common Currency Area" arise from the microeconomic efficiency gains from a common currency. Transaction costs are eliminated and a common currency enhances price transparency by minimizing price discrimination and market segmentation. The creation of the European common market provides the largest test case of the theoretical notions underlying OCAs. The Eurozone is characterized by high degree of labour and resource mobility, intra-EU trade in goods and services, easiness of doing business due to single currency and infrastructure; boost to tourism industry due to single currency, uniform visa and customs rules; established supranational institutions like the European Central Bank (ECB) which conducts the monetary policy of the Eurozone; Council of the European Union, European Parliament among others. However due to the common monetary policy, the EU countries have very limited flexibility in manoeuvreing the exchange rate policy or monetary policy in times of crisis. The only tool at the disposal of the EU states is to adjust their government spending or taxation or restructuring their debts to adjust their fiscal deficits. Ironically, this is precisely the current situation of the GCC countries as they do not have any flexibility in terms of exchange rate or monetary policy adjustments in times of macroeconomic crisis due to their pegged currencies. The only way the GCC states can aim to overcome their current budget deficits, due to low oil prices, is through more borrowings by the government or by cutting government spending. Historically, GCC states have imposed little or no taxation on individuals and corporates. The government subsidies are widely and universally prevalent in utilities, food and fuel sectors. However, in recent times, GCC states have unanimously reduced subsidies in such key sectors and have replaced them by cash transfers to the needy. Bahraini government has slashed fuel subsidy by 60 per cent in January 2016 with further rationalization strategies in subsidy schemes in electricity and water services starting March 2016. This policy of fiscal restructuring in the short term alone will contribute substantially towards recuperating significant losses of the government revenue due to lower oil prices in recent times. Apart from the many advantages highlighted above regarding the EMU of the GCC states, one of the key demerits, that will continue to exist, would be the lack of flexibility in exchange rate and monetary policy tools during any crisis in the GCC states. This lack of economic policy flexibility has been highlighted in the case of Greece crisis in 2015 when Greece had no exchange rate or monetary policy leeway to emerge from the crisis and was forced to depend only on fiscal policy and debt restructuring tools. The US government, on the other hand, could print currency notes (extensive use of stimulative monetary policy) and paid off its debt to international investors during period of financial crisis after 2008 to avoid any major default.

Fasano-Filho and Schaechter (2003) examine 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 *et al.* (2010) have argued from the standpoint of traditional OCA and have concluded that though the GCC countries have successfully maintained their peg to the anchor currency/ies, 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 activities 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.

The above studies have examined the GCC from the perspective of a potential EMU candidate and, based on Mundell's (1961) seminal paper on OCA and flexible exchange rates, most have concluded that though GCC members may show signs of similarity, yet there are significant hurdles that prevent establishment of a sustainable union. The current paper is an empirical analysis of the potential GCC EMU using the convergence criteria of the European experience in an era of declining oil prices. The paper focuses on the effect of volatile and particularly declining oil prices to show that the fundamentally similar GCC economies may not be ready yet for the EMU. Hence while the results of the previous studies are similar to those of the present study, yet the latter has identified that while convergence criteria may be met during periods of high oil prices, yet the current situation of low oil prices clearly makes the integration of the potential EMU risky and unsustainable under present economic conditions of the GCC states.

4. Research methodology

In June 1988 the European Council confirmed the objective of the progressive realization of an 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 meant a common central bank and a common monetary policy, i.e. ECB (ECB in EMU of Europe). In view of the adoption of the Euro as a single currency on 1 January 1999, 11 European Union member states were evaluated on a number of criteria for a period of a minimum of two years. This was done to ensure that the economies exhibited enough commonality in terms of economic and monetary policies to integrate and work in tandem as a monetary union in the future. This also meant that each accession country would have to abandon their individual currencies and adopt the flexible single currency Euro. A set of economic criteria called the "convergence criteria" was considered as pre-requisites for accession to the European Monetary Union where specific economic and monetary variables of different countries were required to demonstrate similar trends within an acceptable range. Mundell's (1961) seminal paper identified this process as a purely empirical one with no theoretical implications. He mentioned that for a stable flexible exchange rate to work effectively in an OCA the following conditions need to be met satisfactorily, namely – the price system should be stable; existing exchange rates should exhibit stable movements towards the new currency without causing major disruptions to the import and export-

competing industries; monetary policies should exhibit stability; and adequate protection of debtors and creditors in capital markets were to be ensured. Prior to the creation of the European Monetary Union, a treaty was signed in Maastricht in 1992 that proposed five convergence criteria to be met by countries which were 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). The member states locked themselves in the Exchange Rate Mechanism II which was set up to ensure minimal disruption between Euro and non-Euro currencies for a possible accession of a non-Euro country to the European Monetary Union. Prospective non-Euro member countries can fix their currencies against the Euro. Permissible fluctuation limit is only within a band of ±15 per cent for a period of two years and they also should maintain other convergence criteria as in Table I before they can be a part of the European Monetary Union. The Maastricht guidelines were translated to measurable factors, namely, harmonized index of consumer prices inflation, government budget deficit, government debt-to-GDP ratio, exchange rate stability and long-term interest rate. Growth and stability pact required the government budget deficit of each accession country to be less than or equal to 3 per cent of GDP and government debt-to-GDP ratio to be less than or equal to 60 per cent. Table I lists the Eurozone EMU convergence criteria.

This paper examines the degree of convergence achieved amongst GCC members based on similar convergence criteria tailored for the GCC (Table II) and determines

Table I.
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 2 years without severe tensions

Table II.
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 2 years without severe tensions

whether sustainable economic integration is feasible between member states. European Monetary Union was the first application of flexible single currency in OCA idea of Mundell (1961) where the following conditions of the stability criteria specified by Mundell were used to examine the convergence. These include price stability where the member states required to exhibit a degree of similarity in their price movements and are also meet rates of convergence in their monetary and fiscal policies to meet the stability and sustainability of public finances and exchange rate movements. The member states locked themselves in the Exchange Rate Mechanism II which was set up to ensure minimal disruption between Euro and non-Euro currencies for a possible adoption of the single currency Euro. The present study considers the convergence criteria of the GCC within the European context with a minor difference. Since the GCC interest rates have followed the US monetary policy due to the pegging of the GCC currencies to the USD (with the exception of Kuwait who has pegged its currency to a basket though with the heaviest weight on the USD), the convergence criterion on the long-term interest rate is considered redundant. All GCC states follow the USD interest rates. Instead, the GDP growth rate has been considered as a convergence criteria. GCC economies are fundamentally similar in their GDP composition with some minor variations. The rest of the convergence factors, namely, price stability, soundness and stability of public finance, exchange rate stability have been considered in this analysis just as they were in the European case.

5. Empirical analysis of the data

For the purpose of this analysis, time-series data for ten years (2005-2014) for the six GCC states have been collected and assessed to check whether they satisfy the convergence criteria in Table II. The data are publicly available and has been sourced from the IMF (www.imf.org), The World Bank (www.worldbank.org) and UNCTAD databases (www.unctadstat.org).

Table II lists five separate components which are proposed as GCC convergence criteria for accession of member states to a 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 lacks independent monetary policy and follows the USD interest rates due to the pegging of the currencies mostly to the USD. This has been earlier referred to in Section 4.

5.1 Analysis of GCC EMU convergence criteria

Figure 2 confirms that real GDP growth rate 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 2). 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 degrees 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 3 shows the comparative inflation 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

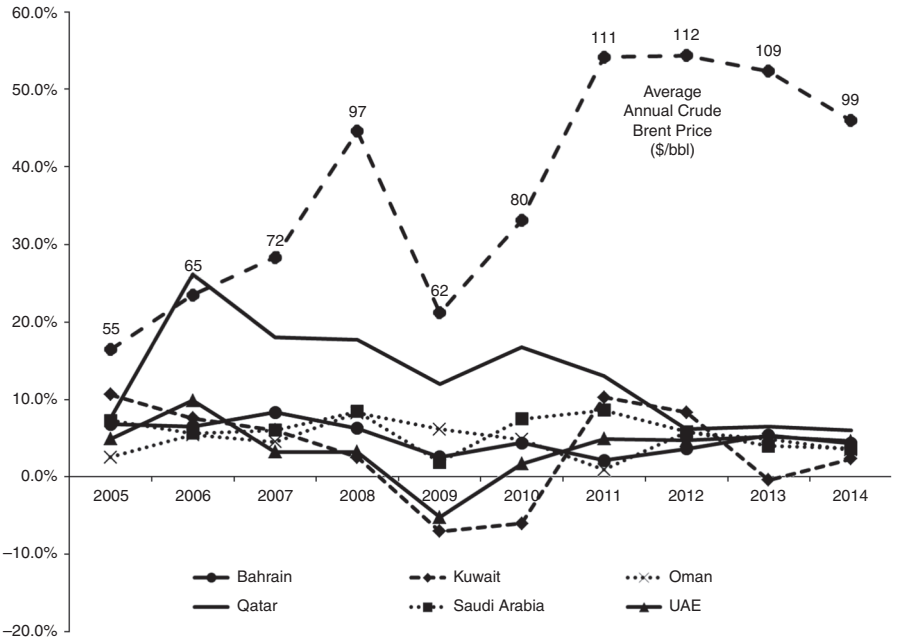
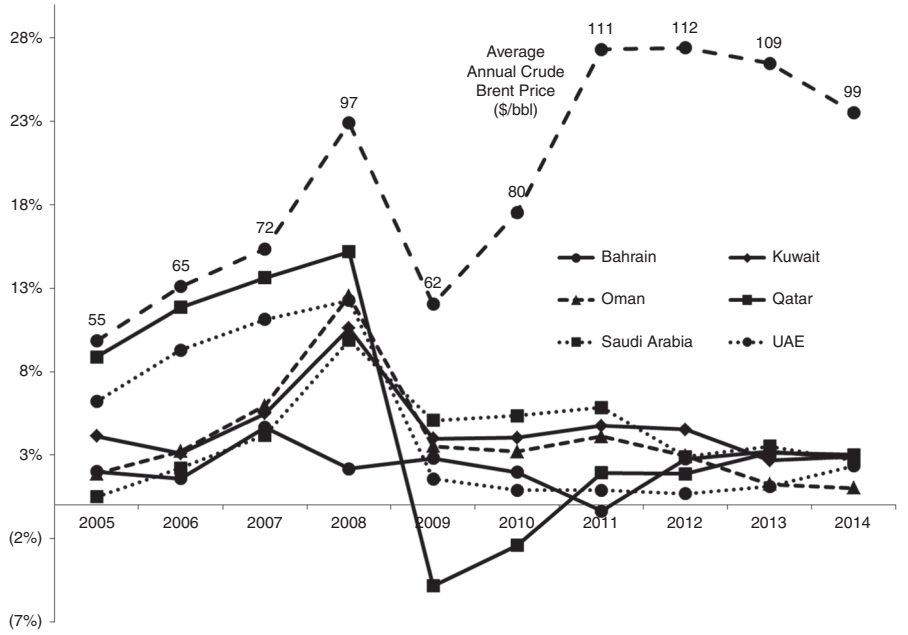


Figure 2.
Comparative GDP growth vs oil price ($/bbl)

Sources: IMF Regional Economic Outlook: Middle East and Central Asia (October 2015); UNTADstat; US Energy Information Administration

since 2003. Inflation in the oil-driven economies were led by heavy government spending which in-turn fuelled 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 fuelled 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 in all GCC states. As oil prices started to show signs of volatility from 2010, the inflation rates have remained moderate and showed signs of convergence during 2011-2014.

The fiscal deficit-to-GDP ratio (Table III) 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 per cent. 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. Most of the GCC states except Kuwait will not be meeting the convergence criterion regarding sound public finances. It is evident from Table III that while governments may increase spending during high oil prices to foster economic growth, such levels of spending are difficult to curtail during the period of lower prices, especially when different economies have different break-even prices. Figure 1 depicts the historical oil prices against break-even prices for balancing the budget of each GCC state. The most challenging obstacle towards sustainability of a potential GCC EMU is the combination of high fiscal break-even



Sources: Based on IMF; Regional Economic Outlook: Middle East and Central Asia (October 2015); UNTADstat; US Energy Information Administration

Figure 3.
Comparative inflation rate vs oil price ($/bbl)

%	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	−2	−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 III.
Fiscal surplus/ deficit-to-GDP ratio

prices for Bahrain and Oman combined with high dependence on oil for Saudi Arabia, Qatar and Kuwait (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 IV). 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 political uprising of the Shia population against the Sunni monarchy. Government revenue in GCC states is dependent on a low available supply of oil. Kuwait, Qatar and Saudi Arabia widely meet the convergence criterion for debt-to-GDP ratio; however, the criterion poses

%	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
Sources: Based on IMF; Regional Economic Outlook: Middle East and Central Asia (October 2015)

Table IV.
Debt-to-GDP ratio

serious risks for specific countries like Qatar and Bahrain as oil prices have continued to dip since 2015. The sustainability of the potential EMU is at stake with Bahrain and Qatar at much higher debt-to-GDP ratios, namely, 44 and 32 per cent, 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.

The exchange rate stability convergence condition (Table II) 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). 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 in the future.

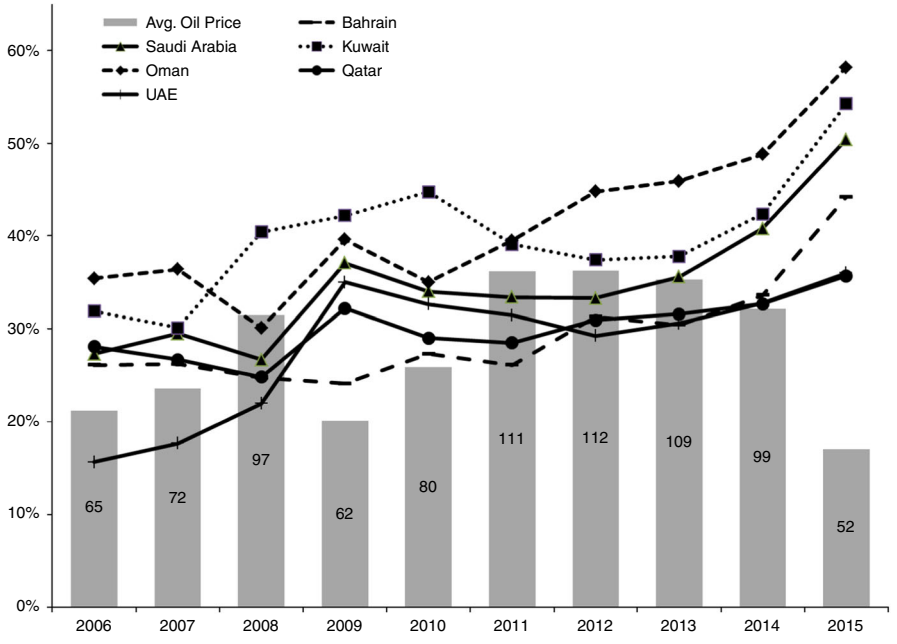
6. Conclusion

The OCA analysis of Mundell and subsequent introduction of the single currency within GCC has been a topic of discussion at various quarters including policy makers and academicians. It has been universally accepted that due to the similar nature of GCC economies, namely, cultural, social, and religious and language – the process of achieving economic and monetary integration would be easier than that in the accession countries of the Eurozone (who are distinguished by their individual languages and cultures, economic policies, nature of diversification among other factors). The single currency GCC region would reap several economic benefits from this integration in the form of price transparency of goods and services, exchange rate risk mitigation due to single currency, competitive and efficient resource allocation and reduction in price inefficiencies due to monetary integration. However, GCC states should be able to create the supranational institutions which would be essential for the creation and sustainability of the EMU. Such institutions – monetary, financial, economic, social and political – would create the necessary infrastructure for GCC-wide policies, laws and regulations for implementation. European Monetary Union has successfully set up such supranational institutions embracing regional interests. After analysing the GCC EMU convergence factors, based on the EMU Maastricht criteria, the paper concludes 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, debt-to-GDP ratios 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 fiscal deficit-to-GDP ratio and the debt-to-GDP ratios, though have increased in recent times, yet are clearly lower than all G7 countries. Again, the history of cooperation and friendly relations between the GCC monarchies are cemented through various family and social ties. This union goes beyond the economic and political integration that OCA region analysis or the European Monetary Union have witnessed so far. The GCC countries are forthcoming in their help and support towards each other. Recent restructuring of the fiscal deficits and withdrawal of subsidies and introduction of the taxation schemes across GCC in 2016 is a testimony to this fact.

This study does not consider examination of the financial markets, labour markets or the capital markets of the GCC and does not study the intra GCC trade flows or the trade between GCC and the rest of the world to study their effects on potential GCC EMU.

The study aims to provide recommendations for policy makers and regulators in the GCC to consider diversification of their economies away from hydrocarbons and hydrocarbon-related products. Such diversification in the medium to long term will alleviate their current fiscal vulnerability to low oil prices before they embark on the strategic plan of accession to a GCC EMU. Due to lack of convergence of the GCC states on the fiscal deficit-to-GDP ratios and debt-to-GDP ratios, the sustainability of the potential EMU may be threatened in the short to medium term. Hence the policy makers should consider diversification strategies for restructuring the GCC economies to alleviate the degree of dependence on oil and oil-related products in their GDP composition before the GCC EMU becomes a reality (Figure 4).



Note: 2015 expenditure numbers are IMF estimates

Sources: IMF Article IV releases; IMF Fiscal Monitor October 2015; US Energy Information Administration

Figure 4. Government expenditure (as percentage of GDP) vs average annual oil price

Note

1. 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.

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