EE

Currency Union and Exchange Rate Issues

Lessons for the Gulf States

Edited by
Ronald MacDonald
Abdulrazak Al Faris

New Horizons in Money and Finance

Currency Union and Exchange Rate Issues

Lessons for the Gulf States

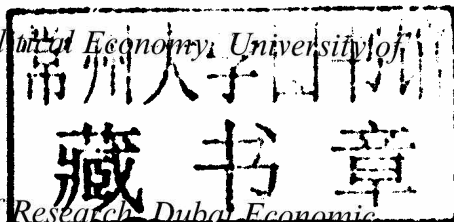
Edited by

Ronald MacDonald

Adam Smith Professor of Political Economy, University of Glasgow, UK

Abdulrazak Al Faris

Chief Economist and CEO of Research, Dubai Economic Council



NEW HORIZONS IN MONEY AND FINANCE

مجلس دبي الاقتصادي

Dubai Economic Council

Edward Elgar

Cheltenham, UK • Northampton, MA, USA

© Dubai Economic Council 2010

Dubai Economic Council
PO Box 112288
Dubai
UAE
Telephone: 00971 4 223 4555
Fax: 00971 4 228 5050
www.dec.org.ae
email: info@dec.org.ae

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system or transmitted in any form or by any means, electronic, mechanical or photocopying, recording, or otherwise without the prior permission of the publisher.

Published by
Edward Elgar Publishing Limited
The Lypiatts
15 Lansdown Road
Cheltenham
Glos GL50 2JA
UK

Edward Elgar Publishing, Inc.
William Pratt House
9 Dewey Court
Northampton
Massachusetts 01060
USA

A catalogue record for this book
is available from the British Library

Library of Congress Control Number: 2009940968

The material in this publication is copyrighted. Copying and/or transmitting portions or all of this work without permission may be a violation of applicable law. Dubai Economic Council encourages dissemination of its work and will normally grant permission to reproduce portions of the work promptly. All queries on rights and licences should be addressed to the office of the Publisher.
This volume is a product of several authors. The findings, interpretations, and conclusions expressed in this volume do not necessarily reflect the views of Dubai Economic Council or the Government of Dubai. Dubai Economic Council does not guarantee the accuracy of the data included in this work.

ISBN 978 1 84844 857 5

Printed and bound by MPG Books Group, UK

Currency Union and Exchange Rate Issues

مجلس دبي الاقتصادي

Dubai Economic Council

NEW HORIZONS IN MONEY AND FINANCE

Series Editor: Mervyn K. Lewis, *University of South Australia*

This important series is designed to make a significant contribution to the shaping and development of thinking in finance. The series will provide an invaluable forum for the publication of high quality works of scholarship on a breadth of topics ranging from financial markets and financial systems to monetary policy and banking reform, and will show the diversity of theory, issues and practices.

The focus of the series is on the development and application of new original ideas in finance. Rigorous and often path-breaking in its approach, it will pay particular attention to the international and comparative dimension of finance and will include innovative theoretical and empirical work from both well-established authors and the new generation of scholars.

Titles in the series include:

Banking Reforms in South-East Europe
Edited by Zeljko Sevic

Russian Banking
Evolution, Problems and Prospects
Edited by David Lane

Currency Crises
A Theoretical and Empirical Perspective
André Fourçans and Raphaël Franck

East Asia's Monetary Future
Integration in the Global Economy
Suthiphand Chirathivat, Emil-Maria Claassen and Jürgen Schroeder

Reforming China's State-Owned Enterprises and Banks
Becky Chiu and Mervyn K. Lewis

Financial Innovation in Retail and Corporate Banking
Edited by Luisa Anderloni, David T. Llewellyn and Reinhard H. Schmidt

An Islamic Perspective on Governance
Zafar Iqbal and Mervyn K. Lewis

Currency Union and Exchange Rate Issues
Lessons for the Gulf States
Edited by Ronald MacDonald and Abdulrazak Al Faris

试读结束：需要全本请在线购买： www.ertongbook.com

Contributors

Abdulrazak Al Faris, Chief Economist and CEO of Research, Dubai Economic Council

Willem H. Buiter, Professor of European Political Economy, European Institute, London School of Economics and Political Science, UK

Warren Coats, Director, Cayman Islands Monetary Authority

Paul De Grauwe, Professor of International Economics, University of Leuven, Belgium

Zubair Iqbal, Scholar, Middle East Institute, Washington, DC, USA

Mohsin S. Khan, Senior Fellow, Peterson Institute for International Economics, Washington, DC, USA

Ronald MacDonald, Adam Smith Professor of Political Economy, University of Glasgow, UK

Contents

List of contributors vi

1 Introduction 1
Ronald MacDonald and Abdulrazak Al Faris

2 Currency union in the GCC countries: history, prerequisites and implications 7
Abdulrazak Al Faris

3 Economic, political and institutional prerequisites for monetary union among the members of the Gulf Cooperation Council 29
Willem H. Buiter

4 The euro experience and lessons for the GCC currency union 70
Paul De Grauwe

5 The GCC monetary union: choice of exchange rate regime 83
Mohsin S. Khan

6 International experiences in operating exchange rate regimes: drawing lessons from the United Arab Emirates 98
Ronald MacDonald

7 Operational implications of changing to alternative exchange rate regimes 120
Warren Coats

8 The United Arab Emirates: exchange rate regime options 154
Zubair Iqbal

Index 191

1. Introduction

Ronald MacDonald and Abdulrazak Al Faris

ABOUT THIS BOOK

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

Abdulrazak Al Faris provides in Chapter 2 a historical perspective of the main developments in the GCC integration process that led to the decision to adopt the single currency. The literature on the subject is reviewed, and the costs and benefits of a monetary union are critically evaluated before moving on to an analysis of the criteria required for a successful integration, followed by an investigation into the implications of such a union on the political and economic landscape of the region. Al Faris reviews the steps taken thus far in the process of achieving a currency union within the framework of wider regional integration. Moving on, the author then provides a critical analysis of the fundamental criteria necessary for successful integration, particularly their relevance, consistency and compatibility

with the Gulf region. The author stresses that convergence criteria should reflect 'the particular circumstances of the region, level of development and the degree of sophistication the members have in terms of fiscal and monetary management'. Moreover, since reliable and timely statistics on key macroeconomic indicators are absent from most of these countries, the emphasis should be put now on transparency, a mandatory deadline for the provision of data and an independent international and regional surveillance on the observance of standards and codes and convergence criteria.

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

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

Paul De Grauwe uses the historical experience of the European countries' move to full monetary union (EMU) to draw lessons for the Gulf States and their planned monetary union. He argues that the overriding lesson from the European experience is that a monetary union is not created in a political and institutional desert and that monetary union was made possible in Europe because of at least 40 years of preparatory work in terms of institution building. For example, the creation of the European Central Bank was made possible by the pre-existence of numerous European institutions (the European Commission, the Council,

the European Parliament, the European Court of Justice) to which the member states of the EU gradually transferred part of their national sovereignty. Once the process of institutional building started, an endogenous dynamic took over, whereby limited first steps called for other steps towards further institutional cooperation.

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

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

However, and as recent history shows, fixity can have a number of disadvantages. Crucially, failure to provide adjustment to changing economic conditions affecting the underlying equilibrium real exchange rate, including temporary real shocks (such as temporary oil price shocks), means adjustment has to be made by other means, particularly changes in the level of domestic prices and costs, which in turn lead to changes in

the level of economic activity – growth – and employment. In particular, adjustment to negative real shocks will have to be effected through a contractionary fiscal policy since a fixed rate implies monetary policy is assigned primarily to maintenance of the exchange rate, which could make it more difficult to simultaneously achieve internal and external objectives. Moreover, greater terms-of-trade volatility implies higher costs associated with a pegged exchange rate. Also, if the pegged regime is adopted when conditions are favorable, but without adequate policy commitment and institutional foundations to withstand the potential strains on the peg, it can entail a costly crisis when conditions turn unfavorable, particularly in an environment of capital mobility.

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

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

试读结束：需要全本请在线购买： www.ertongbook.com

monetary, fiscal and structural policies (that is, policies related to price formation in labor and product markets), and the broader institutional development of the GCC region.

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

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

must estimate and forecast the relationship between its monetary liabilities (the monetary base) and its chosen monetary aggregate.

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

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

2. Currency union in the GCC countries: history, prerequisites and implications

Abdulrazak Al Faris

INTRODUCTION

From a global perspective, the GCC countries do not exhibit extraordinary qualities from several standpoints: they have the geographical size of the eurozone, albeit with a combined GDP equivalent to a medium-size European country like the Netherlands. The region's total population amounts to less than 0.6 percent of the total world population, and its export represents 1.5 percent of global exports. However, looking beyond the surface the GCC's significance is demonstrated in a variety of other factors: its members control more than 40 percent of world-proven oil reserves, around 23 percent of global gas reserves and nearly 38 percent of global official financial reserves. Moreover, the region's impressive development in infrastructure, financial services and communications allowed it to benefit from the process of globalization, be better integrated in international markets and take a leading role in several development spheres in the Middle East and North Africa (MENA) region. The Gulf States, due to massive investment in education, health, housing and other social services, rank high in many international indicators such as Human Development Index (HDI), competitiveness, economic freedom and transparency. Given all this, if realized, the Gulf single currency would be the second largest common currency after the euro, and its constituent, the Gulf Monetary Union, would be the second most important supranational monetary union in terms of GDP after the euro area.

This chapter provides a broad survey of the main issues in the GCC currency union experience. It starts with a background on the start of the initiative, the main achievements so far and the process to achieve single currency within the framework of wider regional integration. Next, the chapter surveys the growing literature on the subject, summarizes their main hypotheses and findings and highlights the relevant lessons from

other currency union experiences. The remainder of the chapter critically reviews convergence criteria; their relevance, consistency and compatibility with the Gulf region, before moving on to some concluding remarks.

BACKGROUND

Economic integration among the six member states of the Gulf Cooperation Council (GCC) goes back to December 1981, when a unified Economic Agreement was ratified. The agreement set the stage for the GCC Free Trade Area (FTA) and closer regional economic cooperation. In the first two decades after its inception the Council was preoccupied with rising regional tensions, the escalating war between its neighbors Iraq and Iran and the invasion of Kuwait by Iraq in 1990. Despite that, several practical steps toward economic integration were taken: in March 1983 a decision was adopted to exempt all GCC national products from custom duties, and the first services sectors were opened to GCC citizens by early 1986. In the 1990s, the GCC efforts shifted toward achieving custom union, and an agreement was reached in 1999 to establish the custom union no later than March 2005, then brought forward to January 2003.

Immediately after the events of 9/11 (2001), the integration process among the GCC members gained momentum, where in the December 2001 summit in Muscat (Oman) a substantially revised Economic Agreement was agreed upon to expedite the completion of the common market, and begin the process of economic and monetary union that will lead to a single currency by 2010. The Agreement contains revised and new provisions addressing the custom union, common market and the monetary union. According to this revision, the Free Trade Area was brought forward to January 2003 from its initial plan for January 2005, an external common custom tariff (ECT) was set at 5 percent on all foreign imports with some exceptions, while all goods produced in any GCC member states are accorded national treatment and will be allowed to move freely within the region. The GCC adopted a two-tier ECT that is based on a unified common tariff of 5 percent on most imported products; a 0 percent rate on imports of some of 53 tariff lines at the HS 6-digit level, mainly 'essential' goods, and a 5 percent ECT that applies to 'other' goods. Additionally, the role of a single entry point where common customs duties are collected was put in force, along with the Single Customs Declaration (SCD) for the purposes of importation, exportation and re-exportation.

At Muscat's summit, the Supreme Council also agreed on the following: the establishment of implementation guidelines, including convergence criteria for the monetary union by 2005, the completion of the common

market by 2007, and the adoption of the single currency by 2010 (see GCC, 2004). Article 3 in the new Economic Agreement specifies several areas where complete equality must be achieved in order to implement the single market. These areas are: residence and movement of GCC nationals and granting them equal treatment in the entire GCC member states and work in private and government sectors.

After some delay, the GCC common market was launched in January 2008, which gives, in principle, equal treatment to all GCC citizens, including unrestricted employment opportunity in private and public sectors and equal coverage of pension and social security. Significant progress toward regional integration has been achieved since then through elimination of barriers to free movement of goods, services, capital and national labor and a common external tariff, and many measures have been taken to harmonize their standards, codes and regulations, and align their monetary, fiscal and economic policies.

The financial committee (ministerial) agreed, in preparation for the currency union, to peg all the Gulf States' currencies to the US dollar. All the GCC members, with the exception of Kuwait, had already chosen the dollar as the nominal anchor well before the planned monetary union, and this has become an official policy since 2003. Kuwait, after pegging its currency to the US dollar in 2003, switched back to the system of a basket of currencies in the middle of 2007 to deal with declining dollar and high inflation rate. However, it is widely believed that the dollar still retains a decisive weight in this basket.

LITERATURE REVIEW

There has been an ever-growing literature on the monetary union in the GCC region. This literature has concentrated on three main themes, namely: the costs and benefits of a single currency in the short and long term; the degree of macroeconomic policy coordination and the extent to which the Gulf States meet the theoretical criteria of an optimal monetary union; and finally the best exchange rate regime for the single currency.

Jadresic (2002) and Badr-El-Din (2004) discussed in detail the pros and cons of monetary union, highlighting the main challenges by taking into consideration the long-term perspective. For Jadresic, the benefits of the program are overwhelming and include: enhancing regional economic efficiency, deepening economic and political integration and promoting structural diversification away from the oil sector. To reap the full benefits, the monetary union should be part of a wider integration process that entails the removal of all intra-regional barriers, and harmonization

of macroeconomic policies. Badr-El-Din (2004) presented a cost–benefit analysis for the potential GCC monetary union. By looking at the criteria of convergence – flexibility, investment, financial services and growth, stability and unemployment – the author determined that fiscal policies are the least coordinated. He goes on further to assert that the benefits to the countries of the GCC from a monetary union may not necessarily outweigh the costs.

A large body of the literature addresses the issue of the GCC countries' compatibility to form a currency union. This includes papers by Dar and Presley (2001), Laabas and Limam (2002), Darrat and Al-Shamsi (2005), Kamar and Bakardzhieva (2006), Kamar and Ben Naceur (2007), Abu-Qarn and Abu-Bader (2008), Coury and Dave (2008) and Al-Hassan (2009). The main questions raised by these papers are the extent to which the GCC represents an optimum (or optimal) currency area (OCA), the degree of monetary and fiscal coordination among the Gulf members and whether these countries are subject to symmetric external shocks and similar supply and demand disturbances.

Abu-Qarn and Abu-Bader (2008, p. 629) examined the readiness of the GCC members to form a currency union by employing three methods: the structural VAR (vector autoregression) procedure to identify demand and supply disturbances, the Johansen cointegration test to verify the existence of long-term relationships of real GDP among all countries and finally a test for common business cycles. Their main conclusion is that 'the requirements for a successful union are not yet met . . . and significant efforts are needed to align the fiscal, financial and political systems'. Dar and Presley (2001) argued that the GCC countries, despite great advances in areas such as communications and infrastructure networks, remain quite far from a successful monetary union. Citing the domination of one economy (Saudi Arabia) over all others, heavy dependence on oil and oil-related products, as well as heavy dependence upon trade, the authors argued that the GCC countries will remain on a slow path toward a monetary union. The authors further assert that the GCC should strive for heavier intraregional integration through encouraging the private sector and foreign direct investment, which together would allow for the successful formation of a monetary union.

Laabas and Limam (2002) attempted to evaluate the degree to which the GCC countries represent the criteria essential for becoming an optimum currency area. Using a generalized purchasing power parity test as well as other tests based on OCA literature the authors then concluded that GCC countries remain unable to fulfil all prerequisites for the successful establishment of an OCA. This is true given issues such as the dominance of most GCC economies by the oil sector, a lack of synchronized

试读结束：需要全本请在线购买： www.ertongbook.com