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Establishing Monetary Union in the Gulf Cooperation Council: What Lessons for Regional Cooperation?

Shinji Takagi

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Shinji Takagi is professor of economics at the Graduate School of Economics, Osaka University, Japan.

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Please contact the author for information about this paper.

Email: takagi@econ.osaka-u.ac.jp

Asian Development Bank Institute
Kasumigaseki Building 8F
3-2-5 Kasumigaseki, Chiyoda-ku
Tokyo 100-6008, Japan

Tel: +81-3-3593-5500
Fax: +81-3-3593-5571
URL: www.adbi.org
E-mail: info@adbi.org

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Abstract

The paper reviews the experience of regional economic cooperation in the Gulf Cooperation Council (GCC). Conceived as a regional security alliance, the GCC has evolved to become a common market in the making. All six GCC countries participate in the common market project, and additional countries may join. But the timing of introducing a common currency, initially targeted for 2010, remains uncertain, especially in the light of the ongoing euro area crisis. Two countries have withdrawn from the common currency project; another has ceased to comply with a prerequisite for entering the monetary union. But the GCC is not the same as the GCC Monetary Union, nor should the success of the GCC be judged solely on the basis of how many member states end up participating in the single currency.

From the standpoint of Asia, the contrast appears striking. In Asia it has been a slow and difficult process to form consensus on regional cooperation, but political agreement collectively to promote economic integration was reached rather quickly in the GCC. Even so, regional institution building, especially in creating regional decision-making bodies, has been slow in the GCC; the region is yet to see the degree of economic integration already experienced in Asia. An important lesson of the GCC experience is that political will and leadership alone is not a sufficient condition for success. What ultimately determines the success of any regional cooperation effort is the willingness of countries to surrender part of their national sovereignty, a difficult feat for any group of countries.

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1. INTRODUCTION

This paper presents a review of regional economic cooperation in the Gulf Cooperation Council (GCC), with a focus on the organization's ultimate goal of establishing monetary union. Since the early 1980s, the GCC—which comprises six monarchies of the Arabian Peninsula: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates (UAE)—has been forging ahead with regional cooperation efforts, with a view to promoting economic integration among the member states, including the eventual introduction of a single currency. The GCC is located in a politically volatile region; it holds more than 30% of the world's proven oil reserves and supplies nearly 25% of the world's petroleum needs (OPEC 2011). The world's increasing interest in the GCC's regional economic cooperation efforts stems not only from this geopolitical importance but also from the rising economic might of the region as it has amassed trillions of dollars of petroleum wealth. The GCC's experience is bound to receive even greater attention, given the strong likelihood that a single currency will be introduced in the near future, at least among a subset of the member states, and as the membership is likely to expand to include Jordan and Morocco, if not Yemen.[1]

The purpose of this paper is to draw potential lessons for regional economic cooperation by identifying the ingredients of success and failure seen through the three decades of GCC experience. In doing so, the rest of the paper proceeds as follows. Section 2 reviews the role of economic cooperation in the GCC, which was conceived as a regional security alliance, paying particular attention to the Unified Economic Agreement of 1981. Section 3 outlines the overall framework of governance and decision making in the GCC, along with the institutional apparatus for monetary cooperation. Section 4 provides an overview of the economic characteristics of GCC countries that are relevant to our discussion of economic and monetary cooperation. Section 5 summarizes the GCC's institutional achievements in regional economic cooperation, including the revised Economic Agreement of 2001, the launch of a customs union in 2003 and a common market in 2008, and the establishment of the Monetary Council in 2009. Section 6 relies on the existing literature to discuss the pros and cons of monetary union in the GCC as well as what the future holds for the GCC single currency project. Finally, section 7 concludes by drawing lessons from the GCC experience.

2. REGIONAL SECURITY THROUGH ECONOMIC COOPERATION

The Gulf Cooperation Council (GCC), formally called the Cooperation Council for the Arab States of the Gulf, was established in May 1981. The group was formed against the backdrop of a tense political situation in the region created by an Islamic revolution in Iran, the subsequent Iran–Iraq war, Egypt's decision to sign a peace treaty with Israel, and the Soviet invasion of Afghanistan. More than anything, all these events (setting aside any differences among them) accelerated the countries' decision to unite in pursuit of common security objectives. It is important to keep it in mind that, though the fruit of cooperation may be more visible in the economic sphere, the GCC was first and foremost conceived as a regional security alliance. While regional economic cooperation has often been initiated by political considerations, as was the case with the European Union (EU) and the Association of Southeast Asian Nations

[1] In 2011, Jordan's request for membership was received, while Morocco was invited to join. Although Yemen has also applied for membership, most experts believe that the country will not be admitted as a full member, given its republican form of government, large population, and low per capita income.

(ASEAN), the launch of the GCC is unique in that ensuring the survival of the existing monarchic regime appears to have been the primary motive.[2]

A high degree of homogeneity is evident across the member states. They are all monarchies with limited political participation, speak the same language, and share a common cultural and religious heritage. In these societies, tribal customs prevail where social bonds are based on loyalty to and dependence on the ruler. Appropriately, a large number of citizens are employed in the public sector as a way for the ruler to distribute wealth, while most private sector jobs are filled by expatriate workers. Citizens have become accustomed to subsidized consumption and short-range spending, made possible by oil wealth (Johar 1997). GCC states face similar economic challenges—gross domestic product (GDP) heavily derived from hydrocarbon-related activities, a large public sector, a need to diversify to create private sector employment as well as in anticipation of the eventual depletion of hydrocarbon reserves, and dependence on foreign countries for labor and basic food (to be more fully explained below).

Social tensions are no less daunting. With economic prosperity comes greater demand for political participation, and the monarchs are faced with an increasing challenge to their legitimacy. Pressure will likely intensify as the level of literacy among women has risen. In recent years there has been increasing democratization and political participation in Bahrain, Qatar, Oman, and Kuwait, where parliaments have been created (Kechichian 2004). While younger generations expect the continuation of the "rentier state," in which all services are guaranteed by the government, there is great uncertainty as to how long the current level of services can be maintained (Johar 1997). The high unemployment rates among local citizens in some countries could therefore translate into political discontent and turn into the kind of popular uprising seen in 2010–2011 in a number of neighboring countries. Virtually no two Gulf countries are free from territorial disputes with each other. To survive, each monarch must cooperate with counterparts in the region in maintaining regional political stability and ensuring that economic prosperity continues.

The GCC is a security alliance in economics' clothing, to paraphrase the apt expression that Buiter (2010) applied to the European Economic and Monetary Union (EMU). Though formation of the GCC was originally motivated by security and political considerations, it has achieved more in economic cooperation. Even the GCC Charter and the accompanying communiqué were silent on the question of security cooperation. Instead, the May 1981 establishment of the GCC was immediately followed by the Unified Economic Agreement (UEA) in June 1981. Twinam (1992) explains the GCC's reluctance to be explicit about security cooperation as stemming from a desire to be perceived abroad as a benign venture not hostile to anyone. Whatever the motive may be, the GCC has become primarily a machinery of economic cooperation. This sharply contrasts with ASEAN, where initiatives for deep economic integration in the form of an ASEAN free-trade area did not begin in earnest until after the organization had existed for more than 20 years.

The GCC Charter's preamble spells out the desire of GCC countries to "effect coordination, integration and interconnection between them in all fields." In more concrete language, the UEA, which was signed in November 1981 and came into force in March 1982, specifies that such economic cooperation should take place in six areas: (i) trade exchange, (ii) movement of capital and citizens and exercise of economic activities, (iii) development coordination, (iv) technical cooperation, (v) transport and communication, and (vi) financial and monetary

[2] The United Arab Emirates (UAE) alone is a federation of seven monarchies in which the president and vice-president are selected by and from the members of the Supreme Council of Rulers. In each state the king, sultan, or emir is selected by the members of a ruling family, and most cabinet ministers are also drawn from the ruling family.

cooperation.[3] In November 1982, the GCC heads of state agreed to begin implementing the UEA in stages, beginning from March 1983. The first action was the Intra-GCC Free Trade Area, whereby all GCC national products were exempted from customs duties. Optimism prevailed at the outset, so much so that in 1983 the GCC secretary-general stated that “by the end of the 1980s the Gulf will be one common market, with all the obligations and privileges which that step entails” (in Twinam 1992, 17). In the event, there was little progress during the first 20 years. It took 27 long years to launch a common market, which is still in the process of being completed through the enactment of requisite domestic statutes in all member states.

3. GOVERNANCE AND DECISION MAKING IN THE GULF COOPERATION COUNCIL

The GCC Charter stipulates the governance and decision-making framework. First, the Supreme Council is the highest decision-making body, composed of heads of member states; it meets regularly once a year, and the presidency rotates (Article 7). Each member has one vote. Resolutions of the Supreme Council require unanimity in “substantive matters” and majority vote in “procedural matters” (Article 9). To the Supreme Council is attached the Commission for Settlement of Disputes, which is formed to seek peaceful solutions to problems among member states, including dispute over the interpretation or implementation of the Charter (Article 10). The Supreme Council is to select the members of the commission for each dispute, with nominees drawn from member states other than those which are party to the issue at hand.

Second, the Ministerial Council is made up of foreign ministers or other delegated ministers. Every 3 months the presidency rotates and the council regularly meets. The Ministerial Council proposes policies, prepares recommendations, and manages the implementation of Supreme Council decisions. By acting as the intermediary between the Supreme Council and technical committees in all fields, it is the coordinator of all cooperative initiatives. It submits recommendations to the Supreme Council for decision and to the ministers concerned for action. As is the case with the Supreme Council, each member has one vote; resolutions require unanimity in “substantive matters” and majority vote in “procedural matters.”

Third, the Secretariat-General, consisting of a secretary-general, assistant secretaries-general, and staff, is the administrative body that prepares agendas for meetings and monitors the implementation of policies. The secretary-general is appointed by the Supreme Council for 3 years, renewable once. The secretary-general and those appointed to assist him are required to “carry out their duties in complete independence and for the common interests of the member states” (Article 16). “The Secretariat-General shall have a budget to which the member states shall contribute equal amounts” (Article 18). The Secretariat-General, based in Riyadh, is to provide staff to support the work of the council, but not to make decisions, as the executive and legislative powers of the council reside in the Supreme Council.

The accompanying rules of procedures allow the Supreme Council to form technical committees and select members. The May 1981 GCC summit established five ad hoc committees, whose members are the appropriate cabinet ministers of the member states, to pursue the Charter’s objectives in five areas: (i) social and economic planning, (ii) economic and financial cooperation, (iii) industrial cooperation, (iv) oil policy, and (v) social and cultural affairs. Subsequently, the GCC’s activities have expanded to other areas, including defense and

[3] The language was guarded with respect to monetary integration, which was expressed as “an endeavor to establish a common currency in order to further their desired economic integration.”

international security issues.[4] During the 1980s, however, the council was more preoccupied with the need for security coordination than with the tasks of economic integration, and little progress was made in economic cooperation (Twinam 1992).

Among the several spheres of cooperation, the machinery for financial and monetary cooperation is of particular interest to us. At the top of the hierarchy is the Committee for Financial and Economic Cooperation (henceforth, Financial and Economic Committee), as noted above, comprising the ministers of finance and economy. Another important institution is the Committee of the Governors of Monetary Agencies and Central Banks (henceforth, Central Bank Governors' Committee), which meets twice a year and reports to the Financial and Economic Committee. Assisting these are the deputy-level and other technical committees, which include the Banking Supervision Committee, the Payment Systems Committee, and the Training Committee.

To move toward establishing monetary union, in 2001 the Financial and Economic Committee and the Central Bank Governors' Committee created a high-level technical working group to discuss the modality of monetary and financial cooperation, including the preconditions for monetary union. Based on the work of this group, in 2002 the Supreme Council announced concrete steps to be followed in achieving monetary union (to be explained below). In the same year, moreover, the Supreme Council set up a monetary union unit at the Secretariat-General, though the unit's exact role with respect to intergovernment work is not clearly defined (Rutledge 2009). In 2009, the Monetary Council was established as a precursor to the GCC central bank, in accordance with the Monetary Union agreement signed by four of the six member states (Bahrain, Kuwait, Qatar, and Saudi Arabia).

The preceding discussion makes it clear that GCC economic cooperation so far has been driven by intergovernmentalism, which allows national sovereignty to be preserved. As a reflection of the unwillingness of member governments to surrender sovereignty, there exists no supranational institution with decision-making authority. The Commission for Settlement of Disputes, which is authorized when convened to make an interpretation of the Charter, is the closest the GCC gets to supranationalism. But even this institution is attached and subordinated to the Supreme Council, the ultimate seat of national sovereignty. The limitation of strict intergovernmentalism, however, is moderated somewhat by the stipulation of the Charter that a simple majority rule applies to procedural matters. The Monetary Council is a modest beginning of supranationalism, as members of the board of directors are at least legally shielded from any political influence in making decisions, though the rule of unanimity limits its supranational character. The smooth working of a common market or a monetary union requires an effective supranational body, but there is as yet no such body in the GCC.

4. ECONOMIC CHARACTERISTICS OF GULF COOPERATION COUNCIL COUNTRIES

Although GCC countries are homogeneous in many ways, there are also important differences. The GCC comprises a country of moderate size (Saudi Arabia, with a population of more than 26 million people in 2010) and five smaller ones. The population of the second-largest country, the United Arab Emirates (UAE), was less than 5 million people in 2010; the smallest, Bahrain, had fewer than 1 million people (Table 1). Similarly, the GDP of Saudi Arabia surpasses that of any other country—the Saudi economy produces nearly half of the total output of the GCC (of

[4] In November 1981, for example, the Supreme Council agreed to create a joint air defense system and to convene regular meetings of defense ministers. The first such meeting took place in January 1982.

about US$1 trillion in 2007). Saudi Arabia is, therefore, the dominant regional power and has indeed played the central role in establishing and developing regional cooperation in the GCC (Novati 1985). In per capita terms, Saudi Arabia (US$17,100 in 2010) is the poorest country in this otherwise wealthy group of countries, where the average per capita GDP was almost US$28,000 in 2010. The wealthiest country is Qatar (per capita GDP over US$84,000 in 2010), followed by the UAE (US$64,000).

Table 1: Main Economic Characteristics of GCC Countries

	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	UAE	GCC average or total
Population (mid-year 2010; in millions)	0.8	3.1	2.9	1.5	26.3	4.7	39.2
Nominal GDP (2010; in billions of US dollars)	22.7	132.6	57.9	127.3	448.4	302.0	1090.9
Per capita GDP (2010; in US dollars)	28025	43475	19897	84305	17082	64119	27801
Expatriate workers in total workforce (2006; in percent)	59	81	33	89	47	90	56
Rate of unemployment among nationals (estimates for various years, 2009-11) 1/	<4	3	12-13	2.4	10.5	3	---

Note: 1/ 2003 for Oman and the UAE (Rutledge 2009); for Dubai only, it is estimated at less than 1 percent in 2009 (MCA 2011).

Sources: International Monetary Fund, *International Financial Statistics* database; IMF (2011); MCA (2011); author's estimates.

A unique feature of GCC economies is the large share of expatriate workers in the labor force, which ranged from 33% in Oman to 90% in the UAE in 2006 (Table 1). Typically, expatriates are employed in the private sector, both as professionals and as menial workers, while nationals are employed in the large public sector. There is a serious job mismatch, which prevents the employment of nationals in segments of the private sector. For example, out of the approximately 7 million new jobs created in the GCC between 2000 and 2010, fewer than 2 million went to nationals (Middle East and Central Asia Department [MCA] of the International Monetary Fund 2011). Though the rate of unemployment does not appear to be high except in Oman and Saudi Arabia, it is in fact much higher among young people (e.g., as high as 25% in the 20–29 age group in Saudi Arabia [European Central Bank 2008]). GCC countries have relatively young and growing populations, so governments are under pressure to provide employment to an increasing number of new labor market entrants. While GCC nationals could more or less count on obtaining public sector jobs in the past, this is becoming increasingly difficult, given the already large size of the public sector.[5] The challenge is to provide the growing number of young people with appropriate educational opportunities to qualify for private sector jobs in nonhydrocarbon sectors. Unless the mismatch is resolved through education and training programs, the MCA (2011) suggests that there could be 2–3 million additional unemployed GCC citizens by 2015.

The economic activities of GCC countries are driven by the extraction of oil and gas, which is the single most important economic sector in all countries but Bahrain (where the finance sector

[5] It is difficult to quantify the size of public sector economic activity because the GCC countries do not provide transparent government finance statistics. Cash flow data provided by three countries (Bahrain, Kuwait, and Qatar) show that in 2009 government cash outlays ranged from 31% to 45% of GDP. This understates the size of public sector economic activity, given the dominant position of state-owned enterprises in the hydrocarbon sector.

is equally important). While Bahrain long ago ceased to export its modest crude oil production, it is still largely dependent on refining and other oil- and gas-related industries as well as services tied closely to the oil economies in surrounding countries. In GCC countries, the oil and gas sector accounts for 25%–60% of GDP, 40%–80% of total exports, and 45%–95% of government revenue (Table 2). But this situation is not sustainable in some countries. Oil and gas are expected to be depleted within a decade in Bahrain; in Oman oil will be depleted within two decades (in contrast, oil and gas will last for nearly a century or more at current production levels in Kuwait and the UAE). Given the high hydrocarbon dependency, the macroeconomic performance of GCC countries is highly sensitive to global oil and gas price developments. The GCC governments have been promoting diversification away from the public and hydrocarbon sectors so as to mitigate macroeconomic volatility, prepare the economies for the eventual depletion of hydrocarbon resources, and generate sufficient private sector employment.[6]

Table 2: The Oil and Gas Sector in GCC Countries

	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	UAE	GCC average or total
Proven oil reserves (2010; in percent of world total)	---	6.9	0.4	1,7	18.0	6.7	32.0
Expected life of oil reserves (2010; years)	---	120.3	19.9	94.8	88.8	115.3	94.8
Proven natural gas reserves (2010; in percent of world total)	---	0.9	0.3	13.1	4.2	3.2	21.7
Expected life of gas reserves (2010; years)	---	149.3	---	230.5	82.6	76.3	137.8
Hydrocarbon as a share of GDP (2010; in percent)	25.0	52.0	54.0	57.0	52.0	34.0	49.0
Hydrocarbon exports in total exports (2009; in percent)	58.8	71.9	63.8	64.3	79.1	40.6	61.7
Hydrocarbon revenue in total government revenue (2009; in percent)	74.2	93.8	77.9	44.9	85.1	69.3	78.6

Sources: OPEC (2011); MCA (2011); AMF (2011); author's estimates.

The GCC is a highly open region, with trade openness (measured as a ratio of exports plus imports to GDP) ranging between 80% and 140% in 2010 (Table 3). As noted, a predominant share of exports consists of hydrocarbon products, which are exported to consuming nations, mainly in Asia (whose share exceeds 40% of total exports). On the import side, GCC countries purchase almost all basic supplies, including foodstuffs, from Asia, Europe, North America, and around the world. Little intraregional trade takes place, reflecting these features of the trade structure. In 2010, for example, the share of intraregional trade in the GCC's total trade was only 6.0% (4.8% for exports and 8.5% for imports), though the share tends to be higher for smaller GCC countries. If oil is excluded, however, the intraregional share goes up considerably on the export side (16% for the region in 2003), with the share as high as 51% for Oman and 38% for Bahrain.

[6] The hydrocarbon sector is highly capital-intensive; it cannot be relied upon to generate sufficient employment.

Table 3: The External Sector in GCC Countries

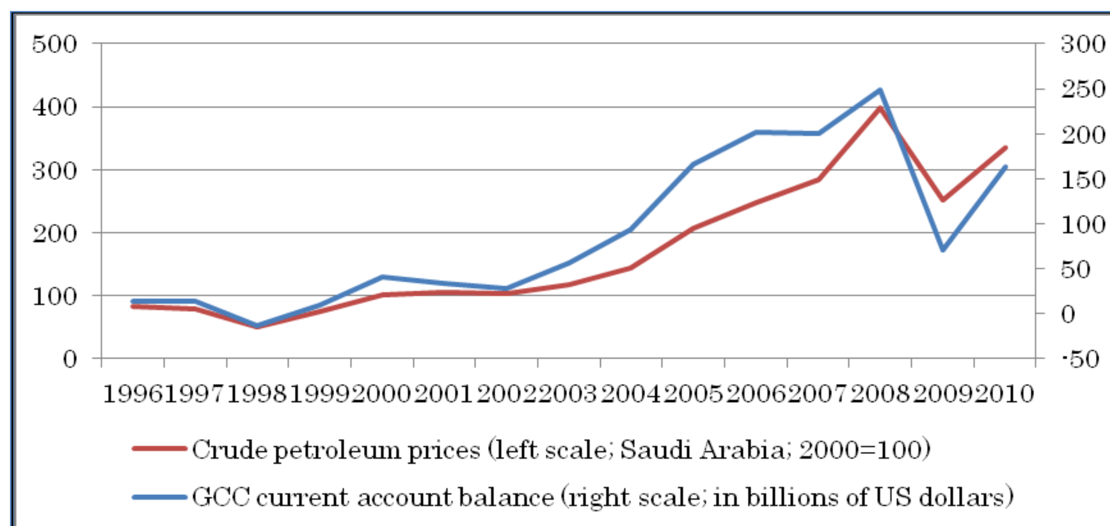
	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	UAE	GCC average or total
Trade openness (2010; percent of GDP)	140.1	81.0	108.5	93.6	98.0	141.7	108.9
Intra-GCC exports (2010; percent of total)	6.7	1.9	13.7	1.3	4.4	5.8	4.8
Intra-GCC imports (2010; percent of total)	28.1	11.7	31.9	16.7	4.3	5.3	8.5
Intra-GCC trade (2010; percent of total trade)	12.7	4.6	21.0	5.0	4.4	5.6	6.2
Non-oil exports to GCC (2003; percent of total)	37.5	5.4	50.9	9.7	20.0	15.8	16.3
Non-oil imports from GCC (2003; percent of total)	16.1	11.4	27.8	14.9	4.4	5.0	7.8

Sources: IMF (2011); International Monetary Fund, *Direction of Trade Statistics*; and Rutledge (2009).

The capital accounts of the GCC countries are open but some controls exist, especially on the purchase of local shares by nonresidents. Their protective attitude toward national industries is shown as controls on inward foreign direct investment (FDI) in the form of maximum foreign ownership. The governments give more favorable treatment to nationals from other GCC countries, but the complete lifting of remaining ownership restrictions is yet to be achieved. Even so, there is a fair amount of arbitrage across national financial markets within the GCC; there is also considerable intraregional investment, especially by Bahraini and Kuwaiti investors (Espinoza, Prasad, and Williams 2010). Equity markets have recently expanded throughout the region, though they differ significantly in size with financial services constituting a major segment of market capitalization. The financial system in the GCC is still dominated by commercial banks; though some governments issue bonds, the secondary markets for these instruments are virtually nonexistent.

As an important consequence of the hydrocarbon-dependent trade structure, the current account balance is highly subject to the volatility of petroleum prices (Figure 1). Although the GCC collectively registered a large current account surplus in the most recent decade as petroleum prices rose, this was not always the case—the GCC collectively was a current account deficit region during much of the 1990s. Although Qatar and the UAE maintained surpluses, Saudi Arabia had a deficit exceeding US$17 billion in 1992 (more than 15% of GDP) and 1993 (more than 11% of GDP) and Bahrain's deficit of US$800 million, while smaller in absolute value, amounted to more than 17% of GDP in 1992. In contrast, the mid-2000s saw these countries record large current account surpluses, reaching a peak of 38% of GDP in Qatar (in 2004), 28% in Saudi Arabia (2005), 45% in Kuwait (2006), 20% in the UAE (2007), and 15% in Bahrain (2007).

Figure 1: Petroleum Prices and the GCC Combined Current Account Balance



Notes: Because of missing data the UAE is excluded for 1999, 2000; the numbers for most years are derived from national income accounts for Qatar and the UAE.

Sources: International Monetary Fund, *International Financial Statistics* database; IMF (2011); author's estimates.

The volatility of petroleum prices affects not only the current account balance but also real economic activity and government fiscal balances (Table 4). When petroleum prices were generally depressed in the 1980s, the GCC as a whole experienced negative growth. For example, Saudi Arabia had negative growth of 1.7% per year through the decade, Kuwait had negative growth of 1.6%, and Qatar and the UAE hardly grew. Growth performance was more favorable in the 1990s but it was not good enough to raise the per capita income significantly where population growth was high. It was only after the turn of the 21st century that growth picked up, along with a surge in oil prices, and the region uniformly recorded strong positive growth. In particular, Qatar registered annual growth of more than 10% during 2000–2010; performance in the other countries was somewhat less impressive.

Table 4: GDP Growth and Fiscal Balance in GCC Countries

	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	UAE
	Real GDP growth (percent per year)					
1980-89 average	3.9	-1.6	7.5	0.3	-1.7	0.0
1990-99 average	4.9	2.5	4.9	5.2	3.1	5.4
2000-08 average	6.2	5.9	5.8	11.7	3.8	7.6
2009	3.1	-5.2	1.1	12.0	0.1	-3.2
2010	4.1	3.4	4.1	16.6	4.1	3.2
	Fiscal balance (percent of GDP)					
1980-89 average	1.4	-4.3	-8.7	-2.8	-7.4	-4.3
1990-99 average	-3.0	-9.0	-7.6	-6.5	-7.1	-9.8
2000-08 average 1/	0.7	27.3	7.1	10.4	13.2	17.3
2009	-6.6	26.7	-1.2	15.3	-4.6	-12.6
2010	-7.8	22.6	5.0	2.9	6.7	-1.1

Note: 1/ 2002-08 for Qatar and the UAE; 2000 and 2002-08 for Saudi Arabia.

Sources: Rutledge (2009) for 1980-99; International Monetary Fund, *International Financial Statistics database*; IMF (2006, 2011); and author's estimates.

A similar picture is observed for the fiscal balances of GCC countries. Especially in the 1990s, all had serious budgetary problems, with the UAE recording a deficit equivalent to nearly 10% of GDP (not to mention the fiscal challenge experienced by Kuwait in the aftermath of the Gulf War). In contrast, the fiscal balance improved significantly in all countries in the 2000s, each showing a turnaround equivalent to 4%–30% of GDP from 1990–1999 to 2000–2008 (but fiscal performance was mixed for 2009–2010 following the global financial crisis). It is significant to note that the political push for economic cooperation was strengthened whenever oil prices fell and economic performance deteriorated. The establishment of the GCC itself coincided with the ending of the boom years of the 1970s. Rutledge (2009) argues that the far-reaching economic integration plans set out in the 2001 Economic Agreement (to be explained below) were in part a response to the lackluster economic performance of the previous two decades. As oil prices began to surge in 2002, the momentum for regional economic cooperation appears to have subsided somewhat.

5. INSTITUTIONAL ACHIEVEMENTS IN ECONOMIC COOPERATION

Chapter 1 of the Unified Economic Agreement (UEA), under "trade exchange," called for a common market with the elimination of tariffs among the member states (Article 2) and the establishment of a uniform external tariff (Article 4). Custom duties on GCC-origin imports were for the most part eliminated from 1 March 1983, but this was of little consequence given the small volume of intraregional trade. Chapter 2, under "movement of capital, citizens, and exercise of economic activities," required member states to grant equal treatment to the citizens of all other member states with respect to the freedom to move, work, live, own, engage in economic activity, and transfer capital. But the goal of creating the common market by the end of the 1980s was hampered by the difficulty in establishing the requisite executive rules. Local interests remained an obstacle to achieving integration (Twinam 1992). The Gulf Investment Corporation (GIC) was created in November 1982, with capital of US$2.1 billion contributed equally by the member governments. The GIC was conceived as a means of bringing the promise of Gulf union into business communities in a tangible way (Twinam 1992), but the scale of operation has been too small to make a difference in promoting regional integration.[7]

After almost 20 years of little progress, but responding to the lackluster economic performance of the 1990s, agreement was finally reached in 1999 to accelerate the pace of economic integration by establishing a customs union by 2005 (the date would later be brought forward to 2003). In December 2001, moreover, the UEA was substantially revised to expedite the process of economic and monetary union. It was under this agreement, called the Economic Agreement between the GCC States, that the targeted completion of the customs union was brought forward to January 2003. The customs union, which did come into force as scheduled, would involve an external common tariff of 5% on foreign imports (except for such items as basic food, medical supplies, and intermediate goods), abolition of prior approval requirements for importing goods into any of the GCC states, and single customs declaration. At the same time, the Supreme Council agreed to establish implementation guidelines, including convergence criteria

[7] The GIC is a financial institution operating on commercial principles with the mandate to promote private enterprise by investing in projects that contribute to the social and economic development of the GCC. According to its annual report, total assets were US$5.8 billion at the end of 2010.

for monetary union by 2005, completing the common market by 2007, and adopting a single currency by 2010.

The revised 2001 Economic Agreement explicitly states the goal of "[achieving] advanced stages of economic integration that would lead to a common Market and an Economic and Monetary Union among Member States according to a specific timetable." The areas of cooperation are also broader than under the 1981 agreement and include trade; a GCC common market; economic and monetary union; development integration; human resources development; scientific and technical research; and transportation, communication, and infrastructure. The same Supreme Council meeting that approved the Economic Agreement instructed the monetary agencies and central banks to implement its decision to use the US dollar as the common anchor for pegging the currencies of GCC states before the end of 2002,[8] in preparation for the introduction of the single currency "not later than 1 January 2010." A common dollar peg had been conceived as the first stage of the monetary unification process by a joint technical committee of finance ministries and central banks.[9]

Progress since has been substantive, beginning with the formation of the customs union in January 2003, but not without setbacks. In October 2006 Oman announced that it would not join the GCC monetary union by 2010, and in May 2009 the UAE also withdrew from the single currency project, ostensibly because of disagreement over the location of the proposed regional central bank in Riyadh. In May 2007, Kuwait, faced with inflationary pressure arising from a weakening dollar, declared that it would be moving from the dollar peg to an undisclosed currency basket peg, while reaffirming its commitment to join the union as planned. In a possible violation of the Economic Agreement,[10] Bahrain and Oman separately negotiated and then concluded (in 2004 for Bahrain and 2006 for Oman) free-trade agreements with the United States. Nevertheless, after some delay, the GCC common market was formally launched in January 2008, though the implementation is yet to be completed. Harmonization and mutual recognition of national standards, among other things, must be established to complete both the customs union and the common market.[11]

In the event, the goal of introducing a single currency by 2010 was not achieved, however it is far from abandoned. In 2007, the GCC countries agreed to five convergence criteria:

1. the inflation rate shall not exceed the weighted average inflation rate of the member countries (weighted by GDP) by more than 2%,
2. the interest rate shall not exceed the average of the lowest three rates (3-month interbank rates) by more than 2%,

[8] At this time all currencies except for the Kuwaiti dinar had already been pegged to the US dollar. The Kuwaiti dinar had been managed with respect to a basket of currencies in which the weight of the dollar was believed to be substantial. As the Kuwaiti authorities began to peg the dinar to the US dollar, however, they maintained a relatively wide margin of 3.5% on either side of parity.

[9] The technical committee had recommended that the process should proceed in two stages: (i) GCC currencies be pegged to the US dollar, and (ii) convergence to common economic criteria be achieved progressively during the 5 years from 2003.

[10] Article 2, under international economic relations, stipulates that member states "collectively conclude economic agreements with trading partners," while Article 31 states: "No Member State may grant to a non-Member State any preferential treatment exceeding that granted herein to Member States, nor conclude any agreement that violates provisions of this agreement." The UAE also negotiated but did not conclude a free-trade agreement with the United States.

[11] Differences have delayed agreement on how to introduce a permanent system to distribute customs receipts among the six member states. According to the 8 May 2011 issue of the *Khaleej Times* (a UAE newspaper), the UAE minister of state for financial affairs stated in a press conference that all outstanding issues were to be resolved by 2015 to make the customs union fully operational. Even if this is true, it means that the completion of the common market will be later than 2015.

3. foreign reserves shall be sufficient to cover at least 4 months of imports,
4. the public budget deficit–GDP ratio shall not exceed 3% as long as the average oil price is equal to or above US$25,[12] and
5. the public debt–GDP ratio shall not exceed 60% for the general government and 70% for the central government (Al Faris 2010; Khan 2010).

These are almost identical to the EU's Maastricht criteria, except for the addition of foreign reserve adequacy.[13] There is uncertainty as to how binding they are as entry conditions (as opposed to simple monitoring devices). There are also serious questions about the quality and compatibility of national economic data even when they are disclosed (Al Faris 2010).[14] To the extent that the data were credible and compatible across countries, all countries, including Oman and the UAE, are said to have met the criteria except for inflation convergence at the end of 2008 (Al Faris 2010).[15]

In June 2009, the foreign ministers of Bahrain, Kuwait, Qatar, and Saudi Arabia signed the Monetary Union Agreement and the accompanying Basic Statute of the Monetary Council, a precursor to the GCC central bank. The Monetary Union Agreement explicitly declares that "a monetary union shall be established," and calls for the development of the requisite financial infrastructure, including payment and settlement systems, statistical systems, and the adoption of uniform banking regulation and supervisory rules. The role of the Monetary Council, as a precursor to the GCC central bank, is to prepare such infrastructure, formulate rules of policy coordination, monitor compliance with the convergence criteria, and recommend necessary legislation for the establishment of the central bank and the introduction of banknotes and coins. The Monetary Union Agreement guarantees independence for the central bank when it is eventually established.

The Monetary Council consists of the board of directors and the executive body. The membership of the board of directors is composed of the governors of the national central banks, who meet at least six times a year. Each board member has a single vote. The executive body, consisting of an executive president and senior executive staff, is responsible for preparing studies, monitoring the implementation of board recommendations, and preparing rules and directives. National central banks equally share the administrative costs. Independence is assured by the statute, which states: "Neither the Monetary Council nor any member of its Board of Directors or Executive Body shall receive instructions from any GCC bodies or any governments of member states or any other entities" (Article 7). Yet, decisions of the board require unanimity in "objective matters" and absolute majority in "criminal matters" (Article 10). This means that, despite the pretense of independence, the Monetary Council has limited utility as a supranational institution. The requirement of unanimity in objective matters is a hallmark of intergovernmentalism and only indicates the unwillingness of GCC countries to surrender their national sovereignty.

[12] If the average oil price falls below US$25 (per OPEC Reference Basket) the deficit is allowed to rise above 3% in proportion to the price difference, as stipulated by a prescribed formula.

[13] Some experts believe that this is to make sure that Yemen, if ever it is allowed to join the GCC, is kept out of the single currency.

[14] Some GCC governments do not release price and fiscal data to the public in a transparent and timely manner.

[15] While GCC countries generally maintained small foreign exchange reserves (less than 4 months of imports in the case of Bahrain), this criterion is largely irrelevant because they hold large net foreign assets, though not as liquid reserves (Al Faris 2010). The ECB estimated that GCC governments held up to US$1.5 trillion worth of financial assets in their sovereign wealth or other similar investment funds (ECB 2008).

6. WHAT THE FUTURE HOLDS

Several studies have applied standard optimum currency area (OCA) criteria to discuss the pros and cons of monetary unification in the GCC (e.g., Jadresic 2002). Limited intraregional trade, low intraregional factor mobility, and the lack of transparency and regional political institutions argue against monetary union (Buiter 2010; Al Faris 2010).[16] On the other hand, small size and the commonality of production structure are factors more favorable to establishing monetary union.[17] Though not conclusive, most empirical studies suggest that GCC countries typically face symmetric shocks, likely reflecting their heavy hydrocarbon dependence (see, for example, Al-Hassan 2009 and Rafiq 2011).[18] Increasing macroeconomic interdependence is indicated by Suliman (2011), who shows the pivotal role of Saudi Arabia in propagating shocks across the region based on data from 1987–2002.

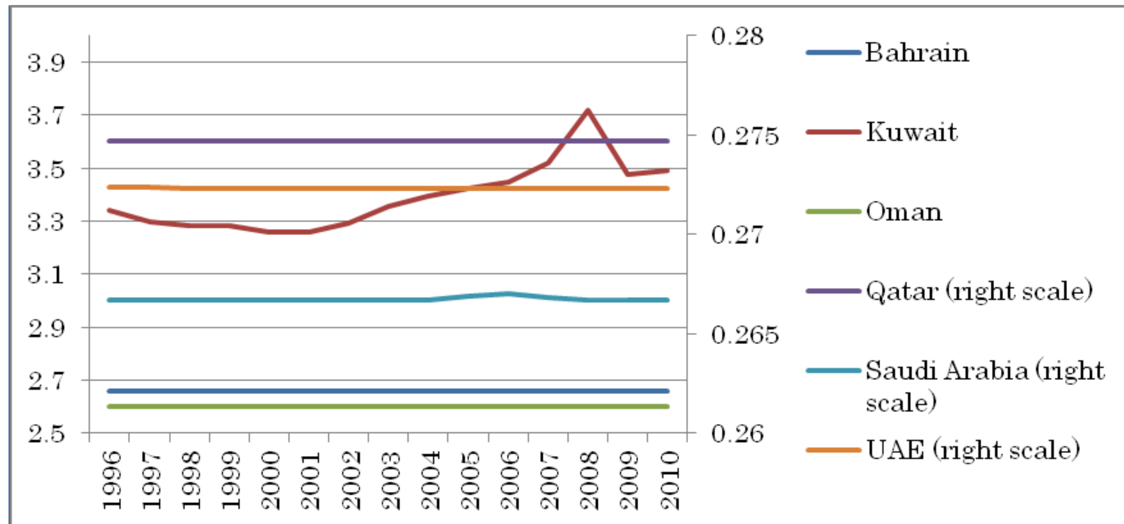
There are other OCA considerations, such as financial integration, labor market flexibility, and the presence or absence of a fiscal transfer mechanism, but the literature only suggests that there are likely to be both costs and benefits of monetary unification without offering judgment about the relative magnitude of each (Rutledge 2009). This is to be expected. On balance, the consensus view appears to be that both the costs and the benefits of monetary union in the GCC are small (Buiter 2010). This view reflects not only OCA considerations but also the observation that the GCC has practically lived with a common currency over the past several decades. Except for Kuwait, the countries have pegged the nominal values of their currencies to the US dollar since the 1970s (de facto or de jure, at rates unchanged at least since the mid-1980s). Even the Kuwaiti dinar has remained fairly stable with respect to the dollar (and hence to the other five currencies), fluctuating between US$3.26 and US$3.72 dollars per dinar (or a margin of less than 15%) during 1996–2010 (Figure 2).

[16] These characteristics are believed to reduce the transactions cost savings from a common currency (in the case of limited intraregional trade), increase the costs of adjustment when the exchange rate is irrevocably fixed (in the case of low intraregional factor mobility), and impair the accountability of a regional central bank (in the case of lack of transparency and regional political institutions).

[17] This is because (i) the utility of money and the scope for risk sharing increase in a larger economic area and the costs of giving up exchange rate adjustment is smaller for a price taker who cannot use the exchange rate to affect the terms of trade, and (ii) the likely predominance of symmetric shocks reduces the costs of giving up independent monetary policy.

[18] Al-Hassan (2009) used sector data for 1980–2007 to show that as few as three common shocks explained business cycle developments for the GCC area; similarly, based on GDP data for 1980–2005, Rafiq (2011) shows that the synchronization of output growth fluctuations between the GCC countries increased over time, and that a good portion of business cycle fluctuations were driven by common shocks.

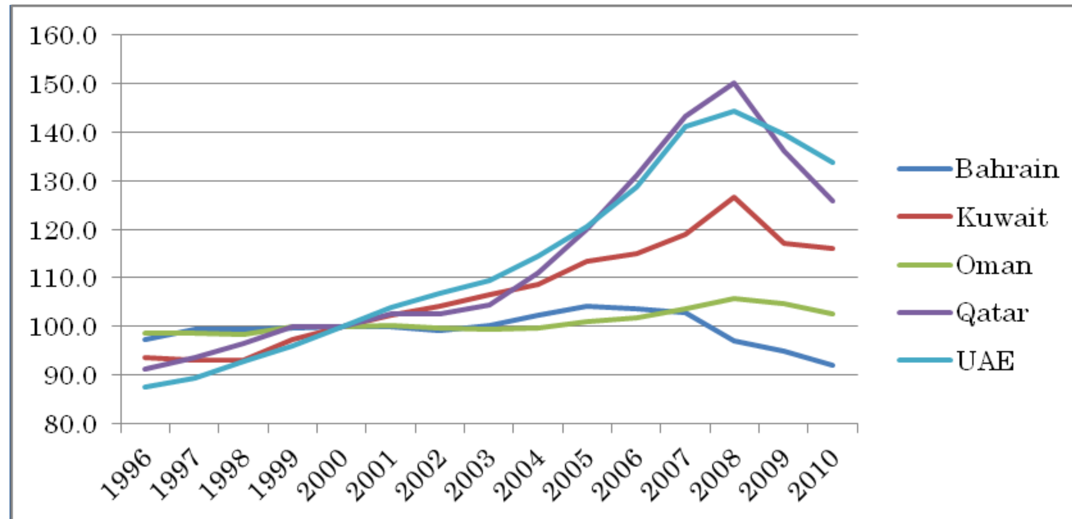
Figure 2: GCC Exchange Rates (US dollars per national currency; annual averages)



Source: International Monetary Fund, *International Financial Statistics* database.

If any additional costs of moving from a dollar peg to a single currency are small, GCC countries have already been paying for any costs of giving up nominal exchange rate adjustment across countries within the region. Such costs may not be negligible. From 1996 to 2008, for example, both the UAE dirham and the Qatari riyal appreciated against the Saudi riyal in real terms by as much as 65% each, and the Kuwaiti dinar appreciated by 35%, although the Omani rial and the Bahraini dinar each had a maximum divergence of less than 10% (Figure 3). This means that price developments have been quite diverse among the GCC countries, putting pressure on resource flows across national borders. The lack of significant intraregional trade certainly has mitigated the pressure, as has the heavy use of expatriate workers that introduces labor market flexibility in a country with a large public sector (Willett et al. 2010; Buiter 2010). With the oil wealth, moreover, the governments have been able to bear any costs that come from the lack of exchange rate flexibility against the currencies of their neighbors as well as against those of their major trading partners. As noted, large sustained fiscal deficits when hit by adverse external shocks are the flip side of the ability of GCC countries to pay for the costs of maintaining a fixed exchange rate.

Figure 3: Real Exchange Rate Movements of GCC Currencies against the Saudi Riyal



Note: An increase in the index denotes a real appreciation against the riyal in terms of consumer prices; 2000=100)

Sources: International Monetary Fund, *International Financial Statistics* database; IMF (2011); Arab Monetary Fund, http://amf.org.ae; author's estimates.

From this standpoint, whether or not the GCC satisfies the OCA criteria is not so useful to the political choice of exchange rate regime by a group of wealthy countries bound by a common security objective. A political decision has already been made by some GCC member states to introduce a single currency among them, and they have the resources to pay for any costs associated with it. In this respect, the Maastricht-type convergence criteria make little sense, except perhaps as a device to keep some unwelcome potential candidates out.[19] The EMU convergence criteria were a "rite of passage" and, except for the fiscal and debt criteria, had little basis in economic theory; they should therefore have offered nothing useful to the GCC as a precondition for participation (De Grauwe 2010). The inflation criterion (the only benchmark not yet met by all countries) is even problematic and could become an obstacle when the countries are politically ready to introduce the common currency. Given a tight peg to the US dollar, no country other than Kuwait has an independent policy tool to control inflation; yet, the GCC as a region has experienced significant relative price changes over the years and may continue to do so.

Economic theory is more useful in anticipating what the future may hold for the GCC monetary union. As countries are successful in diversifying production, especially at different speeds and in different directions, they are bound to experience structural changes, and divergent relative price movements could intensify across the region. There is an old debate in the context of European integration as to whether a common currency (the ultimate form of a single market) would yield a convergence in output movements. If economic integration leads to greater specialization it could result in weaker output synchronization (Krugman 1993); if, on the other hand, the direct trade channel dominates (such that a positive output shock in one country is transmitted as a positive demand shock across borders), there is a presumption that output synchronization would increase with economic integration (Frankel and Rose 1998). In the case of the GCC, which is starting with a nearly identical production structure and the virtual absence

[19] This is especially true of the foreign exchange reserve adequacy criterion, given the massive financial assets of the GCC governments (even if not in the form of liquid foreign exchange reserves).

of intraregional trade, one could with some confidence predict that output and relative price movements could only diverge.

Economic reasoning is more relevant to the long-run sustainability of monetary union than the ability of GCC countries to adopt a single currency in the near future. Are the individual countries willing to give up independent monetary policy, given the prospect of asymmetric output movements? Can the single currency stand the pressure of significant relative price changes on resource flows, if the monetary union indeed succeeds in promoting greater intraregional trade? Can the region continue to count on the oil wealth to weather the impact of adverse shocks, as it has done in the past in maintaining a peg to the US dollar? Can it continue to use expatriate workers as a shock absorber if the governments succeed in replacing them with the rising generation of nationals? The irony of GCC monetary union is that long-run success—in economic diversification, regional integration, and private sector development for the local population—could end up creating a seed of self-destruction.

These considerations underscore the need to build strong institutions as the GCC moves toward establishing monetary union. De Grauwe (2010) notes that in Europe political and institutional integration preceded monetary unification. When the euro was launched, there already existed regional institutions that could take decisions with a qualified majority, accompanied by a well-established culture of cooperation among senior national policy makers. The absence of a supranational political institution in the GCC could undermine the accountability of the regional central bank (Buiter 2010), especially when member countries do not disclose critical economic and fiscal data in a transparent and timely manner. Decision by fiat at the level of the Supreme Council can only go so far. The recent debt crisis has made it clear that, even in Europe, the coordination of fiscal, regulatory, and structural policies at the regional level was inadequate for a common currency. GCC countries must use the single currency project as an opportunity to build strong supranational institutions, including transparent mechanisms of surveillance and policy coordination (possibly by building upon the global mechanism offered by the International Monetary Fund, if not by creating an entirely separate mechanism), to make sure that the single currency, when introduced, is durable to the benefit of all.

7. CONCLUSION: WHAT LESSONS FOR REGIONAL ECONOMIC COOPERATION?

This paper has reviewed the experience of regional economic cooperation in the GCC, from the early 1980s to the present. Political calculation and bureaucratic capacity has dictated the way the GCC has evolved over time. The GCC was first and foremost conceived as a regional security alliance, but only limited progress has been achieved in military and political cooperation. This is easily understood in the context of independent sovereigns who have differing views and preferences. Given the lack of explicit progress in security cooperation, the GCC was quickly transformed into a framework in which mutual security is enhanced through economic cooperation. Even so, little was initially achieved in this area as well. It took the GCC nearly two decades of depressed oil prices and lackluster economic performance to renew its commitment to promoting regional economic integration, but then the surge in oil prices weakened its resolve during the latter half of the 2000s. Though the common market was finally "launched" in January 2008, national vested interests and bureaucratic capacity have so far delayed the enactment of various national statutes necessary to allow the truly uninhibited movement of goods, services, capital, and labor.

The GCC is a common market in the making, and this is where the GCC appears to be most comfortable. All GCC countries participate in the common market project; Morocco and Jordan

may also some day participate.[20] But to go beyond the common market is an exercise that requires the greater surrender of sovereignty than some governments are willing to accept. Given what has so far been achieved, and in view of the public statements of political leaders, it is almost certain that a common currency will be introduced in the future. But the introduction of a single currency, officially targeted for 2010, was not achieved as scheduled. Oman and the UAE have officially withdrawn from the common currency project, at least for now. Kuwait has returned to a basket peg after briefly complying with the requirements to peg its currency to the US dollar, a step agreed upon in 2003 that would lead up to monetary union. The ongoing fiscal crises in the euro area, moreover, may also have prompted the GCC leaders to reassess the timing of introducing the single currency.[21] This only highlights the fact that the GCC is not the same as the GCC Monetary Union, nor should the success of the GCC be judged solely on the basis of how many member states end up participating in the single currency.

From the standpoint of Asia, the contrast is striking (Table 5).[22] Whereas Asia is diverse in terms of language, culture, political philosophy, stage of development, and per capita income, the GCC is a highly homogeneous group of countries. In Asia it has been a slow and difficult process to form consensus on regional cooperation, but agreement collectively to promote economic integration was reached rather quickly by the heads of state of the six Gulf countries. While the possibility of a single currency for Asia is only a dream held by a few, it was part of the vision unanimously upheld by the GCC from the inception, nearly a decade before the successful launch of the euro. Asia started with a mutual financing arrangement in the form of the Chiang Mai Initiative (followed by its multilateralization). Building on the experience gained from the Economic Review and Policy Dialogue process, Asia is now developing a mechanism of regional mutual surveillance in the form of the ASEAN+3 (footnote 22) Macroeconomic Research Office. In contrast, the GCC even at this advanced stage of financial cooperation, has no such institutional mechanisms.[23] In Asia, market-driven economic integration has created pressure to build institutions to deal with its consequences. In the GCC, a political decision to promote economic integration came first. Now a common market, it is yet to see the kind of economic integration already experienced in Asia.

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[20] Although Yemen now participates in the work of some GCC councils and agencies (such as the GCC Standardization Authority, GCC Council of Health Ministers, and the GCC Education and Training Bureau), resistance is said to be strong to its admittance as a full member. Simulation based on the IMF's Global Economy Model, however, shows that the inclusion of Yemen could produce large economic benefits for both Yemen and the GCC countries, amounting to an increase in GDP of as much as 14%–18% for Yemen and 7%–20% for GCC countries in the long run (Chami, Elekdag, and Tchakarov 2004). The benefits largely accrue from greater competition and efficiency in the goods market of Yemen and in the labor markets of GCC countries.

[21] This is appropriate. An important issue to sort out at this stage is whether the mandate of the regional central bank should narrowly focus on price stability, as currently envisioned, or should it include financial system stability and even the role explicitly as the regional safety net in the event of a sovereign debt crisis.

[22] Asia here means ASEAN+3, which consists of the 10 ASEAN member countries (Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Viet Nam) plus the People's Republic of China, Japan, and the Republic of Korea. In this framework the case of the European Union (the euro zone in particular) appears to fall somewhere between the GCC and Asia in almost all categories. In Europe, political consensus, economic outcome, and institution building developed side by side, reinforcing each other over time.

[23] Though the Arab Monetary Fund exists as a pan-Arab institution to which all GCC countries belong, given the political and economic realities of the Arab world it has remained dormant as a vehicle of monetary cooperation (Kawai and Takagi 2005).

Table 5: Regional Economic Cooperation, GCC vs. Asia

	GCC	ASEAN+3
Political philosophy, stage of economic development, per capita income	Homogeneous	Diverse
Consensus on economic cooperation	Agreement reached quickly	Process slow
Single currency	Goal from inception	A dream held by few
Mutual financial support	None	Evolving (from CMI to CMIM)
Regional surveillance	None	Evolving (PRPD/AMRO)
Economic integration outcome	Yet to occur, institution building came first	Market-driven, pressure for institution building
Sequence	Politics before economics	Economics before politics

Source: Author

If Asian integration can be characterized as strong in economic outcome but weak in political will, the opposite is true with the GCC. But the contrast stops here. The reason that three decades of cooperation efforts have yielded so little by way of integration outcome in the GCC is the unwillingness of member states to surrender sovereignty to regional institutions. Unlike the EU, where the member states have gradually surrendered parts of sovereignty to pan-European institutions (though the recent crisis proved the process far from complete), the GCC has no regional decision-making body: decision-making authority rests solely with the six monarchs, where the rule of unanimity applies. Concentration of power, especially given the dominant leadership of Saudi Arabia as the single largest entity, did sometimes make decision making quick and efficient. At the same time, sovereignty is the very raison d'être of a monarch. Surrender of national sovereignty is not easy for any country or region, but it is especially difficult to believe that, in the GCC, the heads of state will make a voluntary decision that will undermine their own existence, unless their survival itself depends on it. The political underpinning for economic cooperation is therefore not to be taken for granted, even in the GCC. The case is no different from Asia.[24]

Perhaps the single most important lesson of the GCC experience for regional economic cooperation is that political will and leadership alone is not a sufficient condition for success to be achieved quickly. This of course is not meant to minimize the importance of political will as a critical ingredient of successful regional cooperation efforts. But even with a strong political will, the process of institution building for regional economic cooperation has been a slow process in the GCC. The goal of economic integration—not to mention the ultimate goal of monetary union—has not yet been achieved after more than 30 years of cooperative efforts following the signing of the GCC Charter by the six monarchs in 1981. The lack of human capital has certainly been a constraining factor, but also lacking has been broad public support,

[24] The reluctance of ASEAN countries to surrender national sovereignty in pursuit of regional integration instead comes from the colonial experience of some of them. (I owe this insight to Chalongphob Sussangkarn.)

accompanied by the sense of ownership in the project among the common people, which is essential to the sharing of certain national privileges with foreigners. Successful regional institution building presupposes the gradual surrender of sovereignty, so that certain decisions can be made at the regional level according to a prescribed set of rules. To receive the requisite public support, moreover, calls for a high degree of transparency and accountability in the operation of regional institutions. At present, the GCC countries do not even provide critical economic data of sufficient quality and timeliness.

Transparency is the area of critical weakness in the GCC integration process. As long as the GCC remains a "monarchs' club,"[25] no significant surrender of sovereignty could be expected. But the successful operation of a single currency will require the ultimate surrender of national sovereignty in key macroeconomic policy areas. GCC countries have in the past used their massive oil wealth to pay for the costs of maintaining a fixed exchange rate regime, but the costs could rise and capacity decline even as oil and gas reserves are depleted in some countries. Success could ironically create a seed of self-destruction—economic diversification, intraregional trade expansion, and private sector development could at times cause the pressure of divergent relative price developments to intensify on cross-border resource flows. To cope with these and other challenges of managing a common currency, GCC countries must develop robust regional mechanisms of surveillance, policy coordination, mutual financial assistance, and fiscal transfers, for which the current "one country, one vote" principle of decision making may have to yield to a system of weighted voting commensurate with the economic size and resources of each country. Without an effective supranational institution authorized to make decisions when disputes occur, no smooth operation of a customs union or common market, let alone an economic and monetary union, can be expected. Are the monarchs willing to surrender more of their sovereignty to make this possible? This is the same as asking if the single currency will be successful in the GCC.

[25] This was expressed in a private conversation to the author by Mohsin Khan of the Peterson Institute.

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