Long road ahead for GCC single currency

At a regional finance ministers and central bank governors meeting over the weekend, officials revealed plans to establish a monetary council by January that would serve as a transition body for the GCC Central Bank in expectation of the single Gulf currency. They indicated the four states involved in the project were under pressure to ratify a monetary union agreement before an annual summit of Gulf Arab leaders in December.

While the comments come as a show of support for the beleaguered project to create a European Union-style single currency, in our view momentum behind the project is still weak and we believe it could take four to five years before a single currency comes into circulation.

We regard divergence of views among GCC, or Gulf Cooperation Council, states as a key factor holding back currency union. Institutional capacity building is also a prerequisite which needs to be addressed.

Building the institutions

Saudi Arabia was the first GCC state to ratify the monetary union deal while the other three states – Kuwait, Qatar and Bahrain – are likely to do so in the coming months. This is likely to happen prior to the annual summit of Gulf heads of state in December.

Once the ratification process is complete, the four countries will establish a monetary council that would act much like the European Monetary Institute (EMI) that preceded the European Central Bank (ECB). The purpose of the EMI was to encourage cooperation between the national banks of EU member states. Upon creation of the ECB, the EMI was dissolved – similar to the process envisioned by the GCC.

The Gulf monetary council would be governed by a board of directors comprising the central bank governors of member states and would be charged with developing a new timetable for issuing a single currency. It is also likely to appoint an independent executive director to help guide the project. The candidates for this role and their respective nationalities will provide insight into the backstage politics that characterise the GCC.

Gulf Arab economies by size in 2008

Source: Official data of respective countries
Having the monetary council in place will be pivotal in pushing forward currency union. The body would hold meetings more frequently to streamline decision-making, although questions remain about how much monetary policy-setting powers the council would have. We view this as an important issue that demands further clarification. According to some indications, only the fully fledged Gulf central bank would be able to make decisions on monetary policy.

Obstacles remain, but much has been done

A lot of work remains before a Gulf monetary union can reach fruition, especially following its shaky history. In 2001, the six member states of the GCC, which also includes the United Arab Emirates and Oman, agreed to set up a monetary union like that of the European Union. According to the plan, the Gulf currency would be issued on January 1, 2010.

But the project was fraught with delays and eventually Oman dropped out of the plan in 2006. In March, the GCC abandoned an initial 2010 deadline for issuing common notes and coins. It said a monetary council would determine a new timetable for the issuance.

The UAE, the region’s second-largest economy, then dealt the biggest blow to the project to date when it withdrew from the plan in May in protest of the decision to base the regional central bank in Riyadh rather than Abu Dhabi. Without the UAE, Saudi Arabia’s economy accounts for 63% of the currency union area, up from 47% prior to the UAE pullout.

We think that for any union to be established, compromise is the name of the game. Still, Saudi Arabia’s role at this juncture is instrumental in driving the project forward. It is natural for Saudi Arabia to lead the process, due to its sheer economic presence, accounting for 44% of overall Gulf GDP in 2008 and 63% of the total population, according to official 2007 data. Saudi Arabia has deep institutional memory, experience and technical know-how to support the project, but losing key member states could weaken any union that does emerge.

The remaining countries have rallied their support behind the plan since the UAE pullout and we believe that, at least for the medium-term, political support to push ahead remains strong. We also continue to think that the UAE’s participation in the future is plausible.

Steps towards regional integration

A single currency is expected to encourage further trade and financial integration, facilitate foreign direct investment, and foster the development of the GCC into an optimum currency area ex post even if the GCC grouping may not constitute one ex ante.

GCC countries have achieved virtually unrestricted intraregional mobility of goods, national labour and capital. Prudential regulations and supervision of the banking sector are being gradually harmonized. Intra-GCC imports have more than tripled in size over the past 15 years, although their share in the overall imports remained steady and low at less than 9%.

One could argue that GCC states have already fulfilled many of the preconditions for a currency union: they are mainly oil exporters (with the exception of Bahrain); are very open to trade and imported labour; have flexible labour markets in which even nominal wages can adjust; and have complete factor mobility within the GCC. Furthermore, they all have full convertibility.

But a great deal of work remains to prepare for the common currency and the creation of a common, independent central bank. Monetary policy frameworks, payment and settlement systems, regulatory and supervisory structures, macroeconomic statistics, and other specific central bank functions have yet to be fully harmonized.
Furthermore, Gulf countries have yet to agree on the management of reserves and non-reserve assets, and on the fiscal side, setting up a common accounting framework and adequate budgetary procedures would be a high priority in the period leading up to the currency’s introduction.

Complete implementation of the Gulf common market, meanwhile, is crucial. The common market – which includes freedom of movement in labour, capital and goods and services – requires the adoption of a series of national laws. Toward this end, the GCC Secretariat, based in Riyadh, has developed dispute resolution mechanisms, including a common market committee, a ministerial level committee, and an arbitration centre in Bahrain, and plans are underway to create a supranational court.

**Keeping currency union on track**

To keep the currency project on track, we believe the monetary council should push to launch the accounting unit of the single currency by the end of next year. This essentially means that the bloc would determine the individual exchange rate parities of each Gulf currency, marking the launch of an electronic currency much like the European Currency Unit which preceded the euro.

In our view, once the accounting unit is unveiled it will become less likely that another state – particularly Qatar – would pull out of the project. Between the end of 2010 and 2014-2015, the monetary council and central bank could then arrange for the design and distribution of the common notes and coins.

Chairing the monetary council next year will be the Kuwaiti central bank governor, who has defended his own country’s decision to sever its dinar’s peg to the U.S. dollar in favour of a basket of currencies comprised mainly of dollars. The region’s other oil exporters maintain currency pegs to the dollar. In our view, the region is unlikely to move away from the dollar in the short and medium term. The single Gulf currency, meanwhile, is likely to remain pegged to the dollar in the beginning. The region is known more for its patience and long-term view than the simple vagaries of currency fluctuation. The dollar peg has provided a credible anchor for monetary policy, is easy to administer and has simplified trade and financial transactions. Pegged exchange rate regimes are also preferred by major oil exporters. Of the 26 countries for whom the oil sector accounts for more than 50% of total exports, 18 maintain conventional fixed currency pegs.

**Breakdown of population by Gulf country, 2007**

Source: Official data of respective countries
Gulf dollar pegs came under scrutiny in 2007 and 2008 because the regional economic boom was out of sync with the economic trends in the United States, where the Federal Reserve started slashing interest rates in September 2007, compelling the GCC to follow suit despite escalating inflation. The pegs thus hampered the ability to the region’s central banks to set appropriate monetary policy.

Depending on where the GCC and U.S. economic cycles stand at the time of union, the Gulf could opt for one of four different exchange rate mechanisms: pegging the single currency to a currency basket, the IMF’s Special Drawing Rights or the export price of oil. Alternatively, the Gulf could choose to adopt a managed floatation or a free float.

In deciding a long-term currency policy for the Gulf currency, the Gulf central bank would need to consider the importance of the oil sector, exports and government revenues. Any currency policy should also take into account the non-oil private sector – a stronger currency would make exports less competitive but lower the cost of imports. Striking the right balance will be crucial for the region’s competitiveness.

Yemen on the agenda

Plans to include Yemen in GCC integration plans appear to be gaining momentum. Gulf policymakers are discussing extending a GCC high-speed railway network, estimated to cost around $23 billion, to Yemen through its border with Oman. The rail network – among plans for $100 billion worth of rail projects in the Gulf – will span 1,940km, with each GCC state contributing a share to its start-up capital.

Yemen’s political and economic stability is of crucial strategic importance to all the GCC states, and how the bloc deals with the country represents and test case for the region’s economic and political resolve. Yemen is facing insurgency in the north where Zaidi Shi’ite Muslims took up arms against the government in 2004, as well as frequent clashes with separatists in the south. In our view, GCC states, in particular Saudi Arabia, remain committed to support Yemen economically at this stage to ensure unity and stability of the country.
Disclosure appendix

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Additional disclosures

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2 - All market data included in this report are dated as at close 18 October 2009, unless otherwise indicated in this report.

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