

The GCC monetary union and fiscal reform requirements

Daniel Hanna

The GCC monetary union and fiscal reform requirements

Daniel Hanna

Treasurer and Head of Global Markets, Qatar
Standard Chartered Bank

April 2006

Summary

The six member Gulf Cooperation Council (GCC), which includes the oil producing countries of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates, is moving towards a single currency by 2010. The area is structurally similar and exhibits a high degree of monetary and fiscal convergence. Moreover, the entry criteria set by the GCC in 2005 are likely to met. However, the emphasis of current GCC discussions has focused on entry to, rather than sustainability of, monetary union. Given the likely change to the homogeneity of the GCC economies over the medium to long term, particularly as the hydrocarbon resources of some members are exhausted, further reforms are needed to ensure the monetary union's fiscal credibility remains intact. This paper focuses on the fiscal implications of the GCC monetary union and suggests establishing and monitoring a new fiscal framework based on non-hydrocarbon fiscal balances.

Background

The combined GDP of the GCC is USD 595bn, on a par with Holland, with a population of 35m and average per capita incomes of USD 17,000¹. Its global significance comes from its endowment in natural, principally hydrocarbon, resources. The GCC sits on 40% of the world's known oil reserves and 20% of its known gas reserves. Combined with the other Persian Gulf countries of Iran and Iraq, the GCC accounts for 30% of the world's crude oil exports. The US Department of Energy estimates that this will rise to 38% by 2025 as other significant areas of exports, such as the North Sea, decline. Given the central role of oil in the world markets the development of this region has obvious global significance.

Oil and gas are key to the region's economic outlook, and with oil prices currently above USD 50 per barrel, the GCC is experiencing an exceptional period of economic expansion. Standard Chartered estimates that growth averaged 7.3% in real rates averaging 30%, on the ground the boom feels even stronger. The region's macro position has been transformed in recent years. In 2005, Standard Chartered estimates that the GCC posted a current account surplus of over USD 157bn, equivalent to 26% of the region's GDP and a combined government fiscal surplus of surplus of USD 95bn, or 16% of the GCC's GDP. Indeed, from 2000-2005, Gulf governments have generated surpluses exceeding USD 230bn.

Since its formation in 1981, the GCC has pursued a slow path towards greater economic integration. Although a common economic agreement was passed in June 1981 real progress towards integration has only been made in the last six years. A customs union was established in 2003 and GCC citizens can now travel, work and own property in all member states. In 2005, the GCC Committee for Financial and Economic Cooperation set out a timetable for the

Chart 1: Hydrocarbon reserves underline the GCC's global importance

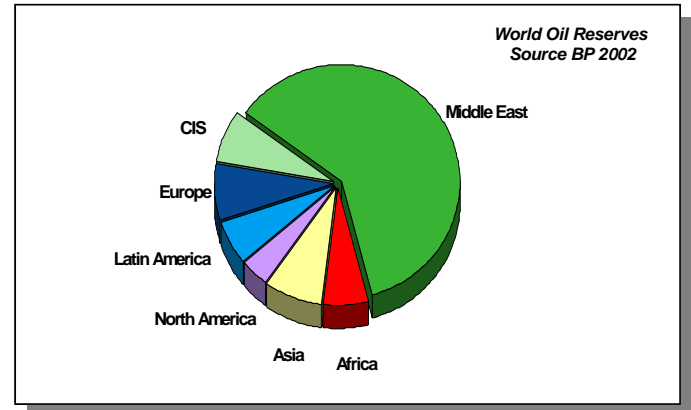


Chart 2: The GCC is experiencing an exceptional period of economic expansion (Source: Standard Chartered)

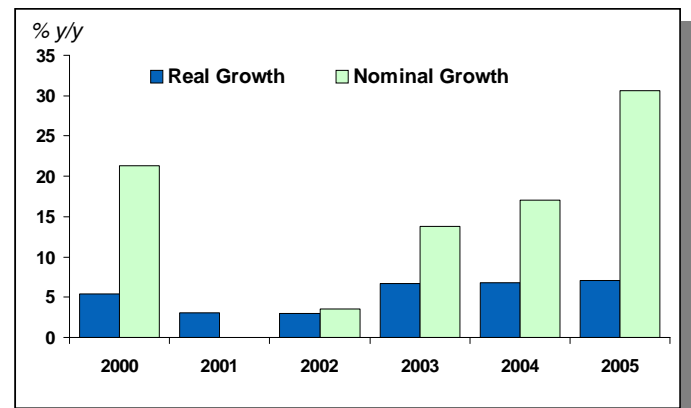
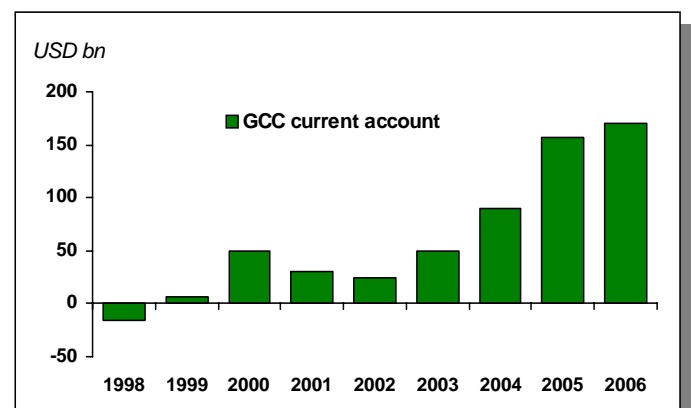


Chart 3: The Gulf's macro position has been transformed (Source: Standard Chartered)



region's most ambitious goal, the establishment of a single currency by 2010.

This paper has four key points:

1. The GCC economies are structurally similar and convergent
2. The entry criteria set out by the GCC are likely to be met with the possible exception of the inflation target
3. The current debate surrounding the single currency should shift from entrance to the single currency to the sustainability of the GCC monetary union
4. In particular, a long term sustainable fiscal framework should be put in place to prepare the GCC for the exhaustion of hydrocarbon resources

Structurally similar GCC ready for entry to monetary union

At first glance, the move towards a single currency should be a relatively easy task and much less controversial than in Europe. The GCC is a relatively homogenous block in terms of history, culture, economic structure and monetary and fiscal trends. All countries face similar economic and social challenges. The customs union, established in 2003, is deepening the integration among member states and increasing the four freedoms of people, capital, goods and services.

Crucially, the GCC has experienced an unprecedented period of twenty years of broad exchange rate stability between member states. There is also a policy consensus across the region of the benefits of a single currency. Indeed, membership has effectively already been decided independent of any economic criteria. The biggest hurdle appears institutional, in terms of setting up a single GCC monetary authority. Although this is a key issue it is outside the remit of this particular paper.

The six members of the GCC share a common social and political history. Arabic and Islam are the official language and religion of all members. The national populations are relatively homogenous with a Sunni majority in all countries, with the exception of Bahrain. Moreover, all the economies are important employers of foreign labour, which account for at least half of the workforce in each country.

Oil and gas dominates all the national economies. Although recent efforts to diversify, notably by Bahrain and the UAE, have made some impact, as Chart 4 highlights, oil remains central to the economic outlook. Overall it accounts for about a third of the GCC's GDP, three quarters of GCC government revenues and exports. to the GCC economies. This dominance naturally makes the economies of the GCC relatively synchronised. Given the lack of other significant sources of revenue, with no general tax framework in place in the GCC, fiscal trends are subject to similar pressures.

The remarkable level of exchange rate stability against the US dollar over the last two decades of all GCC countries has meant that there is already a high degree of monetary convergence among the member states. The GCC countries have had a *de facto* peg to the US dollar over the last two

Chart 4: Oil and gas dominates the GCC economies
(Source: Standard Chartered, IMF 2005)

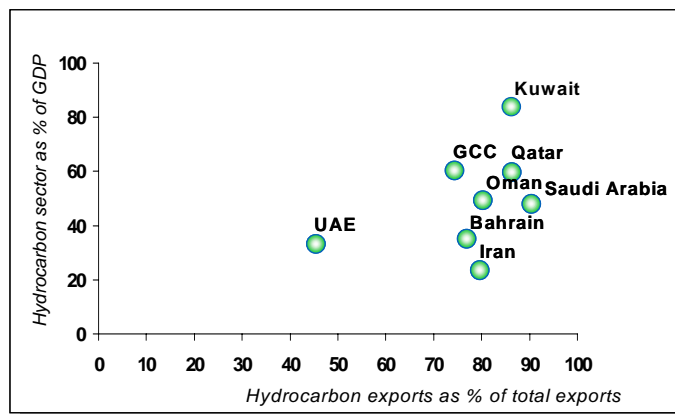


Chart 5: Synchronised GCC economies
(Source: Standard Chartered, selected economies)

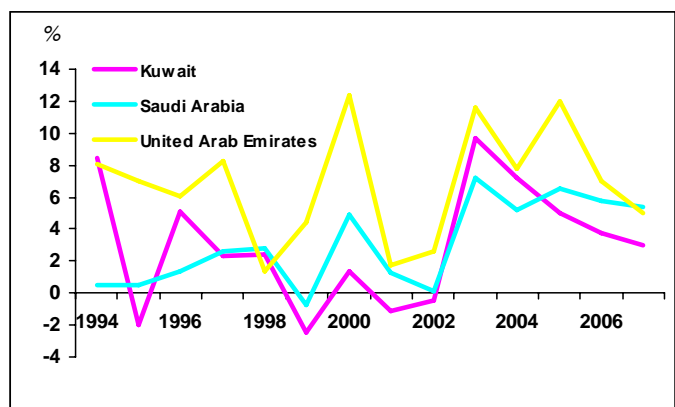
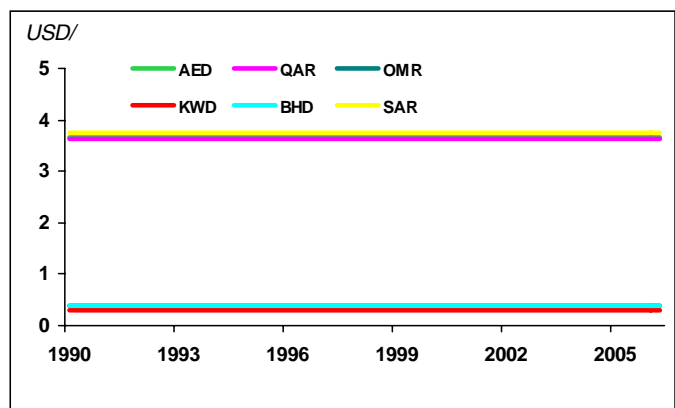


Chart 6: Remarkable exchange rate stability
(Source: Standard Chartered, Reuters)



decades. Kuwait is a partial exception. It was tied to a basket of currencies with a dominant US dollar weighting up until 2003 when all GCC countries announced that they were adopting a de facto and de jure peg to the dollar. As a result monetary trends are similar across all the GCC countries. As demonstrated by both interest rates, see Chart 8, and monetary growth trends

The progress in integrating the economies of the GCC over the last six years can be gauged against the benchmarks of the free movement of goods, services people and capital. The most significant change has come with the launch of a customs union in 2003, which established the principle of a one point of entry for goods into the GCC and a unified external tariff of 5%. While trade integration remains low, this reflects a common set of exports and the lack of a major manufacturing base. Excluding oil, increases intra-regional trade from 4% to 30%. However, trade in services does remain very low. This reflects the wide range of different regulations and restrictions present in the GCC. Nonetheless, with the rising external and internal pressures to bring regulations in line with international best practice, through external initiatives such as the bilateral US free trade agreements and internal ones such as the new Qatar and Dubai financial centres, the integration of services is likely to improve over the medium term.

Rising levels of intra-regional capital flows also point to increasing integration. Although not yet captured in the official data, anecdotal evidence points to a large increase. This is primarily due to a shift in Arab investor appetite for regional assets since 2001, and the opening of property and equity markets to all GCC residents. Thanks to the common cultural and linguistic heritage, the freedom of movement of labour is fairly entrenched within the Gulf. That said, few GCC citizens have located permanently in another GCC country. Although expatriates, who make up the majority of the working population, do not enjoy the same rights, in practice they tend to move between the Gulf countries with relative ease.

The relatively high level of homogeneity between the GCC economies and their growing integration underlines the suitability of the GCC for monetary union. The economic structural similarities is a positive as it reduces the risk of an asymmetric shock (i.e. a shock that effects only one country within the union) while the integration will strengthen the union's ability to deal with such shocks by transferring factors of production, particularly people and capital, between the affected and non-affected areas.

Most entry targets already met but inflation a problem

In 2005, the GCC Committee for Financial and Economic Cooperation, which is a forum of the GCC Ministers of Finance, and the Committee of Monetary Agencies and Central Bank Governors agreed upon a set of convergence criteria. In line with the Eurozone's Maastricht criteria, the requirements for entry are:

1. A country's budget deficit is less than 3% of GDP
2. Public sector debt is less than 60% of GDP

Chart 7: GCC similar trade flows
(Source: Standard Chartered, IMF DOTS 2002)

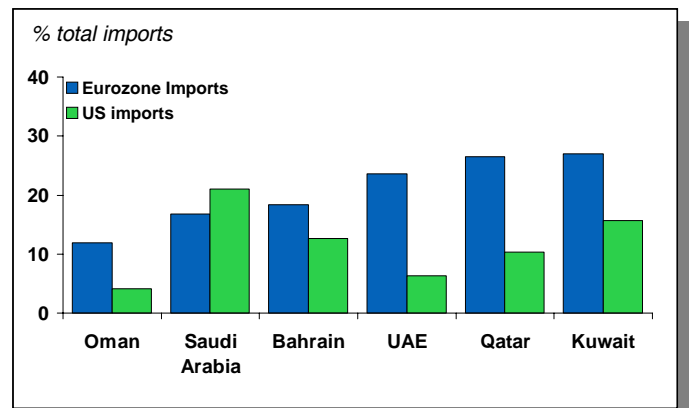


Chart 8: Interest rates show high degree of synchronisation
(Source: Standard Chartered, Reuters, deposit rates)

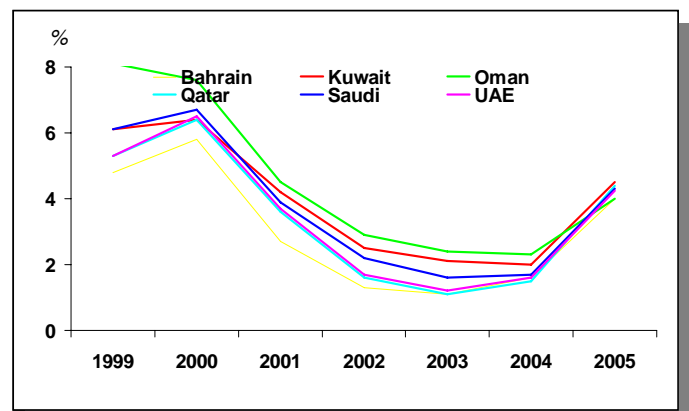
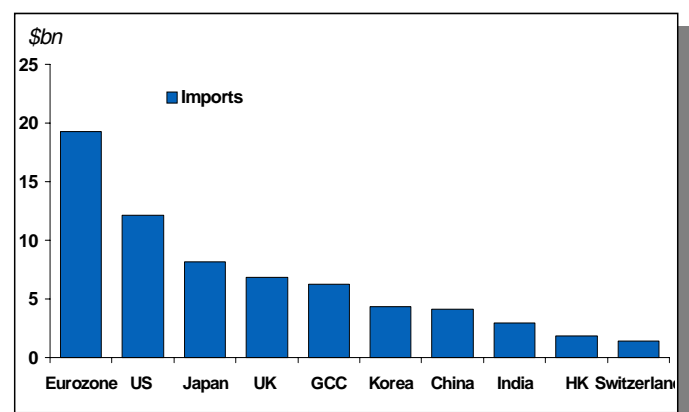


Chart 9: Low trade integration reflects common exports
(Source: Standard Chartered, IMF DOTS 2002 data)



3. Currency reserves are in excess of 4 months of imports.
4. Interest rates must not exceed the average of the lowest three countries by more than 2%
5. Inflation must not exceed the weighted average of the six countries' inflation rates by more than 2%

Given high oil prices, all six countries are likely to have complied with the first four criteria as of the end of 2005. Indeed, as of 2004 data (the most recent confirmed data), only two countries failed to meet the criteria. First, Saudi Arabia failed to meet the public sector to GDP ratio. Second, Bahrain fell marginally below the FX reserve requirement threshold. However, Standard Chartered estimates that Saudi's debt to GDP ratio fell to 41% at the end of 2005 as strong oil revenues boosted government revenues and lifted the level of nominal GDP. Bahrain's import cover remained at 3.8 months but this is unlikely to be a significant hurdle given the likely current account surplus in 2006.

The fifth criterion on inflation is more problematic. Two countries failed to meet the criteria in 2004. Bahrain was marginally above the inflation threshold, while Qatar had by far the highest inflation rate of the region. What is a concern is that we estimate that the spread in inflation widened further in 2005. Indeed, there appears to be little evidence in terms of inflationary convergence over the last decade.

This may not be too significant an issue. As Chart 11 highlights, higher inflation rates has been a consistent feature of Qatar and the UAE over the last decade. Despite this there has been no evidence of a loss of competitiveness either in terms of falling exports or pressure on the exchange rate. In Qatar's case, this is likely to be due to the dominance of hydrocarbon activity in the economy (it accounted for 60% of GDP in 2005) as its demand is not influenced by domestic price movements. The rapid growth of the UAE's non-oil exports testifies to the strength of its non-hydrocarbon productivity, which would have helped insulate the economy from price changes.

Nonetheless, the diverging inflationary trend raises the issue of whether the criteria are correct for the GCC. Most notably, at no point do the criteria deal with the underlying volatility of oil prices. If oil prices were to slump dramatically, then budget deficits may once more become a problem before 2010. Indeed, the central role of oil price volatility in the GCC economies is not dealt within the entry criteria. As we will examine below, given the differences in hydrocarbon resource endowment, this is an important oversight

Overall, it is clear that entrance into a single currency should be a relatively smooth process. Crucially, the political decision to introduce a single currency has already been taken. The membership is known and fixed.

The current focus on *entrance* criteria should, therefore, be switched to *sustainable* criteria that will ensure the long-term strength of the GCC monetary union and the countries within it. This is important as given that over time the GCC is likely to become more heterogeneous. Three key themes will shape the GCC over the medium to long term, which will

Table 1: How countries measure up to the criteria on 2004 data (Source: Standard Chartered)

	Budget surplus % of GDP	Public debt % of GDP	FX reserves Months of import cover
Bahrain	0.7*	34.3*	3.8
Kuwait	19.1	21.1	8.5
Oman	4.8*	13.1*	5.5
Qatar	8.6*	34.6*	6.6
Saudi Arabia	10.4*	65.3*	8.0
UAE	18.3	8.4	4.1

* Central government

Source: IMF/IIF estimates, SCB Global Research calculations

Chart 10: No sign of convergence of inflation rates (Source: Standard Chartered)

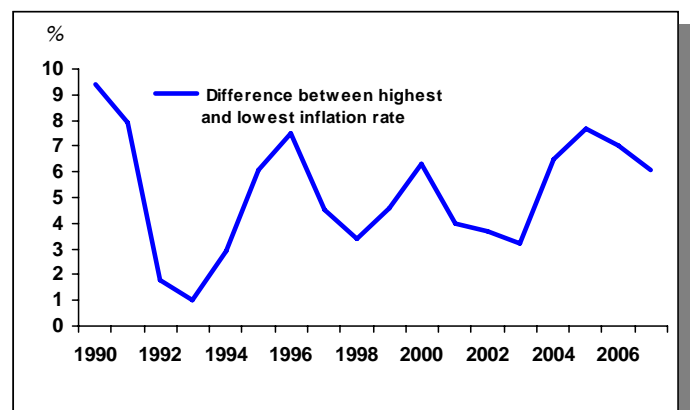
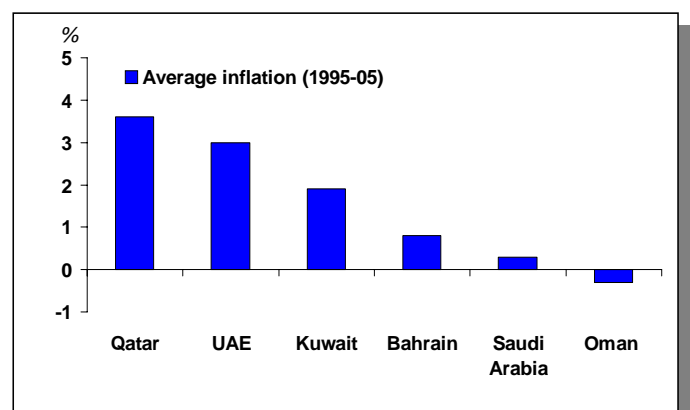


Chart 11: Difference in inflation longstanding (Source: Standard Chartered)



have implications for the monetary union and may constrain the GCC countries' ability to adjust to shocks, both asymmetric and symmetric, to differing degrees.

First, the reduction of absolute and per capita hydrocarbon wealth. While hydrocarbon resources will remain central to all GCC countries within the next twenty years, some countries will face the challenge of their reserves being exhausted. Second, more generally the process of economic diversification away from hydrocarbon activity is advancing at different speeds among GCC members. Third, demographic and labour market pressures are more advanced in some countries than others. With half the GCC under the age of twenty, the labour force is set to grow at 3% per annum until 2020. Some countries are better placed to deal with this than others. Saudi Arabia's unemployment rate is estimated to be 20% while the UAE's is 3%.

Given the variance in hydrocarbon wealth different economies will face the challenge of replacing oil revenues over different time horizons, some will have to adjust their finances within the next twenty years. On the labour market front, while the increased involvement of the national population within the labour force is clearly positive it is likely to diminish the flexibility of the labour markets as nationals are likely to have a greater wage bargaining power than expatriates. This could reduce some GCC countries ability to adjust to shocks through nominal wage changes. More diversified economies are likely to reduce the convergence of the GCC countries. Further, what type of exchange rate regime will be best suited to these changing factors needs to be assessed. More research needs to be done on the all these issues, but this paper will focus on the first and perhaps most important issue of how to prepare the GCC monetary union for when some member states' oil runs out.

Fiscal sustainability within the GCC single currency

A sustainable GCC monetary union will require a more robust medium term fiscal framework than currently anticipated. Focusing on an overall budget balance, as in the first Maastricht criteria, in an oil producing country can lead to misleading signals about the sustainability of a country's finances.

The first two Maastricht criteria on fiscal sustainability were based on assumptions of what stabilises government debt at 60% of GDP. This was seen as a prudent level that would not interfere with the monetary union's macro economic stability nor cause any negative spillover effects to other member countries. The levels of the first two criteria were chosen on the basis that the Eurozone's trend growth is 3% and inflation is 2%. Putting to one side that the GCC's trend growth and inflation will be different, the most pertinent fact is that it these rules overlook the importance of oil revenues to the GCC's fiscal trends and debt levels.

A budget deficit target that focuses exclusively on the overall budget balance can give misleading signals about the underlying health of government finances in oil producing countries. This is due to 1) oil price volatility 2)

Chart 12: GCC oil and gas reserves vary greatly
(Source: Standard Chartered, BP)

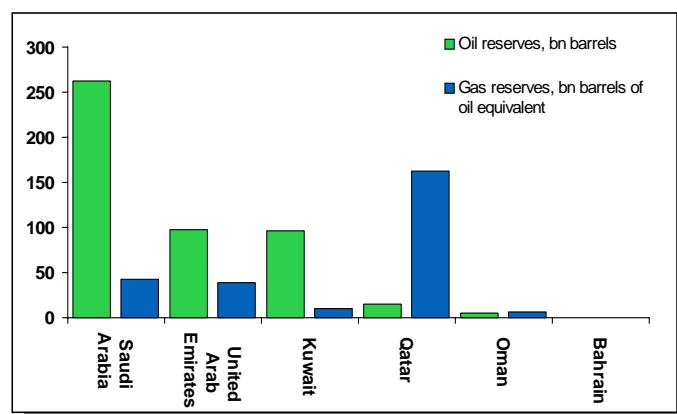


Chart 13: Hydrocarbon revenue per capita
(Source: Standard Chartered)

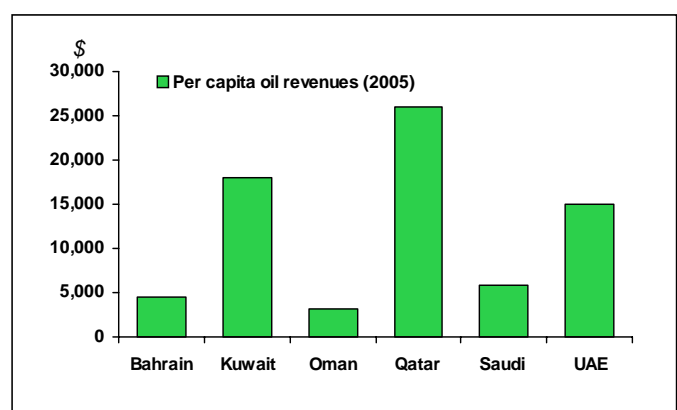
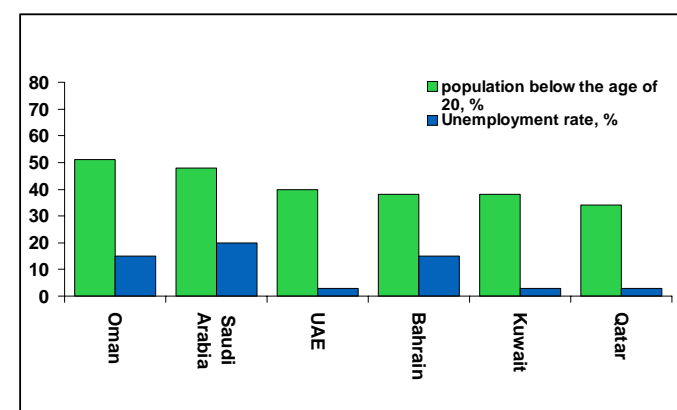


Chart 14: Local labour force set for rapid growth
(Source: Standard Chartered, IDB 2004)



the finite nature of hydrocarbon resources.

In an oil-dominated economy, if the government decides to increase spending due to a rise in international oil prices, it is possible for expenditures to rise and for the overall fiscal balance to simultaneously improve. However, the improving fiscal balance will not illustrate the sustainability of the new fiscal stance. If the rise in oil prices is not sustained and prices subsequently fall, and spending is not reduced in tandem, the underlying fiscal position will suddenly worsen. The dramatic increase in Saudi Arabia's public debt during the 1990s, which reached a peak of 120% of GDP in 1999, highlights the tendency of governments to postpone spending adjustments in reaction to a decline in oil revenues. Equally if a country's oil revenues fall, or even stop, due to the diminishing/end of its oil resources, the deficit will rise dramatically unless the government dramatically cuts spending or raises alternative sources of revenue.

This is perhaps the biggest challenge for the sustainability of the GCC monetary union. While hydrocarbon revenues are central to all of the GCC economies and finances, as Chart 12 highlights, there is a high degree of variance in the level of absolute and per capita resources. Bahrain, Oman and Qatar will probably exhaust their oil resources within the next two decades. Qatar will be able to replace oil with gas, and has sufficient gas reserves for a further 300 years at current extraction rates. Bahrain and Oman are much less well endowed. By contrast, official data suggests that Kuwait and the UAE have a further 100 years of oil production at current extraction rates.

The inevitable decline of oil resources will lead to a reduction in fiscal flexibility for all GCC countries, but particularly for Bahrain and Oman. From the monetary union standpoint, diminishing oil reserves not only increases the likelihood of asymmetric shocks occurring, as the GCC economies become more heterogeneous, but also reduces Bahrain and Oman's ability to adjust to such shocks through fiscal means. Falling oil reserves and therefore oil revenues also increases the likelihood of undisciplined national fiscal policies that could discredit the whole monetary system.

The GCC monetary union should therefore adopt a fiscal target that more accurately signals the underlying fiscal sustainability of GCC countries' fiscal positions and also prepares GCC countries for the eventual decline of their oil reserves and revenues. This we believe is best done through targeting a non-hydrocarbon fiscal deficit, which is the overall fiscal balance minus hydrocarbon revenues. Table 4 lists the current non-hydrocarbon fiscal positions of the GCC member states. Optimal fiscal policy is seen as pursuing a non-hydrocarbon fiscal deficit that allows the accumulation of financial assets so that the return on those assets can finance the target non-hydrocarbon fiscal deficit once the country's oil and gas reserves have been exhausted. This ensures that the country's oil wealth is spread equally across generations but would also assure other GCC member states that a member country's finances were sustainable on a long term basis.

Chart 15: GCC budgets on a strong current footing
(Source: Standard Chartered USD, 2004)

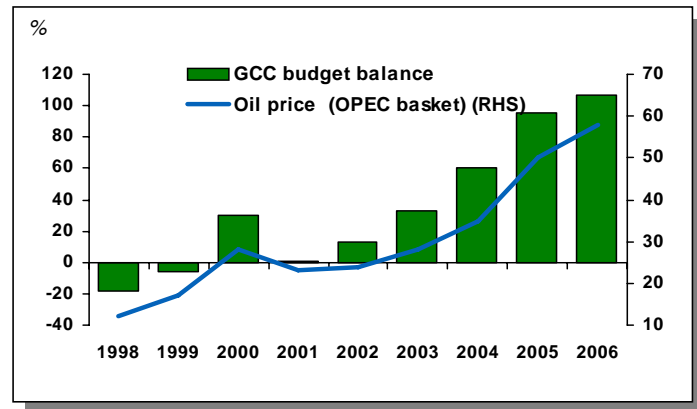


Chart 16: The net present value of the GCC's oil reserves
(Source: Standard Chartered Bank, 2005)

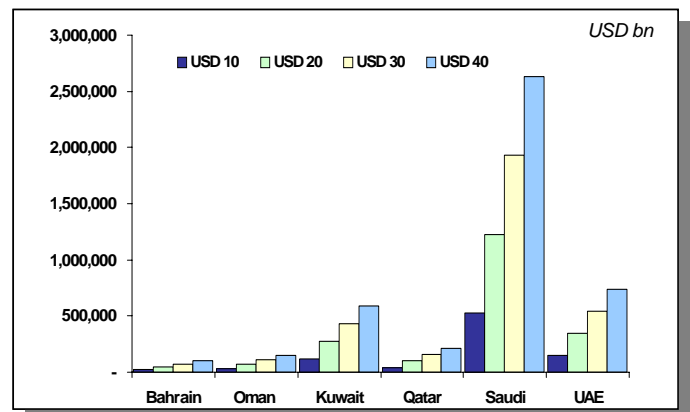


Table 3: Net Present Value assumptions

Assumptions	
Rate of return	4% 30yr US real yields 20 yr average
Reserves	478bn barrels of oil, BP 2004
Population growth 2003	3% International Database, US census
Inflation	0% Oil prices rise in line with inflation

Assessing a country's sustainable non-hydrocarbon fiscal deficit depends on a calculation of a country's total hydrocarbon wealth and future population growth. Under this framework, the extraction of hydrocarbon resources should be viewed as a portfolio transaction whereby oil wealth is transformed into financial wealth. Thus, oil and gas revenues should be treated as investing or spending the country's assets rather than income. A country's total hydrocarbon wealth, therefore, is defined as the present discounted value of future oil and gas revenues. This relies on an estimation of the country's total oil and gas reserves and long-term oil and gas prices.

There are two possible non-hydrocarbon targets. The first keeps a country's resource wealth constant over the long-term (that is, any reduction in hydrocarbon reserves is matched by a simultaneous and equal increase in financial assets). The second, more restrictive, target keeps a country's wealth constant in per capita terms over the long-term (that is, the total amount of financial and hydrocarbon assets should rise over time in line with the population).

As tables 4 and 5 highlight, the level of long run oil prices is a crucial assumption. Here it would make sense for the GCC to take a prudent approach. Adopting constant wealth targets consistent with an oil price assumption of USD 20 per barrel as a base case for example. This is close to the current non-hydrocarbon fiscal deficits for most countries, with the notable exception of Oman and Saudi Arabia, and therefore would not be excessively restrictive. This is also consistent with the average OPEC basket oil price since 1980 of USD 23 per barrel. Moreover, it would position the GCC's finances close to fiscal targets that keep oil wealth constant in per capita terms under a USD 50 per barrel assumption as shown in table 5.

Although this paper has focused on establishing long term fiscal rules for the GCC monetary union, a linked issue is whether it is possible to design intra-GCC fiscal transfers in order to minimise the impact of asymmetric shocks. That is, is it possible to tax the booming areas/countries, and then use the proceeds in the depressed areas? Within successful single currencies not only is there labour mobility, but also fiscal flexibility as well.

One method would be for the richer hydrocarbon wealth per capita countries to subsidise the budgets of the poorer per capita countries. This would be similar to the system established with the UAE where Abu Dhabi, which has 92% of the UAE's oil reserves funds the majority of federal spending across the country.

An alternative would be to examine the imposition of a pan Gulf tax system perhaps along the lines of a consumption tax or value added tax. This has a strong record in the Middle East and has been successfully implemented in Lebanon, Jordan and Egypt. Overall, the region's average 15% rate raises just under 8% of GDP. This is slightly better than the world average. World Bank studies suggest that for every additional increase of 1% in the tax rate an additional 0.4% of GDP is raised in revenues. The better ratio in the Middle East may reflect a higher propensity to

Table 4: Non-hydrocarbon fiscal targets
(Source: Standard Chartered Bank)

Non oil fiscal balance target under USD 20 per barrel oil price			
	2005 balance	Target constant wealth	Target constant wealth per capita
Bahrain	-18.1%	-14%	-5%
Kuwait	-32.7%	-16%	-1%
Oman	-30.8%	-9%	-2%
Qatar	-18.0%	-11%	-2%
Saudi Arabia	-29.6%	-16%	-4%
UAE	-11.1%	-10%	-2%

Table 5: Non-hydrocarbon fiscal targets
(Source: Standard Chartered Bank)

Non oil fiscal balance target under USD 50 per barrel oil price			
	2005 balance	Target constant wealth	Target constant wealth per capita
Bahrain	-18.1%	-38%	-13%
Kuwait	-32.7%	-44%	-7%
Oman	-30.8%	-25%	-3%
Qatar	-18.0%	-31%	-5%
Saudi Arabia	-29.6%	-42%	-12%
UAE	-11.1%	-28%	-5%

consume imports. Assuming that this experience was replicated in the Gulf, a 5% sales tax would probably yield around USD 15bn, or 2.5% of non-oil GDP. Though theoretically sound, in reality both solutions may be very difficult to achieve for political reasons.

The GCC has already taken some important steps towards improving fiscal management. Without exception budgets are done on an extremely conservative oil price assumption (around USD 30 per barrel in 2005) generating surpluses that provide a cushion for periods of low oil prices. More importantly, most States have established public investment authorities, which have a mandate to manage a proportion of any annual surplus to prepare for the needs of future generations. Adopting explicit non-hydrocarbon fiscal targets would build on this approach and strengthen the region's financial position and the future monetary union further.

Bibliography

Boom, Bubble and Avoiding the Bust, Standard Chartered 2005

Fiscal Policy Formulation and Implementing in Oil Producing Countries, IMF 2003

Oil Boils, Middle East Booms, Standard Chartered 2004

Preparing for Sanctions, Standard Chartered 2006

Qatar 2020 Report, Standard Chartered 2006

Regional Monetary Integration in the Member States of the Gulf Cooperation Council, ECB 2005