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Ongoing Reforms in the Oil Exporting Countries of the Gulf and their Impact on the Position of USA in the Region

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<u>**CONTENTS**</u>

List of Abbreviations

ADF – Autoregressive Dickey Fuller
BSE – Bahrain Stock Exchange
CEFTA – Central European Free Trade Agreement
CET – Common External Tariff
DM – Deutsche Mark
ECB – European Central Bank
EMS – European Monetary System
EMU – European Monetary Union
EP – European Parliament
EU – European Union
FATF – Financial Action Task Force
FDI – Foreign Direct Investments
GCC – Gulf Cooperation Council
G-PPP – Generalized Purchasing Power Parity
GDP – Gross Domestic Product
HRDF – Human Resources Development Fund
IBRD – International Bank for Reconstruction and Development
IMF – International Monetary Fund
IT – Information Technologies
KSA – Kingdom of Saudi Arabia
KSE – Kuwaiti Stock Exchange
LNG – Liquefied Natural Gas
MERCOSUR – Mercado Común del Sur
ER – Exchange Rate
MU – Monetary Union
NAFTA – North American Free Trade Agreement
NHRDEA - National Human Resource Development and Employment Authority
OCA – Optimum Currency Area
PPP – Purchasing Power Parity
PF – Production Factors
RER – Real Exchange Rate
SAGIA - Saudi Arabian General Investment Authority
SDR – Special Drawing Rights
SEC – Saudi Electricity Company
UAE – United Arab Emirates
UEA – United Economic Agreement
USD – United States Dollar
WTO – World Trade Organization
FTA – Free Trade Area

Introduction

The Persian Gulf is notoriously known for its oil and gas reserves that provide the Gulf States with immense wealth and prestige. However, this wealth has, in combination with historical and cultural characteristics of this region, brought some problems and complications as well. Particularly the overspecialization of their respective economies in fields such as oil&gas drilling and refining. Furthermore to the overly focus on one or two branches of industry, the resources they rely on are non-renewable (or at least in relevant time horizon). All this puts the GCC members to a really interesting position in which the economy seems to be sound providing tremendous wealth to its citizens but, at the same time, relying on more or less single source which is soon to be depleted. To make things worse, most of these countries do not have much experience in other fields of global economy having based their respective industries on oil and gas from the very beginning of their industrialization.

Since I find it quite interesting to see how the Gulf States tackle this complicated situation, I would like to take a closer look and analyze some of the above-mentioned issues and provide a prospective outlook for the member states. Thus, the two main questions I will attempt to answer in this thesis are:

"Firstly, are the GCC member states making a progress towards an open market economy through introduction of various reforms? Additionally, this question relates closely to the issue of regional integration, which will also be addressed since it is the GCC as a whole rather than the individual states that is supposed to be scrutinized in this work. Incidentally, studying this issue will help us to better understand the second question, which is essentially of an integrational manner.

"Secondly, is the common currency a suitable solution for the six member states and, if so, are they ready to adopt it?" I will try to deal with this question by employing two different methods. The first method is rather theoretical while the second is more of a mathematical nature. Eventually, I will compare the proposed GCC currency union with

the existing European Monetary Union and try to draw some applications from the successful introduction of euro for the GCC.

In addition to these two questions, I will try to provide a brief insight into the US-GCC relationship that is so significant to both parties involved.

Due to the limited scope of this work and the sheer complexity of the studied issues, I will be using some methods in order to simplify the whole matter and make it possible to be analyzed. One of these methods is the abstraction that simply disregards some variables in the equation to make it more comprehensible. Others include comparison (GCC vs. EU) or the old-fashioned pros-and-cons analysis. Since the addressed issues are current and dynamic, I try to use mainly Internet sources that contain the most up-to-date information.

At this point, I would like to explain two fairly frequent terms used in this thesis – foreigner and non-oil activity. The term foreigner stands for a person who is not a citizen of any of the six GCC member states. Usually it involves expatriate workers from neighbouring (mostly poorer) countries, foreign businessmen and investors. The term non-oil activity comprises all activities other than those directly related to oil&gas extracting, transporting, refining or storing.

1. Gulf Cooperation Council

The Cooperation Council of the Arab States of the Gulf (hereinafter called GCC[1]) is a regional organization, which has been established in 1981 by Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates. The main reason for this was the sense of their own vulnerability, which was arising from the contrast between the oil wealth on one side and a small population scattered over large areas and a limited military potential in a traditionally volatile region on the other.

According to the Charter[2], the basic objectives of the GCC are: *to effect coordination, integration and inter-connection between Member States in all fields in order to achieve unity between them; to deepen and strengthen relations, links and areas of cooperation now prevailing between their peoples in various fields; to formulate similar regulations in various fields including economic and financial affairs, commerce, customs and communications, education and culture; to stimulate scientific and technological progress in the fields of industry, mining, agriculture, water and animal resources; to establish scientific research; to establish joint ventures and encourage cooperation by the private sector for the good of their peoples.*

Organization of the Council[3]

Supreme Council is the highest authority of the Cooperation Council and is formed of heads of member states. According to the Charter, it shall endeavour to realize the objectives of the Cooperation Council including: laying down the higher policy for the Cooperation Council and the basic lines it should follow; approve the bases for dealing with other states and international organizations; amend the Charter of the Cooperation Council; approve the Council's internal rules of procedure etc.

[1] Original title: مجلس التعاون لدول الخليج العربية
[2] Cooperation Council of the Arab States of the Gulf - Secretariat General, The Charter, http://www.gcc-sg.org/system.html
[3] Cooperation Council of the Arab States of the Gulf - Secretariat General, http://www.gcc-sg.org

Each member of the Supreme Council shall have one vote and resolutions of the Supreme Council in substantive matters shall be carried by unanimous approval of the member states participating in the voting, while resolutions on procedural matters shall be carried by majority vote

Commission for Settlement of Disputes is attached to the Supreme Council and if a dispute arises over interpretation or implementation of the Charter and such dispute is not resolved within the Ministerial Council or the Supreme Council, the Supreme Council may refer such dispute to this Commission. The Commission shall then submit its recommendations or opinions, as applicable, to the Supreme Council for such action as the Supreme Council deems appropriate.

Ministerial Council is formed of the Foreign Ministers of the member states or other delegated ministers. It convenes every three months and may hold extraordinary sessions at the invitation of any member seconded by another member.

Its main functions are to propose policies, prepare recommendations, studies and projects aimed at developing cooperation and coordination between member states in various fields and adopt the resolutions or recommendations required in this regard. It should also encourage means of cooperation and coordination between the various private sector activities, develop existing cooperation between the member states' Chamber of Commerce and Industry, and encourage the movement within the GCC of workers who are citizens of the member states.

The voting system is similar to the one of the Supreme Council.

The Secretariat General is composed of a Secretary-General who is assisted by assistants and other staff. He represents the Cooperation Council with other parties within the limits of the authority vested in him.

The Secretariat General is responsible for preparing the budgets and closing accounts of the Cooperation Council. Furthermore, it prepares studies related to cooperation and coordination, and to integrated plans and programmes for member states' action as well as periodic reports on the work of the Cooperation Council. It also follows up the implementation by the member states of the resolutions and recommendations of the Supreme Council and Ministerial Council.

Past developments

In the last three decades, the GCC member states witnessed an unprecedented transformation of their respective Economies and Societies as a whole. The oil revenues were used to modernize the infrastructure, to create jobs and to enhance social indicators. During these changes, the member states were able to accumulate central bank reserves, maintain relatively low foreign debt and still remain in the position of a major donor to the poor developing countries.

According to IMF, the life expectancy at birth in GCC member states has risen by almost 10 years since 1980 and is now at 75 years while the literacy rate has risen by 20% to almost 80%[4].

The average GDP per capita in 2002 was estimated at 12 000 USD while the overall nominal GDP reached 340 billion USD (more than a half of the GDP of the whole of the Middle East)[5]. Also, while experiencing low rates of inflation the overall real economic growth averaged at 4 percent[6] per annum during the last three decades with the importance of non-oil activities constantly rising because of the governments’ effort to diversify their respective economies.

[4] Ugo Fasano, Monetary Union Among Member Countries of the Gulf Cooperation Council (2003),
[5] Source: International Monetary Fund, www.imf.org
[6] see note 5

This progress has been reached under open foreign exchange and trade systems as well as free capital flows and open borders for foreign labor force. Thus, the GCC region has become a significant centre of regional economic growth.

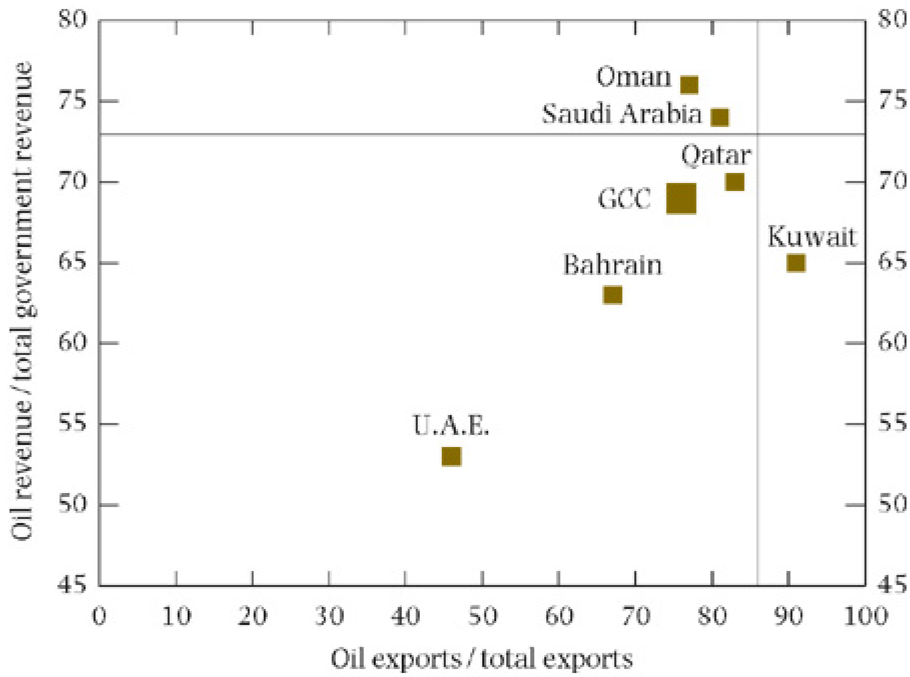
Since the monetary policy is focused on maintaining a stable exchange rate and on controlling inflation, the fiscal policy has become the main instrument of achieving the rest of economic and social goals including the growth, employment and equality. However, the fiscal policy is limited by the dependence of governments' revenues from exports (see Figure 1). Moreover, in most of the member states the high and growing expenditures on government officials' salaries together with high public debt service payments also lower the flexibility of fiscal policy.

The completion of main projects in the area of infrastructure weakened the role of government expenditures in non-oil growth and it is obvious from the existence of a large public sector that the share of investments in private sector in the overall GDP remains, despite its growth, relatively low.

However, new challenges are still arising. A high growth of population in the last two decades, together with an increasing participation of women, has undoubtedly contributed to the growing volume of labor force[7]. In fact, the labor force in GCC member states rose by at least 4 percent per year[8] while, most probably, such a rate will be applicable for the near future as well since nowadays roughly one third of population consists of children younger than 15.

[7] Source: http://www.odci.gov
[8] see note 5

Figure 1. GCC Countries: Oil Dependency



Source: Ugo Fasano, Zubair Iqbal (2003)

Since the capacities for employment in public sector are limited, the unemployment of domestic workers begins to rise in GCC countries (some member countries employ up to 93 percent of domestic labor force in the state administration[9]).

In the final two decades of the last century the GCC member countries began to realize that a continual economic growth independent on oil together with investments into human capital and institutional reforms are critical for solving the ever growing problem of unemployment.

The GCC countries currently implement reforms in order to speed up the growth in non-oil sectors of the national economy; create new jobs for a rapidly growing numbers of those unemployed; and alleviate vulnerability to oil price shocks.

[9] ditto

Apparently, they are aware of the need to adjust to the challenges of a regional integration on one side and to the global world economy on the other. This, however, will not be easy and painless.

1.1. Current Situation

The GCC countries share many characteristics. The oil related activities represent roughly one third of the overall GDP and generate ¾ of the governments' revenues and exports. Altogether, the member states control about 45% of the World's official oil reserves, their crude oil exports amount to 25% of the World's total (Saudi Arabia alone is the World's biggest oil exporter) and they sit on at least 17% of the World's official natural gas reserves with Qatar having become the fourth biggest LNG exporter in the World[10].

The Exchange Rates were effectively used as a nominal anchor while the GCC currencies were pegged to the USD (officially from the beginning of 2003 but practically for decades already).

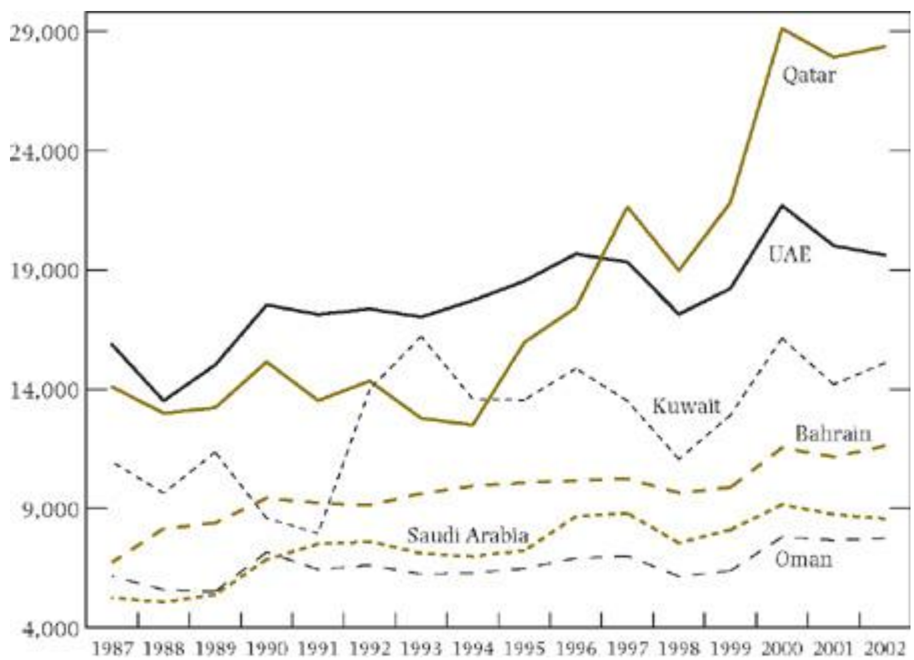
The six member countries are highly dependent on the foreign labour force, namely on expatriates mainly from Asia or other Arab countries. This is caused mainly by the lack of domestic workers (although the work force is growing rapidly), and especially by a limited domestic supply of qualified specialists. The expatriates form in most of the GCC member countries ¾ of the overall work force[11]. Since 1970, these countries have maintained an 'open door' policy in order to attract foreign labourers - something that proved to be very important for the diversification of the production basis and development of the third sector.

[10] Ugo Fasano, Zubair Iqbal (2003)
[11] International Monetary Fund, www.imf.org

The availability of these imported skills in exchange for internationally competitive wages was crucial for keeping the costs on a low or, more precisely, acceptable level. The majority of the domestic labour force, employed by the government as mentioned above, has higher wage expectancy than the expatriates have. Based on this, the labour market remains segmented according to the position, wages, other benefits and qualifications.

Since the hydrocarbon wealth belongs entirely to the governments, these can maintain vast social systems that we can find in every GCC member state. Public services in some member countries are provided free of charge or at highly subsidised prices, especially when it comes to water and electricity, while the taxation is low and consists mainly of the income tax of foreign companies (with the exception of Oman where also domestic companies are subject to income tax).

Figure 2. GCC Countries: Nominal GDP per capita in USD 1987 - 2002



Source: Ugo Fasano, Zubair Iqbal (2003)

Some of these countries gradually recorded an overall fiscal deficit reflecting the volatile oil prices and relatively high current expenses. However, only a few of the states experienced a substantial increase in their government debts. All member countries have healthy and well controlled banking systems. The banks have enough capital at their disposal and are usually profitable. The supervisory framework has been enhanced and is more or less in compliance with international standards. Moreover, the GCC countries gradually adopt steps to implement market based monetary policy, although, direct instruments (e.g. interest rates and credit ceilings) are so far used only in some member states (*Ugo Fasano, Zubair Iqbal, 2003*).

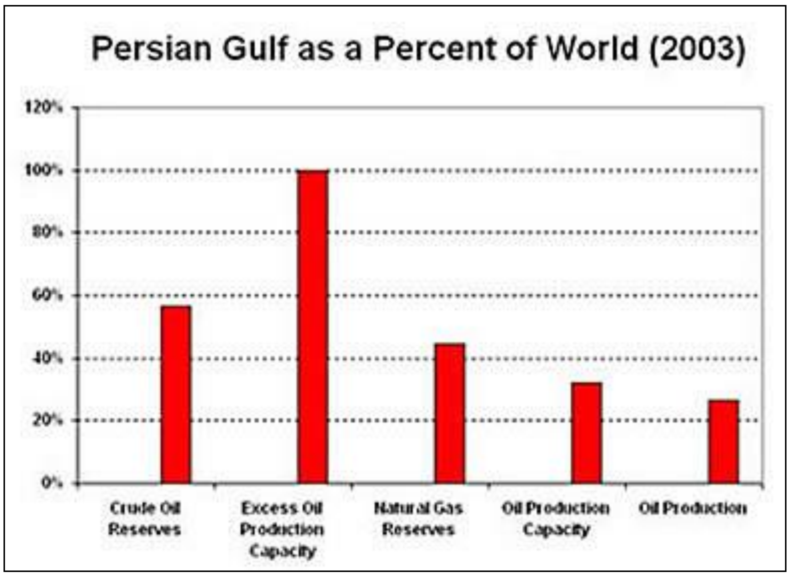
Table 1: Key economic indicators in the GCC member states

	Bahrain	**Kuwait**	**Oman**	**Qatar**	**Saudi Arabia**	**UAE**
Population	708,573	2,505,559	3,204,897	907,229	27,601,038	4,444,011
GDP per capita (USD)	25,800	23,100	14,400	29,800	13,600	49,700
GDP real growth rate	7.8%	12.6%	6.6%	7.1%	2.4%	8.9%
GDP composition by sector: Agriculture, Industry, Services	A: 0.5% I: 38.7% S: 60.8%	A: 0.4% I: 48.3% S: 51.3%	A: 2.6% I: 38,8% S: 58.7%	A: 0.1% I: 77.2% S: 22.6%	A: 3.3% I: 67% S: 29.7%	A: 2.3% I: 61.9% S: 35.8%
Unemployment	15%	2.2%	15%	3.2%	25%	2.4%
Oil production (million bbl/day)	0.1883	2.418	0.740	0.7905	9.475	2.54
Oil exports (million bbl/day)	N/A	1.97	0.721	N/A	7.92	2.5
Gas production (billion cu m)	9.75	9.7	17.2	39.17	65.68	46.29
Gas exports (billion cu m)	0	0	10.43	24.06	0	7.18
Proven oil reserves (billion bbl)	0.121	96.5	4.7	15.2	262.7	97.8
Proven gas reserves (trillion cu m)	0.9203	1.572	0.8291	25.77	6.654	6.006

Source: World Fact Factbook; www.cia.gov

However, there are still significant differences among the member countries. The GDP per capita varies between something less than 8 000 USD in Oman and something more than 28 000 USD in Qatar (see Figure 2.). The structures of their economies and the composition of their exports also differ. The proportion of industrial production rises rapidly in Saudi Arabia while in the UAE it's the reexport and other related activities that are on the rise.

Figure 3. Oil and Gas – GCC's Share of the World Total



Source: Energy Information Administration; Persian Gulf Oil and Gas Exports Fact Sheet; **<u>www.eia.dov.gov</u>**

Furthermore, in Bahrain the banking and insurance sector is by far the most important sector of the economy while in Qatar we could have recently seen gradual substitution of oil by natural gas as the key commodity to the economy and in Oman the growth-oriented strategy focused on the development of the LNG sector and tourism already began to bear its fruit.

It is obvious from all that has been mentioned above that the non-oil growth has differed in the GCC member countries. Inflation, although low, was also different across the GCC region[12] causing different trajectories of the real effective exchange rates.

The differences still prevail also in the regulation of the banking sector, especially when it comes to the conditions of entry, liquidity requirements and classification of loans. In spite of a tremendous progress towards a diversified economy the growth of non-oil activities compared with the growth of domestic labour force remains low in most of the GCC states[13].

[12] World Fact Factbook; www.cia.gov
[13] Ugo Fasano, Zubair Iqbal, 2003

2. Economic and Political Reforms in GCC

A well-sequenced reform strategy to implement comprehensive structural reform over the medium term would help reallocate resources consistent with market signals underpinned by a structural strengthening of the fiscal position and, thus, facilitate sustained rapid growth. According to authors Fasano and Iqbal[14], such a strategy includes the following elements:

1) Fiscal consolidation and structural strengthening of the budget in order to ensure a long-term fiscal sustainability in accordance with long-term economic goals, insulate the economy against terms of trade shocks, and improve incentives for private sector growth. This requires reduction of subsidies and their precise targeting, tax administration reform and introduction of a modern tax system and cutting the expenditures. Moreover, the fiscal policy must be designed in a medium-term framework using a conservative oil price. Such an approach is likely to lower dependency of expenditures on the short-term oil revenues and, in the same time, it will create reserves in case of external shocks. It is understandable that privatisation of state companies is, in this case (endeavour to lower subventions and promotion of competition on the market), self-evident.

2) Expansion of the private sector through legal and institutional reforms (and also through the already mentioned privatisation). This will require several steps including reduction of controls and restrictions for private investments, adoption of common treatment of all investors (including foreign ones, meaning non-GCC)[15] and establishment of guaranteed property rights.

3) Liberalization of restrictions on foreign capital inflows, which, together with technologies, are necessary to support the privatisation and the private sector

[14] Ugo Fasano, Zubair Iqbal, 2003
[15] For example when it comes to taxes.

development. It is also necessary to focus on the undeveloped financial and capital markets.

4) Labour market reforms to prevent negative unemployment pressures from hindering the reform efforts. In order to avoid a fall in competitiveness, this problem must be tackled by a long-term strategy, which will provide enough time to create a qualified labour force. This long-term goal can be achieved through revamping the educational system and redirecting government expenditures toward building human capital. The overall labour market reform must, undoubtedly, tackle another significant shortcoming, namely segmentation of the labour market. It involves revocation of employment guarantees in public sector for GCC nationals, bridging the (artificial) remuneration gap between the public and private sectors and creation of favourable conditions for communication between job-seekers and private employers.

5) Closer integration of the GCC economies and coordination of policies. The expanded regional market will facilitate not only the restructuring and privatization processes but also collective policy reforms. This integration, by creating a larger and more attractive market as well as enhancing competitiveness, will also help the GCC countries to benefit fully from ongoing globalization.

2.1. Current State of Reforms and Differences among Member Countries

Following the severe fall of oil prices in 1998-1999 and related financial pressures, the GCC governments decided to strengthen their structural reforms in accordance with what has already been written above in this chapter. Since these reforms are driven by different pressures in each member country, logically, the state of their implementation varies from country to country. All member states experienced a progress towards fiscal consolidation and thus towards reducing the vulnerability to oil-price shocks[16]. Furthermore, some countries managed to set the decisions on budget expenditures free from short-term trends in oil revenues[17] that tend to be unstable due to high oil-price volatility. The attempts to raise the non-oil revenues led only to mixed results. Moreover, containment of public expenditure has proven to be harder than expected: reducing public sector employment and curtailing the scope and budgetary impact of subsides have been difficult and the generous welfare systems have remained largely unchanged[18].

When it comes to public expenditures, the situation differs slightly in each country. However, in spite of this, it is possible to mention something that could apply to all of the GCC countries: some more assiduous attempts to strengthen the budget through implementation of fiscal rules with strict and transparent accounting procedures and reporting would definitely be beneficial.

Both privatization and restructuring of municipal and other affiliated services were placed on the top of the agenda in some GCC countries. Oman, Qatar and UAE are nowadays totally dependent on private sector and FDI's when it comes to financing and maintaining of the projects in infrastructure, water management and power supply while Saudi Arabia has opted for a radical privatization of its telecommunications[19]. However, in the future, similar reforming steps in state own companies should be supported by further changes. For example: implementation of a system that would monitor and subsequently synchronize the whole process, further deregulation (but not too excessive), making all the investors equal (and not just in theory but also in practice), implementation of fixed schedules for raising the efficiency in state run enterprises and, last but not least, gradual raise of the prices of energy and water in order to cover at least the costs of their production and distribution.

[16] International Monetarz Fund, www.imf.org
[17] For example in Kuwait and Oman through various savings and stabilization funds
[18] see note 16
[19] Source: Ugo Fasano, Zubair Iqbal, (2003)

All GCC countries have recently adopted new incentives to support the inflow of FDI‘s. Those are (among others) creation of regulatory, institutional and legal frameworks in order to control and manage the inflow of foreign capital while most of the countries also have liberal stock and trade systems. Moreover, it is good to see that a 100 percent foreign ownership of enterprises was allowed in most of the non-oil sectors. Also, corporate income tax on foreign companies has been significantly lowered, administrative steps for investment approval simplified and access to local stock markets for foreign investors made much easier.

Some of the most sensitive economic issues worldwide (and not just economic) are, undoubtedly, unemployment and related labour market. The GCC countries are no exception and local markets also have their own unique characteristics. However, these characteristics slightly vary across the GCC region explaining the different approach in member countries. A rapid increase of new (young) workers[20] on the labour market, especially in Bahrain, Oman and Saudi Arabia, has created, in combination with guaranteed wages, ideal conditions for a huge surge in unemployment. Since the governments are aware of the pitfalls of a too hasty nationalization of the labour force, they are right to lean towards more gradual and long-term structural reforms. They are also trying to alleviate negative fallouts of the transition to a market-based system by adopting temporary measures. This is particularly needed in areas where the current salaries are not in line with the current productivity of labour. The truth is that, nowadays, the salaries[21] are way above the actual productivity and any harsh remuneration cuts would undoubtedly be very unpopular.

In fact, all member countries introduced ambitious programmes embodying educational system reforms and retraining in order to meet the demand for qualified workers in medium- and long-term, especially by the private sector. However, it can be argued that one of the most significant factors that hinder the creation of market

[20] By that it is meant only the GCC nationals entering the labour market. It does not include the so called expatriate workers, who are usually working here but do not have citizenship of any of the GCC member countries.

[21] Please note that we are still talking exclusively about GCC nationals who are usually employed in so called “white collar” jobs.

environment still remains in place. Namely, the government policy of a de facto guaranteed employment for GCC nationals not mentioning the above sated salaries high above their productivity. So instead of this clearly inefficient policy the countries might try introducing a well balanced welfare system (including unemployment benefits, retraining assistance, arranging contacts with private sector employers etc.), which would be more effective in securing employment and equity.

Furthermore, it is necessary to mention one more thing regarding the regional banking system. It is no more influenced by volatile oil prices, mainly due to sufficient capital, diligent supervision and cautious monetary policy that altogether help to maintain the quality of bank assets.

2.2. Recent Key Structural Reforms

This section shall present at least some of the recent significant reforms that have been realized in the GCC member countries. These reforms can be categorized according to the field they relate to (Financial sector, FDI, State companies reform and privatization, Labour market reform) and further classified by individual countries[22].

Financial Sector

Bahrain	Undertaking reforms in the financial sector was crucial for this international bank centre. The government has eked out the rules of Islamic financial institutions; strengthened control of Islamic banking; passed a law against money laundering and strengthened the rules of the BSE

[22] Source: Ugo Fasano, Zubair Iqbal, (2003)

Kuwait Has adopted a law regarding FDI, which allows foreigners to own and trade shares of companies registered at the KSE.

Saudi Arabia Allowed foreigners to trade on the stock markets through mutual funds and enforced recommendations in line with FATF[23] guidelines relating to the prevention of money laundering.

UAE Established formal stock markets in 2000 and a regulatory body for capital markets while enforcing the application of FATF. The central bank has implemented a so called "risk-management module" that should help local banks with handling their own assets (the Islamic banking features some specifics contrary to the western model)

Foreign Direct Investments

Bahrain Has eased rules for companies from non-GCC countries regarding ownership of buildings and lease of land. It has also eased the application process for acquiring licences and the limit for foreign ownership of domestic companies has been raised form 49 to 100% except for oil companies and those dealing with aluminium.

Kuwait Allowed a 100% ownership of Kuwaiti companies by foreigners and lowered the corporate tax for foreign companies from 55 to 25%.

Oman Also allowed a 100% foreign ownership in most of the sectors and narrowed the corporate tax gap between Omani and foreign companies by raising the single rate for the former from 7.5 percent to 12 percent and lowering the rates for the latter from 15–50 percent to 5–30 percent. It is, in accordance with WTO treaties, gradually opening up

[23] Financial Action Task Force – fights against money laundering and financing of terrorism

its service sector to foreign investors including full foreign ownership (with the IT sector being the first in 2003).

Saudi Arabia Has passed a new investment law and established an associated investment authority SAGIA in order to facilitate the inflow of FDI; allowed 100% foreign ownership of domestic companies in most of the sectors including gas, power generation, water desalination, and petrochemicals and lowered the highest corporate income tax on foreign investment from 45 percent to 30 percent. It has also permitted foreigners to own real estate with the purpose of residence and commerce except for the two holy cities.

UAE Launched several new free trade zones intended to establish the emirate as a global centre for trade in gold bullion, research and development of technology, and financial activities. It has also relaxed restrictions for foreign investment in specific real estate projects.

State companies reform and privatization

Bahrain Has completed privatization of public slaughter house and the capital's waste collection and incineration services. Further privatization projects are being prepared, including the public transport company (bus service) and tourist facilities. The telecommunications and postal service sector is being gradually liberalized.

Kuwait A privatization law enacted by the financial committee of the National Assembly has created complex rules for a large scale privatization; specified the areas and particular methods of privatisation and introduced safety measures against job losses. The government plans to sell (to private sector) most of its 62 public sector entities.

Oman — Puts the power sector in the forefront of its privatization efforts. Currently, foreign investors run three power generation projects on the so called "build-own-operate basis"[24] while the existing state owned power stations are being privatised. We can also mention a successful privatisation of the airport services management and the same being planned for telecommunications, water management and postal services.

Saudi Arabia — In 2002, it has announced a new privatisation strategy, which shall include higher independence of management, deregulation and, finally, private ownership. The privatisation should run in roughly 20 sectors including telecommunications, power generation, postal services, industrial parks, water management, railways and air transport. Saudi Arabia has recently privatized 30 percent of the Saudi Telecommunications Company and eight regional electricity companies have been merged into the Saudi Electricity Company.

UAE — Embraced utility privatization, embarking on new power projects through joint ventures with foreign investors, and selling some existing assets.

[24] This means that a foreign investor designs, funds, builds and, subsequently, operates the facility which he also owns. Frequently used is also a different model called "build-own-operate-transfer" where the investor owns and operates the facility only for a given period of time after which it is transferred to the hands of state without any compensation. It is also possible that the private investor owns the project jointly with the government. These models are usually used in sectors such as transportation, power generation, water management and telecommunications.

Labour Market Reforms

Bahrain	It has recently developed a strategy of “National Employment”, which comprises state subsidies for training of domestic workers in private sector and financial assistance for those unemployed. Bahrain has also introduced measures for raising standards in general education and vocational and technical training programs; and increased employment quota of Bahrainis in small and medium-sized companies while abolishing the "free visa" system to expatriate labour force.
Kuwait	Has introduced programs to implement to provide unemployment benefits to unemployed Kuwaiti nationals and provide training and facilitate employment of Kuwaiti nationals in the private sector; approved quotas for Kuwaiti nationals to be employed by private companies including fines and sanctions for not complying with them (e.g. exclusion form bidding for government contracts).
Oman	Has also adopted measures to raise the quality of vocational and technical training and introduced a uniform minimum wage for Omanis (plus one fifth as a transportation allowance) instead of the previous one, which had different rates for skilled and unskilled workers. Moreover, the government is modernizing the educational system at all levels. In 2002, a new ministry for human resources has been established.
Qatar	Has scraped its system of guaranteed employment for Qatari university graduates. It has been substituted by assistance to job seekers – maintaining information on job openings and counselling and training.

Saudi Arabia Has created the HRDF[25] (which is partly financed by private sector) in order to provide training of Saudi labour force in skills required by the private sector, and development of a database for matching and placement of Saudi workers in the private sector.

UAE Has established the NHRDEA[26] in order to improve the skills of UAE nationals and thus the likelihood of them being successful when applying for a job in private sector. It has also created a national labour market database to facilitate nationals' job searches.

2.3. Comparison of two key GCC members

In this subsection, I would like to compare and analyze two key GCC member states, namely, the *Saudi Arabia* and the *United Arab Emirates*. Their significance stems from various factors including religious authority, oil wealth, economic reforms, openness and others. To a layman, these two countries may seem to be the same, mainly for their wealth, oil reserves and common culture. However, from an economist's point of view, they are far apart with each experiencing a different economic development.

The following comparison will be based on the data (economic, geographic, political etc.) provided by the *CIA World Factbook*[27].

Saudi Arabia

This country is usually considered synonymous to immense oil wealth, rigorous society ruled by orthodox religious beliefs (*wahabism*) and more or less closed economy for foreign investors.

[25] Human Resources Development Fund
[26] National Human Resource Development and Employment Authority
[27] Source: World Fact Factbook; www.cia.gov/cia/publications/factbook/index.html

Saudi Arabia has an oil-based economy with strong government controls over major economic activities. It possesses 25% of the world's proven petroleum reserves, ranks as the largest exporter of petroleum, and plays a leading role in OPEC. The petroleum sector accounts for roughly 75% of budget revenues, 45% of GDP, and 90% of export earnings. About 40% of GDP comes from the private sector. Roughly 5.5 million foreign workers play an important role in the Saudi economy, particularly in the oil and service sectors.

The government is encouraging private sector growth to lessen the kingdom's dependence on oil and to increase employment opportunities for the swelling Saudi population. The government is promoting private sector and foreign participation in the power generation, telecom, natural gas, and petrochemical industries.

As part of its effort to attract foreign investment and diversify the economy, Saudi Arabia acceded to the WTO in December 2005 after many years of negotiations. With high oil revenues enabling the government to post large budget surpluses, Riyadh has substantially boosted spending on job training and education, infrastructure development, and government salaries. The government has announced plans to establish six "economic cities" in different regions of the country to promote development and diversification.

United Arab Emirates

Known for its openness, financial services and, last but not least, its construction boom, the 7 emirates play a significant role in the region. Usually considered to be a role model Arab nation forging ahead with reforms in both its economy and society.

The UAE has an open economy with a high per capita income and a sizable annual trade surplus. Despite largely successful efforts at economic diversification, about 30% of GDP is still directly based on oil and gas output, and the fortunes of the economy fluctuate with the prices of those commodities. Since the discovery of oil in the UAE more than 30 years ago, the UAE has undergone a profound transformation from an impoverished region of small desert principalities to a modern state with a high standard of living. The government has increased spending on job creation and infrastructure expansion and is opening up its utilities to greater private sector involvement.

In April 2004, the UAE signed a Trade and Investment Framework Agreement (TIFA) with Washington and in November 2004 agreed to undertake negotiations toward a Free Trade Agreement (FTA) with the US. Higher oil revenue, strong liquidity, and cheap credit in 2005-06 led to a surge in asset prices (shares and real estate) and consumer inflation. Rising prices are increasing the operating costs for businesses in the UAE and degrading the UAE's allure to foreign investors. Dependence on a large expatriate workforce and oil are significant long-term challenges to the UAE's economy.

It is quite clear from this brief description that these two countries differ in several key areas. One would be openness to foreign investment, or foreigners at all. While the UAE is generally held in high esteem when it comes to allowing foreign participation on its markets, Saudi Arabia is considered to be rather hostile in this respect, even though it is slowly opening up its markets (Needless to say, the oil sector remains under government control dominated by Saudi Aramco, a state owned giant).

2.4. Conclusion to Reforms and Integration

Recently, the integration efforts among the GCC countries are gaining on the intensity what could also facilitate the implementation and coordination of numerous structural reforms in this region. In fact, it could be said that since the establishment of the GCC more than two decades ago, the countries has experienced a significant movement towards regional integration.

Barriers to free movement of labour, goods, services and capital have been, to a considerable extent, eliminated. Furthermore, regulatory procedures in the banking sector are being gradually harmonized what should allow banks from member countries to open their branches throughout the whole GCC region. Additionally, same tax rules apply for domestic and GCC registered companies[28] including GCC individuals. They were also allowed to own real estate and invest on the stock markets in any member country.

Nowadays, there is a unified CET[29] administered by the GCC countries. There is no customs duty among member countries if at least 40% of the added value accrues from member countries[30].

However, there are still differences when it comes to foreign investments' regulations, ownership, capital markets etc., while differences in the level of integration into the global banking system hamper the creation of a wider common market in the GCC region. Nevertheless, this could partly be achieved through the Monetary Union projected for 2010. It will of course require an enormous effort and lots of appeasements and compromises from member countries.

[28] Meaning companies registered in other GCC member countries
[29] Common External Tariff – a common customs tariff for imports into the GCC region
[30] Middle East Economic Survey; http://www.mees.com

On the other hand, it can be argued, that creation of a Monetary Union would be beneficial for the whole GCC region while, at the same time, it would facilitate and speed up a future process of integration and boost the positive effects of past reforms.

The pros and cons of the prospective Monetary Union as well as the eventual preparedness of the GCC countries for their membership is going to be discussed in the following chapter entirely dedicated to this integration effort.

3. GCC Monetary Union

This chapter will analyse the prospective Monetary Union (MU), which the GCC countries plan to establish in the near future. The aim of this analysis will be to elucidate the steps necessary for a successful implementation of the MU as well as to evaluate whether the GCC region is suitable for such an Union, or not.

Accords on the establishment of the Union

The first step towards the economic integration was the creation of a Free Trade Area in 1983. Then, in 1999 on the GCC summit in Riyadh, the leaders decided to establish a Customs Union as the next integration step. A timetable has been set up to reach the Customs Union by the end of 2005 but already in 2001 the six member countries agreed on introducing a common 5% tariff two years in advance, in other words, by 2003.

Regarding the MU, in 2000, an agreement to peg national currencies to the USD by 2002 has been reached on the Bahrain Summit. This was a preliminary measure as the prospective single currency[31] is also to be pegged to the USD. The whole Monetary Union project should be fully implemented by 2010.

It is desirable to mention that a successful economic and monetary integration would result a regional entity with an aggregate GDP of approximately 560 billion USD[32], 45% of World's oil reserves and 17% World's gas reserves[33] at its disposal.

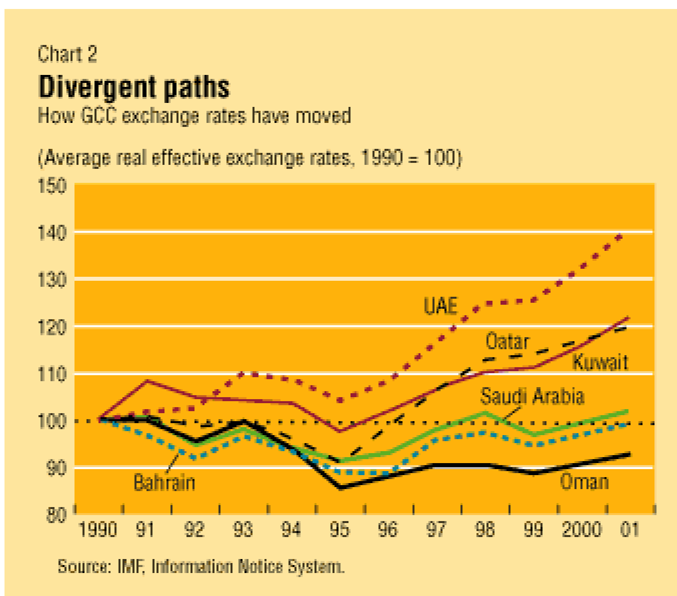
[31] A single currency is considered to be on of the cornerstones of a full economic integration.
[32] World Fact Factbook; www.cia.gov/cia/publications/factbook/index.html
[33] Ugo Fasano, Zubair Iqbal, Common Currency, www.imf.org

Regional environment – regional disparities

GCC Members already meet some convergent criteria like stable nominal (bilateral) exchange rates and mostly identical monetary policies. Moreover, a forementioned Customs Union, with a unified single tariff of 5%, has been established[34].

On the other hand, it is necessary to say that despite these efforts the GCC countries show some crucial differences in economic results and political goals. In spite of a traditionally low inflation in the GCC region, the inflation rates have differed in individual states resulting in disparate development of real effective exchange rates (see Figure 4). Needless to say, the bilateral real exchange rates are one of the most important indicators of preparedness for a single currency.

Figure 4. Development of GCC exchange rates



Source: Ugo Fasano, Zubair Iqbal, Common Currency, www.imf.org

[34]Cooperation Council of the Arab States of the Gulf - Secretariat General, http://www.gcc-sg.org

There is also a disparity among the countries' real GDP growths, while this disparity arises mostly from the part of GDP accrued in the non-oil activities. Obviously, these activities are the best to characterize the economic differences since the oil sector is mostly dependent on external influences which are reflected in all countries similarly. Moreover, these activities are to be the future income generators, or at least most of the member states hope so and strive for it, so they should be taken into account with a much higher weight than just what represents their share on the GDP.

Some countries have experienced fiscal deficits that only reflect the volatile oil prices on the World markets on one hand, and relatively high government expenditures on the other[35]. In spite of the fact that the monetary policies of GCC members were all aimed at maintaining stable RER and low inflation, they have differed in instruments used to achieve these aims. Further disparities arose from different regulations of the banking sector (terms and conditions for entering, liquidity requirements etc.) that only slowed the integration of individual banking sectors and prevented them from reaching a straight-out integration of financial and capital markets in the GCC region.

3.1. Supporting Factors of the MU

It is a common knowledge that countries with smaller differences in the structure and system of their economies are much more likely to be successful when it comes to integration and, particularly, to formation of a Monetary Union. In this respect, we could say that the GCC countries are promising candidates for a membership in such a Union. That is to say, there are many similarities among them and not just when it comes to economic activities:

[35] Something that resulted in significant increment of government debt in some member countries.

- Six countries forming an uninterrupted belt circumscribing the Arab Gulf.
- People share a common language, religion and traditions.
- Oil exports, priced in USD, are the main source of government's income in all member countries. (Kuwait 92%, Saudi Arabia 81%, Oman 77%, UAE 76%, Bahrain 74%, Qatar 56%)[36]
- In general, it is possible to say that all GCC countries levy low or no income taxes at all. The customs tariffs for most products are low as well.
- In spite of the fact that the inflation rates in individual member countries have differed in the past, all GCC states followed anti-inflation policies including fixed exchange rates against the USD. There are no barriers to exchanging currencies or investments flows. GCC governments follow open market policies.

With a certain degree of abstraction, it is possible to say that the GCC member countries have behaved quite consistently and there were no major conflicts among their policies regarding their aims or means of achieving them. Basically, all member countries strive for the same, that is to say: transformation of their economies, liberalization of the entrepreneurial environment, opening of regional markets, development of the private sector and attracting foreign investments.

It is fairly clear that none of these aims is in a direct conflict with the proposed Monetary Union; to the contrary, such a Union together with a deeper economic integration could strengthen these efforts by increasing the efficiency of individual reforms.

[36] Al-Bassam, K., The Gulf Cooperation Council monetary union, http://www.bis.org

3.2. Pros and Cons of Economic Integration and the Prospective of the Monetary Union among GCC Member States

The most important direct *benefits* of the economic integration and of the Monetary Union of the GCC countries are basically identical with those accompanying the introduction of *euro*:

- Elimination of transactional costs will result not only in savings of money but time as well. For small and medium companies that do business across the whole GCC region but have neither the necessary experience nor the resources to maintain their portfolio in several different currencies this would mean cutting the costs[37] as well as the risk.
- Elimination of the above mentioned risk could boost the mutual trade and investments among the GCC countries[38].
- Higher transparency in pricing, enhanced competitiveness (but at the same time a tougher competition) and simplification of trade procedures will, in the end, bring benefits to consumers in the GCC region.
- Fiscal discipline of the GCC members will have positive effects on the inflation (lower rates) and interest rates.
- Also major banks in the region will experience long-term effects. A single currency means a more effective handling of cash while the costs of hedging against volatile exchange rates will be significantly lowered[39].
- A unified GCC market, which nowadays represents an area with an aggregate GDP of more than 560 billion. USD[40], would bring new trade and investment opportunities. At the same time, this would attract new foreign

[37] Meaning the costs of: monitoring: the ER fluctuations, forecasts of ER trends, currency exchange and foreign currency reserves necessary for day-to-day trade.

[38]The low level of mutual trade is considered to be one of the main deficiencies of this region.

[39] However, these costs will not be cut down to zero as there are also other currencies these banks will handle, exchange and keep in stock as reserves. Naturally, this does not apply only to banks but to any kinds of businesses that are involved in foreign (meaning outside the GCC) dealings.

[40] World Fact Factbook; www.cia.gov

investors who could already today focus on the manufacturing and service sector.

- The GCC Monetary Union would probably represent the biggest and most liquid capital market in the Middle East. Foreign and domestic investors could focus on this region as a whole what would truly make the work a lot easier for the portfolio managers and private investors who could choose freely from shares without taking in to consideration any additional risks related to fluctuating exchange rates.

As for negatives that are associated with monetary integration, the following major issues should be taken into account:

- Loss, to a certain degree, of independence and national identity (this, however, is rather a psychological problem).
- Forfeiture of their own monetary policies and thus of the control over exchange rates.
- Risk of harmful joint decisions/policies pursued by majority against the will and interests of minority.

From what has been stated above, it might look as if there are by far more pros than cons of the MU. However, some of the mentioned cons (Especially the third one) could have serious consequences for the economic future of some of the GCC's members since while a particular monetary policy may be beneficial for a particular group of states it can, at the same time, be devastating for the other.

In order to reduce the risks of mutual incompatibility (e.g. different impacts of common policies) of the would-be members in the future, an analysis of their preparedness/compatibility may be carried out. And since this issue of compatibility is considered to be crucial for future success of the Monetary Union, the next few pages are entirely dedicated to this matter.

3.3. Are the GCC Member States ready for the Monetary Union?

In order to prosper within the proposed MU, the candidate states have to meet certain requirements in the first place and, in case they don't, they have to adopt relevant measures so that they do. Following, an analysis of their preparedness will be carried out while the suitability of such Union alone for the GCC region will be questioned.

3.3.1. Optimum Currency Area Analysis for GCC Countries

In short, OCA is a region for which it is optimal to have a single currency and a unified monetary policy. Thus we are talking about a *currency* or *monetary union.* This comprises monetary integration, single currency and one common central bank handling foreign currency reserves and carrying out a common monetary policy.

The monetary integration itself requires irrevocable fixation of local exchange rates[41], full convertibility of local currencies, integration of local financial markets (harmonization of national financial regulations and institutions), complete liberalization of transactions and, of course, a common monetary policy.

Optimality of a monetary union for any given region can be measured as a degree of fulfilment of certain criteria related to a successful MU. This also depends on how much are the candidate countries economically integrated (through mutual trade, banking and other services etc.); on degree of correlation of economic cycles and on the resemblance of shocks the countries are exposed to.

[41] In case of GCC countries to USD.

When determining whether a particular country is ready to join a MU, we can use various indicators/factors. The most significant are[42]: *openness, factor mobility, degree of commodity diversification[43], similarity of product structure, price and wage flexibility, similarity of inflation rates, degree of policy integration, political factors.*

GCC Countries and factors of preparedness for joining the MU

The aim of this section is to see whether the GCC member states are ready to enter the proposed Monetary Union.

Openness: GCC Countries a generally considered to be one of the most opened economies in the region[44]. This is caused mainly by their natural resources which predetermine their high volumes of exports of oil (whether crude or refined) and natural gas. On the other hand, their dependency on imported goods and capital (since there are no domestic substitutes) increases the total value of imports and thus contributes to the overall volume of international trade. Small and open economies that more or less rely on trading with the rest of the World (exactly the case of GCC countries[45]) are more exposed to volatile ER and uncertainty. Moreover, according to some authors[46], the Exchange Rate is, under these circumstances, rather ineffective as a monetary policy instrument (used to achieve Balance of Payments Equilibrium) due to rigid demand for imports (the only source of certain commodities). According to the aforesaid, entering the proposed MU would be beneficial for all GCC members.

Factor Mobility: Countries with a higher Production Factors (PF) mobility are better candidates for a MU membership. This is because PF mobility can act as a substitute to Exchange Rates as an instrument of correction in case of economic shocks. The UEA Articles of GCC Countries allow a free movement of capital and

[42] Laabas, B., Limam I., (2002)
[43] Meaning how much is a country dependent on production of a particular commodity, in other words, resistant to shocks in a particular branch of industry.
[44] In this case, the openness is measured as a ratio of international trade to the overall GDP.
[45] Except for Saudi Arabia, to a certain degree.
[46] Yoshihide, Ishiyama, 1975

people within the GCC Region and also let them to perform economic activities. However, when looking at the scope of this movement within the GCC Region, it is obvious that the PF mobility will not act as an ER substitute. The reason for this can be found in certain restrictions regarding the activities the GCC citizens can perform (in other than home country within GCC) and also regarding ownership. Also the system of 'social state' pursued in most of the member countries has a negative influence on the overall mobility by creating many disincentives for locals to move where the jobs are. According to this we can assume that when it comes to the mobility of Production Factors the GCC Countries are not the most suitable for joining the proposed MU.

Degree of commodity diversification: The more diversified economy the better it is shielded against external shocks and the less it has to rely on Exchange Rates to alleviate the effects of these shocks. Thus it can be argued that countries with diversified economies are better candidates for a MU. However, contrary to this, the GCC member states still remain highly dependent on one or two commodities (oil and natural gas), which account for approximately 80% of export earnings and governments' revenues[47]. Moreover, the non-oil sector is, in most of the member countries, considered to be only a sort of an enclave the development of which ultimately depends on the performance of the oil sector[48]. Probably the only positive factor regarding this issue is the fact that the GCC Countries do not use the ER as an instrument to accommodate oil shocks[49]. From all this it is possible to conclude that considering the commodity diversification the candidate states are prepared neither to adopt a single currency nor to give up their independent monetary policies.

Similarity of product structure: Countries with similar structures of production will share similar problems in case of various fluctuations in the global economy. This means that they will react to certain changes in the world economy in approximately the

[47] Needless to say, this varies throughout the GCC Region with Saudi Arabia being one of the most oil-dependent countries in contrast to the UAE where the oil&gas sector represents a 'mere' 30% of GDP.
[48] It is necessary to say that most of the non-oil revenues come from trade and services.
[49] Instead they use other correctional instruments, namely government expenditures. However, it is necessary to note that these expenditures are subject to revenues which are generated mostly by the oil sector.

same way using the same or similar instruments. Based on this assumption, it can be said that countries with similar structures of production will be suitable candidates for a membership in a monetary union. This is favourable for the GCC Countries as they more or less share the same production structures[50]. It can be argued that a common policy in this area would be beneficial for member states. Thus we can conclude that this criterion of optimality is met by our group of analysed countries.

Price and wage flexibility: If a country has flexible wages and prices it is easier to deal with shocks, especially in case it is not possible to use Exchange Rates as monetary instruments. This means that in the event of joining the MU (meaning the ERs can no longer be independently used for monetary purposes), more flexible countries are more likely to accommodate future shocks. However, the GCC member countries can not be considered as flexible and particularly when it comes to wages. This is manly due to guaranteed and thus inflexible wages of domestic workers. Past developments also show that even prices do not systematically adjust when oil shocks occur[51]. Based on this, we can conclude that the GCC Countries do not meet the flexibility criterion of a successful membership in a monetary union. However, it has to be said that since the GCC Countries use government expenditures and not Exchange Rates as a main monetary instrument in case of shocks, a prospective membership in the MU would not mean a loss of a significant instrument of monetary policy.

Similarity of inflation rates: By adopting a certain degree of abstraction, we could say that countries with similar inflation rates will also share similar economic policies when it comes to their structure and management. This similarity will certainly be desirable in case countries decide to join a Monetary Union (which requires a mutual coordination). It can be said that GCC members are not very prone to high rates of inflation[52]. However, when it comes to their correlation, it is not very high even in spite of a relatively similar management of macroeconomic policies. Authors *Belkacem*

[50] This structure has already been described in previous chapters so any further expansion on this would be rather redundant.
[51] Laabas, B., Limam I., (2002)
[52] Source: World Fact Factbook; www.cia.gov/cia/publications/factbook/index.html

Laabas and *Imed Limam*[53] ascribe these differences to microeconomic determinants of inflation (in other words, factors affecting the supply and demand). Nevertheless, the important thing for our analysis is the fact that the economic policies of individual member countries are relatively similar and so their eventual coordination within the prospective MU should not represent a barrier to entry.

Degree of policy integration: As it has been already said in the previous paragraph, similarity of economic policies, or at least of the approaches towards them, is a vital factor of a successful monetary integration. Chapter 4 of the GCC Charter covenants, among other things, the same formulations of regulations in the economic and financial spheres[54]. Individual member countries have tried to stick to these accords what led to more or less identical policies regarding the coordination within the prospective MU. For instance, monetary and exchange rate policies in the GCC countries are commonly centered around maintaining a wedge between domestic and foreign interest rates in order to stabilize the ER and stem capital outflows or portfolio reallocation in favor of foreign assets[55]. Based on this, it can be said that the degree of harmonization of common policies (relevant to MU) is ample, or more precisely, on a good way towards a successful coordination within the planned MU.

Political factors: It is undisputable that for an execution of such a fundamental step as joining the MU, it is necessary to have, apart from the above mentioned prerequisites, a strong political will. Past experience shows us that these political factors might even be crucial and decisive for the integration process itself. The GCC Countries approach this problem in a responsible way and in spite of certain set-backs the leaders agree on strengthening of the cooperation towards a political and economic integration[56]. And so when it comes to political cooperation, the GCC Countries are on a good way to create a successful MU.

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[53] see note 40.
[54] Cooperation Council of the Arab States of the Gulf - Secretariat General, The Charter, http://www.gcc-sg.org/CHARTER.html
[55] Laabas, B., Limam I., (2002)
[56] Press Communiqués Issued by the Ministerial Council of the Gulf Cooperation Council, http://www.gcc-sg.org/Ministerial_e.html

Previous evaluation of individual criteria affecting a successful creation of the MU is summarized in Table 1 which classifies each criterion either as *favourable* or *unfavourable*.

Table 1. OCA Test for the GCC region

OCA Criterion	Favourable	Unfavourable
Openness	x	
Factor Mobility		x
Degree of Commodity Diversification		x
Similarity of Product Structure	x	
Price and Wage Flexibility		x
Similarity of Inflation Rates	x	
Degree of Policy Integration	x	
Political Factors	x	

Table 1 clearly shows us that the current state of things in the GCC member states is not quite ideal. The question now is whether the GCC members should rather postpone the MU project and revive it later when they meet all the above mentioned criteria or forge ahead even despite some deficiencies and meet the remaining criteria ex post. Some contemporary authors[57] argue that the would-be members usually meet the full set of criteria only after their entry while the membership itself creates better conditions for their attainment. For example, some members of the EMU did not meet all the above mentioned criteria upon their entry[58]. Moreover, according to Eichengreen[59], the situation in the countries of the euro zone was even less plausible regarding the OCA theory than in the case of independent states of North America before they formed a federation.

As it has been already mentioned, joining the MU itself might facilitate achieving some of the criteria. This could involve promotion of international trade within the GCC Region which is currently insufficient while exactly the single currency and common

[57] Horvath, R., Komarek, L., OCA Theory: An Approach For Thinking About Monetary Integration
[58] Laabas, B., Limam I., 2002
[59] Eichengreen, B., Is Europe an Optimum Currency Area?

rules of trade could be a huge incitement of domestic producers to extend their activities beyond the borders without taking risks arising form volatile ER and costs connected with handling foreign currencies.

3.3.2. G-PPP Analysis for GCC Countries

So far, we have analysed the suitability of the MU only on a purely theoretical level without using any numeric data reflecting the current situation. In order to have a complete analysis it is advisable to include also a mathematical evaluation of the candidate countries.

Generalized Purchasing Power Parity

For this we will use the G-PPP approach developed by *Walter Enders* and *Stan Hurn*, which deals with evaluation of suitability of forming a MU for a given group of countries. This approach is based on certain assumptions[60]:

1) The economic theory implies that the RERs are influenced by certain macroeconomic variables. These are also known as fundamental variables and include *income, terms of trade, government expenditures* etc. It has been empirically proved that these variables are non-stationary. Thus, it is not surprising that also the PPP-defined RERs, influenced and one might say even determined by these variables, will exhibit non-stacionarity.

2) Countries constituting a successful MU should, on average, share the same trends in the development of the fundamental macroeconomic variables. Thus, also the RER of the respective countries that are influenced by these variables should essentially share a common trend. Based on this, we can formulate an argument that, within any

[60] Beatrice Kalinda Mkenda, Is East Africa an Optimum Currency Area?

monetary union, there should be at least one linear combination of individual bilateral RERs. In other words, individual RERs should be cointegrated (interdependent).

Therefore, the G-PPP Test analysis whether there is a cointegration in the following equation[61]:

$$(1)\qquad RER_{12t} = \alpha_0 + \beta_{13}RER_{13t} + \beta_{14}RER_{14t} + \ldots\ldots\ldots + \beta_{1n}RER_{1nt} + \varepsilon_t$$

Where RER_{1it} is the real exchange rate between the base country (country *1*) and country "*i*" in period "*t*", α_0 is a constant, β_{ij} are the parameters of the cointegrating vector, and ε_t is a stationary stochastic disturbance term (random variable).

In case of the GCC Countries, it is possible (advisable) to use Saudi Arabia or the USA as a base country. Regarding Saudi Arabia, this is given by the significance of this country for the integration within GCC itself[62]. On the other hand, using the USD is supported by a strong relation of all GCC currencies to American Dollar. Individual sets of RERs (one for Saudi Riyal and one for USD) are defined as follows[63]:

$$(2)\qquad \mathrm{RER}_{\mathrm{it}} = \frac{\mathrm{S}_{\mathrm{it}}\mathrm{P}^{*}_{\mathrm{t}}}{\mathrm{P}_{\mathrm{it}}}$$

Where $\mathrm{RER}_{\mathrm{it}}$ is a bilateral real exchange rate between the base country and country "*i*" in period "*t*" expressed as the number of national currency units for one unit of the currency of the base country, S_{it} is the nominal exchange rate between the base country and country "*i*" in period "*t*", $\mathrm{P}^{*}_{\mathrm{t}}$ is the consumer price index of the base country, and P_{it} is the consumer price index of country "*i*" in period "*t*".

61 Laabas, B., Limam I., 2002
62 see note 58
63 Beatrice Kalinda Mkenda, Is East Africa an Optimum Currency Area?, http://ideas.repec.org/p/hhs/gunwpe/0041.html

When calculating the RER_{it} as well as the parameters of the cointegrating vector, we will use the calculations of *Laabas* and *Limam*[64] who used the data of IMF and IBRD from 2002 and 2001 respectively. History of the RERs of all six GCC member states for the period of 1960-1999 calculated as per the equation (2) can be found in form of graphs among the Appendices, namely as Appendix 1.

Looking at the Appendix 1, it is obvious from the first sight that the RERs of the six respective countries against USD share certain common trends. There were quite similar slumps (period between 1970 and 1980) and following surges at the same times. These fluctuations share the same time, magnitude and duration. Additionally, the RERs do not share the same development trends just in times of big shocks but also when it comes to long-term development (long-term growth since the end of the 80s).

Next step in the G-PPP analysis is to find the number of the cointegrating vectors of the RERs and their parameters. In order to obtain these data, Messrs *Laabas* and *Limam* used the *ADF stationarity test* and *testing of hypotheses*. Based on their calculations (conducted at a 95 percent significance level), we can say there are two cointegrating vectors parameters of whose are shown in the following Table:

Table 2. Cointegrating and Adjustment Vectors

	α_0	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	UAE
B^1	-1.609	-0.458	-0.188	-0.019	1.302	1.000	-1.952
A^1	-	-0.280	-0.166	-0.006	-0.119	-0.419	-0.058
B^2	1.884	-0.307	1.566	-0.579	-0.645	1.000	-1.470
A^2	-	-0.057	-0.047	0.626	0.010	0.130	0.173

Source: Laabas, B., Limam I., 2002

[64] see note 61

Evaluation of the G-PPP Test

Coefficients "α" represent parameters of the *Adjustment Vectors* and can be interpreted as adjustment speed towards long-term equilibrium. The existence of cointegrating vectors itself tells us that there are relations among the RERs of the GCC member states and, based on this, that the GCC Region meets the OCA requirements regarding the exchange rates.

We will prefer the first cointegrating vector since all the parameters of its adjustment vector are negative. From the parameters of these vectors we can conclude that, maybe except for Oman, the respective RERs function within a significant mutual relation. Thus, Oman can be considered the weakest candidate from among the six member countries for the membership in the proposed MU. Moreover, values of the "α^1" parameters for Oman and UAE are too small indicating that they are moving slower towards the long-term equilibrium than their fellow members[65]. These differences in the adjustment rates might also indicate different circumstances in these two member states that probably required different approaches and solutions. From this point of view, these two countries appear to form a less homogeneous part of the GCC than the remaining for states.

However, it is necessary to mention that the previous mathematic analysis is not capable of explaining further economic relations and interconnections. This means that the results of the G-PPP Test support the creation of the proposed MU among the GCC Counties but only based on the RERs' trends while it evaluates their relations, strength and adjustment rates but not what are the causes of these trends (e.g. factors influencing the RERs).

Thus, we can summarize the outcomes of the G-PPP Analysis for the GCC Region: Overall, the outcomes of this analysis are rather favourable since concrete

[65] This could mean that the deviations from the equilibrium will last relatively longer in these two countries than in other member states

relations among all six GCC currencies were found. However, some of these are not that strong and the adjustment rates for some members indicate still a very long way towards equilibrium. Also, it has to be taken into consideration that there are certain limits of this analysis, which is not able to predict a common development of macroeconomic variables in the future and should not be consider a solid proof of convergence if it is not supported by other tests that altogether provide us with a bigger picture.

Perspectives of the Monetary Union of the Gulf Countries

From a short-term point of view, creation of the MU will bring only costs and sacrifices in terms of loosing control over certain areas. However, from a long-term point of view the Union could promote trade and investments within the GCC Region and, subsequently, reduce the differences among member countries and thus bring prosperity that would accrue from other sources than oil.

As it has been mentioned before, the GCC states do not meet all the requirements for the establishments of the MU (while these criteria are not important only for the Union itself but their fulfilment is beneficial in other respects as well). And here we are coming to a paradox since according to some authors[66], the MU membership itself creates better conditions for the fulfilment of these criteria and thus they support entering the MU even with some deficiencies in the countries' preparedness. They also claim these deficiencies will be removed ex post. This, of course, depends mainly on the political will which is a driving force of the whole integration process.

One of the major deficiencies of the GCC Region is the small level of mutual trade despite the creation of the FTA. According to World Bank, it accounted for 6.8%[67] at the and of the last century while when comparing to other such groups it is truly a small number (EU 62.9%, NAFTA 54.6%, MERCOSUR 20.5%, CEFTA 11.9%).

[66] Horvath, R., Komarek, L., OCA Theory: An Approach For Thinking About Monetary Integration
[67] Exports within the GCC/overall exports of the GCC Countries

However, really alarming is the stagnation of this level while a small diversification of exports hampers the development of regional trade. Moreover, some authors[68] point out that the existence of similar industrial structures in individual member states "could create long-term corruptive overlapping", which could inhibit the efforts to expand mutual trade. Looking at this problem from the MU point of view, it can be argued that a single currency could, in combination with in advance discussed efforts to specialize national industries, support mutual trading but, as it has been already mentioned, this lies mainly with politicians and their will to agree.

3.3.3. Comparison between GCC and the Euro Area

I would like to point out right at the beginning that the countries from these two integration groups are not fully comparable because of their different levels of (mainly economic) development. However, we will try to abstract from these differences in order to make the comparison rather simple and comprehensive.

It is quite clear from past developments in both regions that the abolition of transactional costs and risks related to the existence of different currencies is considered as a must for a full integration of both markets. When it comes to the EU, the monetary integration was sort of a continuation of the economic one while there is an opinion that a monetary integration is not possible without a close political cooperation (integration) which is necessary for complying with the rules of the MU (e.g. convergation criteria)[69]. Speaking about this cohesion of different integration policies, the GCC member states act basically in the same way as the Euro-zone members did. Of course, with the exception of political cooperation as it is currently not at the same level as it was (is) in the case of the EU. This is mainly because, unlike the GCC Countries, the EMU members have established several organizations and institutions (e.g. EP, ECB etc.) prior to introducing the euro whose task was to secure a successful monetary integration. Unfortunately, it has

[68] Peterson, E. R., (1988), The Gulf Cooperation Council: Search for Unity in a Dynamic Region, Westview Press, Boulder, Colorado, U.S.A.
[69] Eichengreen, B., A More Integration, Essays in International Finance

to be said that when it comes to GCC there is no clear plan that would include establishment of similar institutions in this region and the only agreement of such kind is the already mentioned agreement on pegging the national currencies to the USD.

It is a common knowledge that Germany played a crucial role in the EMU as it diligently pursued a strong anti-inflation policy as well as a policy of strong and stable currency. Other EMU candidate states (not all of them) pegged their respective currencies to DM while this action contributed positively to convergence of common policies.

Regarding GCC, there is no such pivotal member or organization that could act as an “informal leader” and which all other members could lean on in their integration efforts[70]. Also, there is no mechanism that would set rules within the MU, thus securing discipline as we know it from the EMU (Maastricht criteria).

Furthermore, in EU’s case, the arrival of euro was facilitated by the establishment of EMS with a sufficient lead before the introduction of euro, while the transition itself was a mere switch from ecu to euro in ratio 1:1.

Up to now, there is no similar system within the GCC. However, we could spot a certain advantage in the fact that all GCC member sates were involved in more or less identical monetary systems. Until 1999, Bahrain, Qatar, Saudi Arabia and UAE had their currencies pegged to SDR, Oman to USD and Kuwait to a basket of currencies according to its most significant trade and financial partners[71]. Nevertheless, it can be said that all member countries maintained a permanent relation between their respective currencies and the USD. This was also the cause why they have recently decided to peg their currencies to USD. This temporary arrangement should at least partially solve the problem of discipline within the MU and also provide a better credibility of the whole monetary integration.

[70] Saudi Arabia is sometimes stated as a key member; however, this is because of its strategic position in the Region rather than because of its integration policies. The problem is that without Saudi Arabia the significance of the whole GCC would rather suffer.

[71] Laabas, B., Limam I., Are GCC Countries Ready for Currency Union? (2002), www.arab-api.org/wps0203.pdf

At the end of this comparison, I would like to state that in my opinion, the establishment of the EMU was a good step towards integration which also demonstrates in reality that independent sovereign states, that share some common traits like culture, history, economic goals or geographic closeness, can work together within a single currency system which may bring them even closer. And I think a similar scenario could be feasible also among the GCC members. If we abstract from certain deficiencies, most of that can be overcome through political will, it is evident that a common currency and an overall cohesion are a call of the future which could indicate a knew chapter in the history of this traditionally volatile region.

3.3.4. Conclusions to the GCC Monetary Union Analysis

The analysis has shown that despite great efforts and past successes, the GCC member states still have to meet certain requirements of a successful Monetary Union. Their economies are still dominated by oil industries; mutual trade is limited and similar trends in the basic macroeconomic variables could also be disputed.

Main factors supporting creation of the MU are the clear-cut commitments of the GCC states to fixed exchange rates, similarities of product structures and, to a certain degree, political will when it comes to economic integration (or at least a declared will). When evaluating the preparedness of GCC members for the creation of the MU, I have taken into account opinions of some contemporary authors[72], namely, that countries (not just the GCC members) meet all OCA criteria ex-post rather than ex-ante and that the growth of mutual trade as well as synchronized economic cycles are more likely the outcomes and not the prerequisites of a successful MU.

[72] See Notes 57 and 58

Based on this analysis, I think that the GCC Countries should form the proposed MU despite some deficiencies (see Table 1.) and try to eliminate them subsequently. However, the MU would bring benefits to the Region only if the member countries achieve a state of economic and political convergence. They might do this by creating a single market eliminating all barriers to free movement of goods, services and production factors. It would also be advisable to establish supranational institutions that would subject national interests to those of the whole region. This, however, means that the member countries would have to forfeit some of their prerogatives; and this will probably be the cause of future setbacks in the integration process.

4. United States and GCC

US diplomatic ties with the Middle East were always characteristic with their complexity. It is nothing unusual for the United States to support (even militarily) a particular Middle Easter country just to become its fiercest enemy once it falls from grace. As the following paragraphs will clearly show, the path of the US in the Middle East was quite diverse with its ever-changing reputation of either guardian or hostile infidel. Unfortunately, due to limited scope of this thesis, it will not be possible to cover the whole complexity of this issue. Nevertheless, mentioning the key events should be enough to picture the whole situation.

Establishment of US presence on the Arabian Peninsula

Needless to say, the United States had ties with the GCC member states a long time before the formation of GCC itself[73]. However, there were some important events in the second half of the 20th century that cleared the way for the United States to become the pre-eminent military and geo-political power in the Gulf as a whole, a role it has been keen to strengthen and expand ever since.

Probably the most important event in this respect was Great Britain's decision (1967) to revoke by the end of 1971 it's nearly 150 years old treaty relationships with nine Gulf principalities by which it administered their foreign relations and defense[74]. This made it possible for Qatar and Bahrain to join the Saudi Arabia and Kuwait which were already independent states. It also led to formation of the United Arab Emirates which later became (as indicated by previous chapters) the regional leader in reforms and development.

[73] Although we must not forget that some of the member states were not formed until early 70s.
[74] Onley, J., Britain's Informal Empire in the Gulf

However, according to *Anthony*[75], the catalyst that most influenced the establishment of the GCC and the need for the United States and other allies to reformulate their policies towards the GCC region was the overthrow of the government headed by the Shah of Iran in December 1978.

The Iranian revolution raised mainly security concerns since before the revolution, Iran together with Saudi Arabia acted as a "two pillar" structure responsible for peace and stability in the region[76]. But after the events in December 1978, there were fears (justified) that the Iranian revolution could spread to Iraq and, consequently, to the rest of the Arabian Peninsula[77]. And so, owing to this and to the Iran-Iraq war (1980-1988), the US was considered crucial for the security of the GCC Region and was expected to act as counter-balance to Iran should it unleash a new conflict in the Region.

Nevertheless, we should not confuse US-Gulf defense and security relations with US-GCC relations since the GCC is based primarily on economic goals and efforts while other issues are left for each member to decide upon independently[78].

4.1. Past and Present Position of the USA in the GCC Region

Gradual disillusionment

As it was mentioned before, the US has always been perceived as a key player not only in the GCC Region but throughout the whole Arabian Peninsula. However, this position has been gradually distorted among Arab citizenry especially by American foreign policy. America has always been seen as a protector of Israel (or in some cases a silent supporter); something that always caused much ire among Arabs and other Muslims around the World.

[75] Anthony, J. D., The US-GCC Relationship
[76] Afrasiabi, K. L., Saudi-Iran tension fuels wider conflict
[77] Anthony, J. D., The US-GCC Relationship
[78] see basic objectives of the GCC according to the Charter (page 1)

And so GCC countries were astounded when the United States remained reluctant to prevent the Israeli aggression against Lebanon in 1982[79]. The disillusionment with America was further augmented a year later when the US did neither prevent Israel from annexing Syria's Golan Heights nor challenge its legitimacy[80]. Furthermore, the Palestinian issue is another good example of American foreign policy harming the USA's image among Arab countries; however, I think this issue is so commonly known it is not necessary to elucidate it any further.

Due to the above mentioned, it was getting more and more difficult for the GCC leaders to defend their close relations with the US whose government continuously pursued policies that were considered unjust by the GCC peoples.

Iran-Iraq War

On September 22nd 1980, the Iraqi president Saddam Hussein ordered the invasion of Iran[81] and unleashed one of the 20th century's longest wars. The reason for mentioning this conflict here is that it strongly influenced the US-Arab relations and also clearly showed their volatility.

The first milestone regarding US involvement in this conflict was reached in June 1982 when Iranian forces managed to push Iraqis back to Iraq and proceeded to attack them from inside their own (Iraqi) territory. This caused a major shift in US military and political strategy towards the conflict. From this moment on, the United States revamped its tactics and began to support Iraq. It has even re-established diplomatic relations with Iraq, which had been severed almost 20 years ago during the Arab-Israel war[82].

[79] see Note 77
[80] Israel had occupied this territory by force in 1967.
[81] Source: Iran Chamber Society, History of Iran
[82] Anthony, J. D., The US-GCC Relationship

This has helped to restore some of the prestige lost due America's inadequate response to Israel's invasion and occupation of Lebanon. However, this relief did not last for too long as only a few years later, the Iran-Contra affair was exposed[83].

The White House apparently gave its permission to Israel to sell American manufactured aviation and other defense equipment to Iran during the Iran-Iraq war. Moreover, it was Iran who later refused to enter negotiations on ceasefire meaning that the US in fact contributed to prolonging the already bloody conflict. This had of course a huge impact on the US relations resulting in a profound dismay among America's GCC allies; it was the greatest blow to US credibility in the eyes of the GCC countries in history[84].

Washington later managed to regain some of its reputation by acting as a protector of naval vessels against Iranian aggression in the tanker war that took place in the Gulf during the conflict.

Aftermath of the Iraqi invasion to Kuwait

This well-known conflict helped the United States to establish its military presence in the GCC area. All GCC member states, except for Saudi Arabia, have bilateral Defense Cooperation Agreements with the US. These agreements quite interestingly show the state of cooperation (or probably the lack of it) of GCC members among themselves as each country proceeded to seek the security of an external security guarantor in the form of the United States, rather than in the enhancement of the collective capabilities of the GCC itself[85]. It also once again proves the prominent position of US in the Region.

[83] Source: The National Security Archive, The Iran-Contra Affair 20 years on
[84] Anthony, J. D., The US-GCC Relationship
[85] The International Institute for Strategic Studies, The GCC and Gulf Security (2005)

4.2. America's role in GCC's economic liberalization

During the 1990s, the United States and the GCC members held a series of so called *GCC-US Economic and Commercial Dialogues* involving key representatives of public and private sector[86]. These took place either in Washington or in one of the GCC member states on an alternative basis. According to Anthony[87], the purpose of all this was to narrow misunderstandings, eliminate barriers to trade and investment, enhance the alignment of their respective systems of standards, weights and measures, and in general strengthen the foundation for future cooperation and the generation of wealth in their private sectors.

It can be said that all these discussed issues were highly important for the GCC members whose economies were still quite isolated in terms of global trade and investments. It can be clearly seen that those member states that opened and made their markets most accessible for foreign investors and businesses have subsequently become the most developed and independent on oil/gas revenues.

Unfortunately, these dialogues were interrupted by the September 2001 attacks against the US and were not held ever since. However, this did not translate into lack of forward movement by the GCC on trade and investment issues in other ways. In fact, all of the six member states entered the World Trade Organization with Saudi Arabia being the last to join, in December 2005, after 12 years of complex negotiations[88]. It is undisputable that US capital and policies significantly influenced Saudi accession to WTO.

Needless to say, American companies have always played a major role in the development of GCC oil sectors. However, at the end of the 20th century it began to look as if America was loosing its grip on GCC oil sectors. Gradually, American companies experienced setbacks in winning new concessions in the region and started loosing them

[86] Embassy of Saudi Arabia in Washington DC, US, www.saudiembassy.net
[87] Anthony, J. D., The US-GCC Relationship
[88] BBC News, Saudi WTO Membership Approved (2005)

to Russian, Chinese and European companies. This could be interpreted as GCC's[89] attempt to shift away from its long-term association with US corporate energy giants that has so far dominated their oil sectors. On the other hand, GCC officials denied these allegations and insisted that it was a mere question of bids with the American ones being higher than those of their competitors from Europe and Asia[90].

This, however, doesn't mean that America is loosing its grip in other areas of its relationship with GCC members. To the contrary, Gulf States are becoming more dependent on the US when it comes to defense – especially after the failed (more or less) invasion to Iraq and potential spills of chaos that has been created there to neighboring states[91].

On the other side, America also recognizes the importance of the GCC region not only for global stability but for the particular US interests as well. These would include price stability, undisturbed energy supplies and regional security protecting US investments and hindering exports of terrorism.

And talking about terrorism, one of the major blows to GCC member states and their citizens was dealt by the Congress that passed the Patriot Act aimed to protect the US from unwanted individuals. However, this resulted in decline in the number of Arab and Muslim students from the GCC region studying in the United States. Furthermore, American economic sectors that had previously long been patronized by GCC and other Arabs were dealt setbacks. Examples were the fall in Arab tourism to the U.S., visits to American hospitals, the contracting of U.S.-based health care services, and Arab purchasing of real estate in the United States. On the other hand, American investment and interest in the GCC region waned, the number of Americans living and working in

[89] Mainly a Saudi Arabia's initiative
[90] Anthony, J. D., The US-GCC Relationship
[91] Other threats would include Iran's nuclear ambitions and hostility towards its neighbors and Al-Qaeda insurgency experienced mainly in Saudi Arabia.

the GCC countries plummeted, and the number of delegations in either direction seeking to explore the possibilities for expanding business decreased[92].

On the other hand, it must be noted that following the September 11th attacks the GCC countries found a common ground in respect of national security and defense interests. This resulted in cooperation in fighting Taliban in Afghanistan, a regime that provided sanctuary to Al-Qaeda terrorists that threatened not only the U.S. but Saudi Arabia as well.

US interests in the GCC

U.S. interests in the Region comprise all major areas including strategic, economic, political, commercial, and defense[93].

- Strategic – mainly matters of regional stability which can significantly influence oil and gas supplies to the U.S.; or at least the price which has further effects on the U.S. (World) economy.
- Economic – similarly to the previous bullet, most of the US economic interests are about oil&gas, namely, uninterrupted supplies and stable/low prices.
- Commercial – apart form the previous two bullets, these are not exclusively about oil. U.S. commercial interests in this region include concluding Free Trade Agreements, establishment of joint-ventures[94] and support of GCC members in pursuit of WTO membership. Furthermore, U.S. strives to promote American exports to GCC in order to offset huge energy imports.
- Defense – ever than before, the U.S. is dependent on GCC members in terms of logistics and regional political support while, on the other hand, the GCC countries are dependent on American arms supplies and protection.

[92] Anthony, J. D., The US-GCC Relationship
[93] see Note No. 82
[94] Clement, C., U.S.-GCC Business Conference

GCC-US economic cooperation – Bilateral Free Trade Agreements

On September 14th 2004, the U.S. signed a Free Trade Agreement with Bahrain[95], a first such agreement in the Region. Other GCC members soon followed suite or are in the middle of negotiations[96]. It is necessary to note here that all these agreements are bilateral, a fact that caused a lot of quarrel within the GCC with Saudi Arabia being particularly critical to its fellow members' actions in this respect[97].

It is here where the disparities among the six members can be clearly seen. While members like UAE are trying to open up as quickly as possible, others such as Saudi Arabia are not so keen to open up its borders to foreign goods or individuals. The problem is that these countries should really work together since they all take part in the customs union, which is an important element for further integration, and especially for the introduction of a common currency.

Although there was a certain downward trend in U.S.-GCC commercial cooperation in the second half of the 1990s with American foreign investment focusing on Asia and Europe rather than Middle East (not mentioning the 9/11 fallout), the abrupt surge in oil prices from 2002 onwards secured a center role for GCC members on the world energy markets and put them back into commercial focus of the U.S.[98]

[95] Markheim, D., America's Free Trade Agenda
[96] World Fact Factbook; www.cia.gov/cia/publications/factbook/index.html
[97] Bilaterals.org, www.bilaterals.org
[98] Anthony, J. D., The US-GCC Relationship

4.3. GCC-US relations in the 21st century

Reforms

As it has been mentioned earlier in this work, GCC member countries are trying to restructure their economies so that they stay competitive in the new millennium and don't burn out together with the last drop of fuel in their reserves.

In order to do so, they have been introducing major reforms in all areas for more than two decades. This, however, must have some impact on their relations with the western countries that usually see GCC as a group of oil rich countries with limited production capacity where foreign investments are highly risky if not impossible.

And yet it is the possibility to investment that is one of the most important gradually changing features. In have mentioned several instances in chapter 2.2 in which the GCC members liberalized foreign investments. These include investments on local stock markets, in real estate or private equity.

Thus the investors start to eye the GCC region as a new opportunity to invest in a relatively stable environment arise. This could, however, result in an outflow of investment money form the US, which, combined with huge oil imports from the same region, could cause a serious headache to the Administration.

One way how to counterbalance this unfavourable position is to attract more GCC investments to the US. Therefore, the US should probably start treating the GCC as a trade and investment partner also in other instances and not just when it comes to oil. Of course there have to be at least to partners to conclude any trading agreement. And so it is good to see that some GCC countries together with the US forge ahead with Free Trade Agreements, although sometimes to the ire of their fellow members.

US Dollar

The US Dollar has always had a strong position in the Middle East. Moreover, it is the "official" currency of the petroleum industry so some of the GCC governments used to receive some 75%[99] of their revenues in USD and not their respective national currencies. Also, as it has been already mentioned, GCC states decided to peg their currencies to USD as a step towards introduction of a common currency.

But the position of USD is gradually changing, and not only in the GCC region. We have seen a slow weakening of USD during the last few years, which can be best observed on its exchange rate to other currencies (e.g. euro, CZK, GBP). And countries like UAE or Saudi Arabia who sit on huge USD reserves might not be willing to keep their dollars forever. It is therefore quite understandable when they opt for the euro or GBP instead.

US foreign policy

It is not the purpose of this work to hail or curse the American foreign policy. However, when it comes to GCC member states, it is quite clear that they will have some issues with the American way of fighting terror – both at home and abroad.

Firstly, a significant drop in visitors to the US has been recorded after 9/11[100]. These visitors include tourists, students, businessmen, people seeking medical attention etc. Some of them were discouraged by the post-9/11 immigration policy but many others, including many Arabs, simply did not want to visit US anymore because their perception of this country has been distorted by its military and other activities abroad. This gap may have further unnecessary negative impact on both the US and Arab

[99] Energy Information Administration, http://www.eia.doe.gov/
[100] The United States Department of State, http://usinfo.state.gov

countries that could, under normal circumstances, benefit from mutual cooperation. Hopefully, neither side will be permanently blinded by these unfortunate events.

Secondly, it would be very unwise to alienate the US in GCC's view since countries like Saudi Arabia help to counterbalance the American trade deficit through their own investment activities in the US[101]. This enables America to grow even if their citizens spend more abroad than they earn. Should countries like Saudi Arabia withdraw their money, the US would probably witness downfall trends on its real estate and stock markets.

Defense Cooperation

The Bush Administration has recently announced a huge arms sale to the six Gulf states with Saudi Arabia being the biggest beneficiary[102]. This is considered as an attempt to counter the Iranian threat and once again shows how crucial the GCC member states are for the US foreign policy. And, undoubtedly, they will remain for the time being.

4.4. Conclusion to the GCC-US relations

It is beyond any reasonable doubt that the six GCC member states represent a crucial ally for the United States. They provide America with significant volumes of vital natural resources, they represent an important trade partner and support the US led war on terror[103].

One can only hope that these relations will remain stable throughout the new century and will not be shattered by various attempts of their mutual enemies.

[101] Saudi-American Forum, www.saudi-american-forum.org
[102] Reuters, www.reuters.com
[103] It is not up to this paper to study any justification for these actions.

Conclusions

I have dedicated the previous pages to an analysis of the current situation in the GCC member states. It is an extremely broad and complicated topic, which by far exceeds the scope of this work. Therefore, at certain points, I had to abstract from some facts and employ methods such as comparison to make a complicated matter more comprehensible. In accordance to the plan outlined in the Introduction, I provide a brief insight into the main reforms the GCC region currently undergoes. It is truly only a brief one but I think it is sufficient to demonstrate the trends these countries experience today. Furthermore, I think I have, more or less, succeeded in providing a satisfactory analysis of the proposed Monetary Union with clear conclusions regarding its suitability for the prospective members. Finally, I have tried to elucidate shortly on the US-GCC relationship, which is evidently significant for both parties and let alone for individual members of the GCC. So what are my answers to the two main questions defined in the Introduction?

As for the first question, in the last two decades, significant changes can be seen in almost all areas including economic, judicial or political. These changes are caused by gradual perception of significant imperfections (or defects) in GCC economies, especially when it comes to a narrow field of economic activities the economies depend on; disregard of market principles on the markets of goods, services and production factors; and relatively low mutual cooperation within the region. Indeed, all six member states are becoming more open towards foreign entities as well as towards other GCC members indicating a gradual regional integration.

However, it is necessary to bear in mind that the current economic system in the GCC member states is far away from market economy (this gap varies from country to country), as we understand it. Furthermore, even though they make efforts to diversify their economies, in most cases, they still remain heavily dependent on oil. For example, the GCC countries usually do not levy taxes - VAT, income tax etc. - that are generally an essential part of the state's budget. Instead, most of the public expenses are still financed from oil revenues. At this point, it is quite clear that the GCC members still have a long way to go in order to become sustainable market economies.

As for the second question, the GCC member countries do meet most of the prerequisites for adopting a common currency, however, they still face lots of obstacles. To be more specific, despite some deficiencies such as insufficient commodity diversification or low factor mobility, the GCC region seems to be a suitable candidate for a single currency area with each member being at a different level of convergence. It is then mainly through the political will that the member countries can forge ahead with the idea of further integration. Without it, any integration efforts will be destined to fail.

Furthermore, I think it is quite clear from what has been mentioned on the previous pages that, despite certain setbacks, the US plays a significant role in various areas of GCC politics, economies etc. It will, however, have a hard time securing its position in the region as indicated in the final chapter of this thesis.

Overall, I think I have more or less managed to achieve the goals set at the beginning of this work. This means I have presented a brief insight into the GCC economies and provided an analysis of their prospective outlook.

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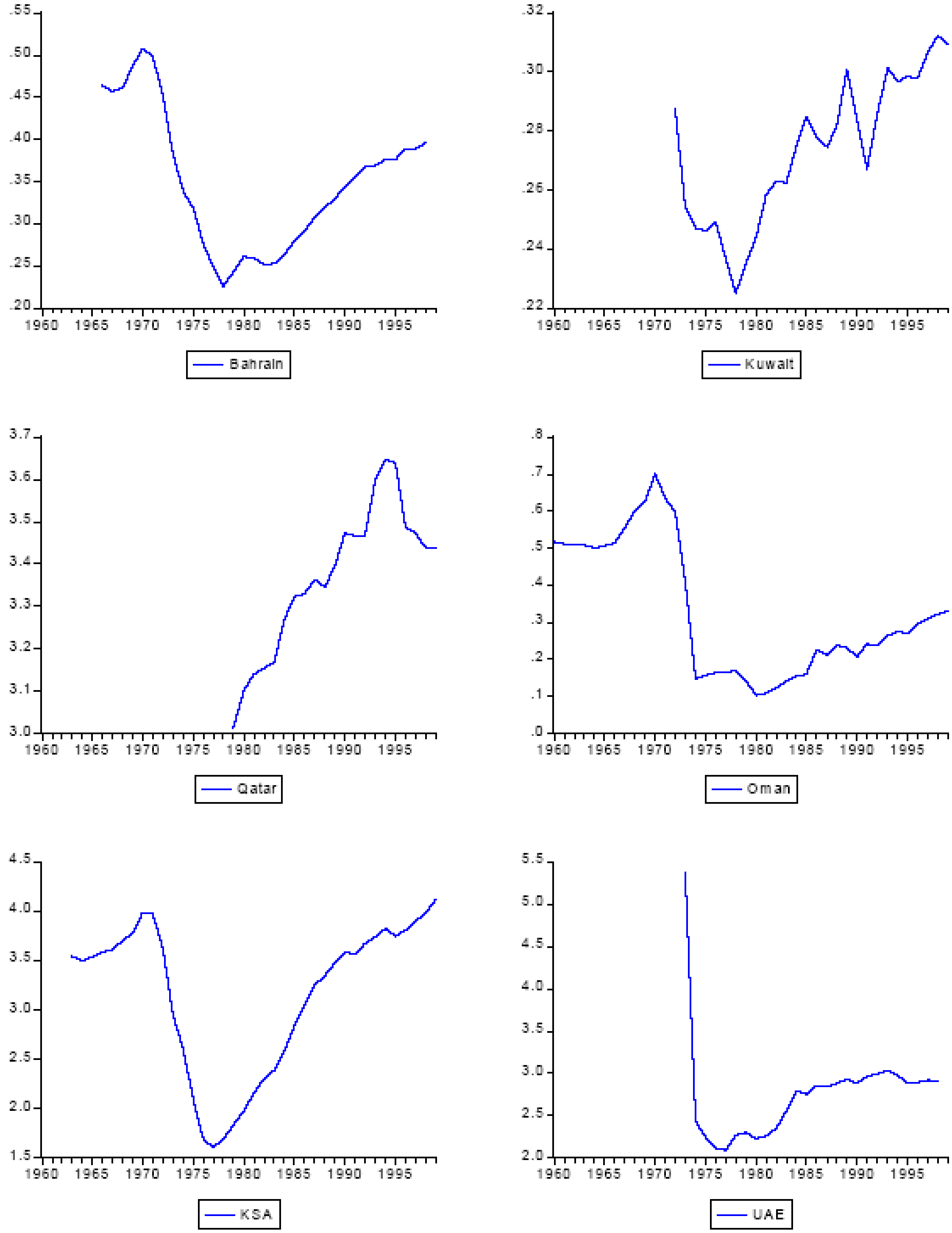
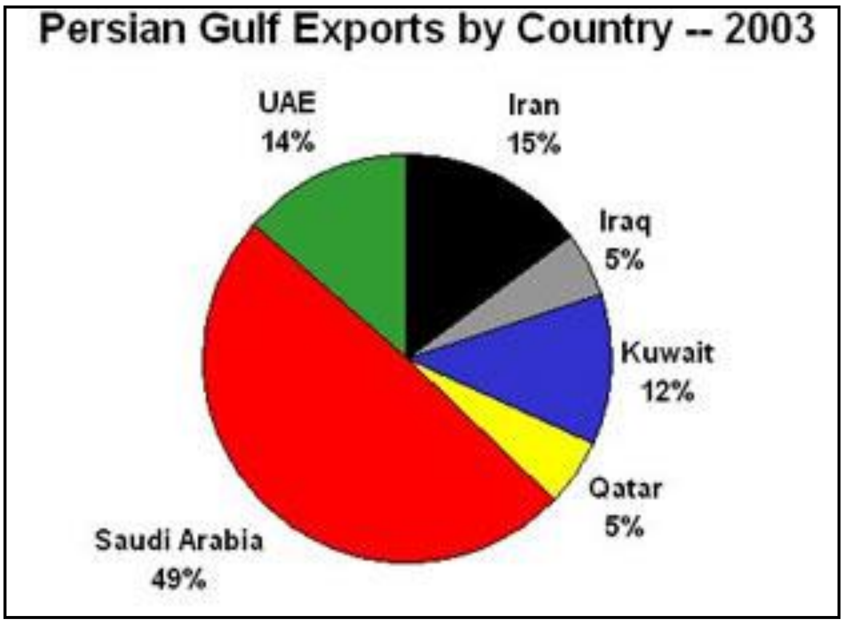
Appendices

Appendix 1. Real Exchange Rate of GCC Countries against USD 1960-1999



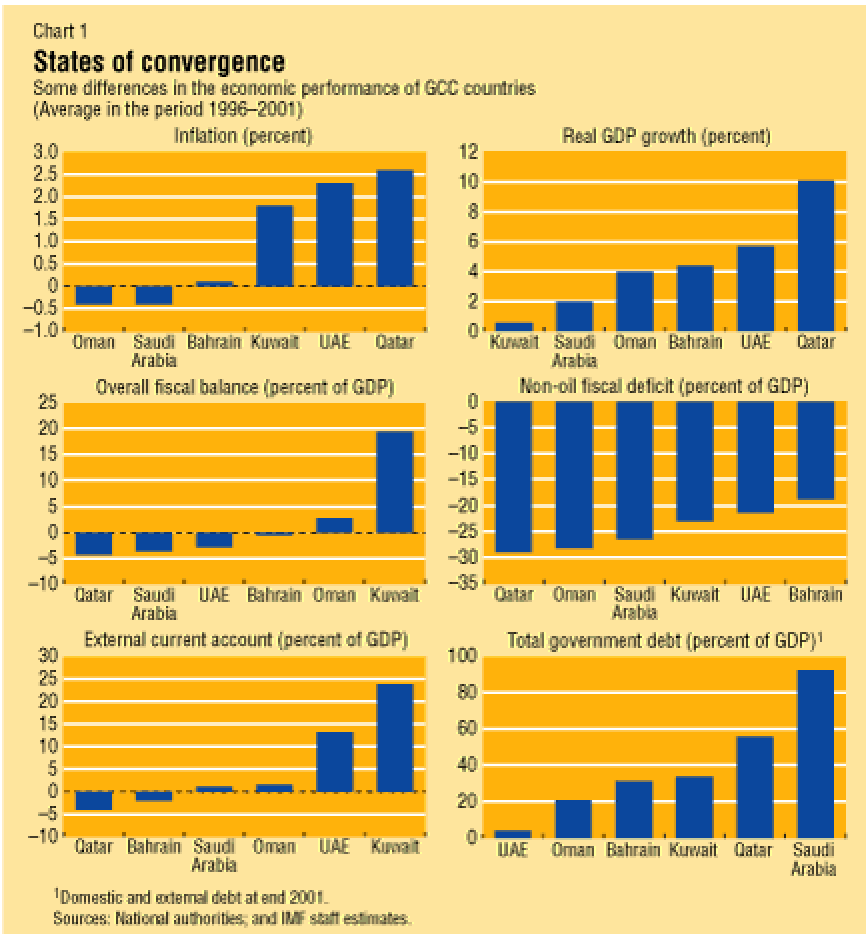
Source: Laabas, B., Limam I., Are GCC Countries Ready for Currency Union? (2002), www.arab-api.org/wps0203.pdf

Appendix 2. Persian Gulf Exports by Country (2003)



Source: Energy Information Administration; Persian Gulf Oil and Gas Exports Fact Sheet; www.eia.dov.gov

Appendix 3. Differences in the Economic Performance of GCC Countries



Source: Ugo Fasano, Zubair Iqbal, Common Currency, www.imf.org