Euro Experience and the Possibility of Financial & Monetary Integration in Arab Gulf Countries[1]

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Abstract: Based on the theories of Optimum Currency Areas and Impossible Triangle, this article considers the practice analysis of the Euro and European Central Bank, and proposes the possibility of monetary integration in Arab Gulf countries. The author argues that at this stage, member states must collaborate closely, and coordinate fully among various conflicts. Only by doing this will they be able to create necessary conditions for upgrading the level of financial and monetary integration in Arabic Gulf countries.

Key Words: Euro; European Central Bank (ECB); Financial & Monetary Integration; Gulf Cooperation Council; Gulf Economy; Impossible Triangle Theory; Optimum Currency Areas; Regional Organization

Sheikh Hamad bin Jassim al-Thani, Qatar's Prime Minister, said in an interview in February 2008 that now was the time for the Gulf Area to have its own currency and countries should put aside differences when establishing the single currency union.[3] Later, finance ministers of members of the Gulf Cooperation Council reached consensus to set up a single currency union and a Gulf Central Bank at the meeting which was held at a harbor city alongside the Red Sea, Saudi Arabia on September 17, 2008.[4] Youssef Hussain Kamal, Chairman of Gulf Cooperation Council and finance minister of Qatar, stated that finance ministers of six Gulf countries reached consensus on establishing Gulf Currency Union and Gulf Currency Council. They also agreed on the draft Charter to establish the Gulf Currency Union. Finance ministers of the Gulf countries also agreed to set up the Gulf Central Bank.

Compared with the monetary integration of the Eurozone, the financial and monetary integration of the Arab Gulf countries bears both common and specific features. This article looks at the practice analysis of the Euro and European Central Bank, and proposes the possibility of monetary integration in Arab Gulf countries.

The Gulf Cooperation Council, which is the major political and economic organization, was set up in 1981. Its members include: The United Arab Emirates,

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[1] This paper is the interim achievement of plan funding project of SHISU "Theories and Practices of Regional Finance Integration" (KX191017).

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[3] "Qatar Prime Minister: The Gulf region should have its own currency," http://finance.sina.com.cn/money/forex/20080225/16264543950.shtml(2008-02-25).

[4] "Finance Ministers of Gulf countries reach consensus with central banks on setting up unified currency alliance," http://news.sina.com.cn/o/2008-09-18/074014464542s.shtml(2008-09-25).

Oman, Bahrain, Qatar, Kuwait and Saudi Arabia. The Council's mission is to coordinate and strengthen the communication and cooperation between member states and to achieve economic integration ultimately.

I. Theories of Optimum Currency Areas and Impossible Triangle

Through years of hard working, the unified currency —the Euro— was created to begin in January 2002 and the following features of the Europe monetary system were formed. The fixed exchange rate was adopted within the region and a floating exchange rate was adopted between the region and other countries in the world. The theoretical basis for the monetary system and policy preferences used by countries in Europe are mainly the Theories of Optimum Currency Areas and Impossible Triangle.

As early as the 1960s, dividing optimum currency areas based on the flow of production factors was described in the Theory of Optimum Currency Areas[5] proposed by Robert A. Mundell. Within the currency areas, labor force and other production factors can flow freely while outside the region, free flow is blocked. Within the currency areas, countries or regions with different economic development levels can be coordinated by the spontaneous flow of production factors. Outside the areas, monetary policies and exchange rate policies can be applied to balance the international payments so as to keep the micro economic efficiency within the region and stabilize the macro economy at once. Mundell emphasized that the flow of production factors are the balancing mechanism within the currency areas and the flexible exchange rate is the balancing mechanism among different currency areas.

After Mundell first proposed the concept of the optimum currency areas and economic standards for forming the currency areas, many economists further developed the theory and explored other gauges for dividing the optimum currency areas: Robert I. Mckinnon regarded the openness of the economy which is measured by the proportion of trade product out of total social output in the production or consumption as the gauge. He argued that it was highly possible for countries which are closely connected with an external economy to form the currency areas. The fixed exchange rate could be adopted within the areas so as to attain the goal of stabilizing prices. Countries within the areas could apply floating exchange rate policy with those outside the areas.[6] Kenen regarded the diversity of products as the gauge. Countries with highly diversified products are the ideal members for currency areas. For these countries, demands for different goods intercept with each other. When the demands for foreign goods change, they can still maintain a relatively stable economy because the diversity of products can disperse the risks.[7]

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5 Robert A Mundell, "A Theory of Optimum Currency Areas," ***American Economic Review***, Vol. 51, No. 4, 1961.

6 Ronald I Mckinnon, "Optimum Currency Areas," ***American Economic Review***, Vol. 51, 1963.

7 See Kenen. P, "The Theory of Optimal Currency Areas: An Eclectic View," in R. A. Mundell & A.K. Svoboda, eds., ***Monetary Problems of the International Economy***(Chicago :Chicago University Press,1969).

G. Haberler regarded the similarities in inflation as the gauge of measuring the optimum currency areas. He thought that any difference in monetary policies and economic structures might lead to the disparity of inflation rates and it would influence the international payment imbalances. Countries with similar inflation rates are easier to agree on monetary integration.[8] J. Ingram said that financial features of economy and society should be taken into consideration so as to optimize the currency areas. When the financial market is highly integrated, one country can take advantage of the free flow of capital to prevent sharp fluctuation of exchange rate triggered by international payments imbalances.[9]

The above theories of Optimum Currency Areas mainly focus on the conditions of establishing the optimum currency areas and ignoring the cost while emphasizing the positive effect of the theories. The Modern Theory of Optimum Currency Areas was widely promoted after 1970. It emphasized cost-profit analysis of currency unions. In the 1980s, economists studied issues related to the Theory of Optimum Currency Areas by using a large number of economic data in the history.[10] The study of the Theory of Optimum Currency Areas entered a new stage in 1990. Rational expectations provided new definition for the theory of optimum currency areas. It proposed the endogenous currency areas, built a balanced model and set new standards for dividing the new currency areas. Corrections have been made to the cost-profit analysis, both for the definition and application. Concrete studies on Europe countries by using Econometrics have been conducted. Thus, it enriched the theory of Optimum Currency Areas significantly.[11]

An important conclusion of the M-F model is that against the background of an open economy, if a free flow of capital is maintained, the monetary policy under the fixed exchange rate is invalid. The monetary policy works only when it is designed under the floating exchange rate system. This means that three goals — free flow of capital, independent monetary policy and a stable exchange rate — can not be achieved at the same time. This is the Impossible Triangle theory.

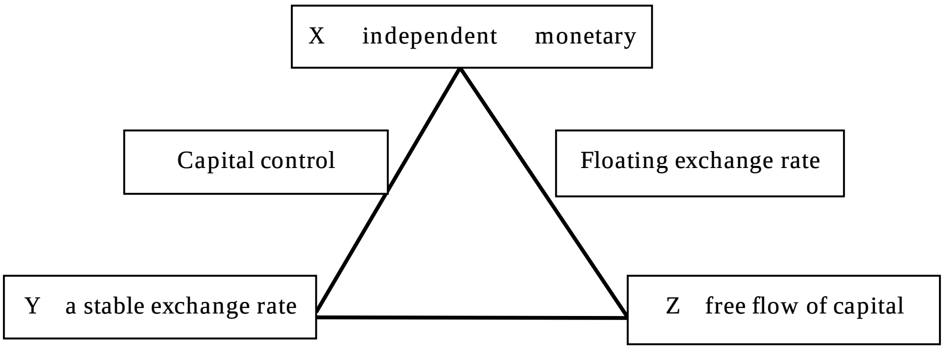
Generally speaking, exchange rate policy is the one most highly connected with the open economic conditions. In fact, there exists a trade-off relationship among monetary policy, exchange rate policy and flow of capital. In other words, the independent monetary policy, fixed exchange rate and free flow of capital forms the Impossible Triangle.

For example, X refers to the independency of the monetary policy of a country. "X=1"means that the country can stabilize the economy and influence output and employment by carrying out monetary policies. Y refers to the stability of exchange

8 G Haberler, ***Reflections on the Economics of International Monetary Integration***, W. Bickel, ed. Verstehen und Gestalten der Wirtschaft, Tübingen ,1971.
9 J Ingram, "The Currency Area Problem," in R. A. Mundell & A.K. Svoboda eds, ***Monetary Problems of the International Economy***(Chicago :Chicago University Press, 1969), P.95.
10 Zhiwei Lei, ***Theory and Mechanism for European Currency Union***(Beijing: China Finance Press, 2002).
11 Francesco Paolo Mongelli, "New Views on the Optimum Currency Area Theory: What Is EMU Telling Us?" http://www.ecb.int/pub/pdf/scpwps/ecbwp138.pdf(2008-11-18).

rate of a country. "Y=1" means its exchange rate is immune to the impact brought by speculative money. Z refers to free flow of capital. "Z=1" means capital can flow in and out of the country freely. Then, the equation for Impossible Triangle is "Z+Y+Z=2", illustrated by graph 1-1. Three points of the triangle stand for the policy goals. Only two out of the three can be achieved. Theoretically speaking, pursuing one goal without considering the constraints of the other two is groundless.

Chart 1-1 Theory of Impossible Triangle



Impossible Triangle indicates that macro policies should be prioritized so as to achieve the goals. For example, the 1945 Bretton Woods system with the purpose of stabilizing exchange rates and encouraging countries to have their own independent monetary policies should abandon free flow of capital. But free flow of capital became the trend later on. Therefore, in order to maintain the independent monetary policies, the floating exchange rate was adopted instead of the fixed exchange rate. This helped to explain economic events that happened in the US and Japan in 1973. However, the Europe monetary system made the decision from another perspective. Each member state gave up its own independent monetary policy so as to stabilize the exchange rate among states. Which one is the most important one among the three goals? Abandoning the free flow of capital is against the background of economic and financial globalization and regionalization. Risking the stability of exchange rates will further increase the financial risks of included countries. "Of two evils choose the less". Giving up each others independent monetary policy is more feasible. And this is exactly the theoretical basis of Eurozone practices.

II. The Euro and the Practices of the European Central Bank

Euro countries put the Theories of Optimum Currency Areas into practice, giving birth to the European Monetary System (EMS). Member states adopted fixed exchange rates within the system and floating exchange rates with the rest of the world. The European Central Bank (ECB), established on July 1, 1998 is the first central bank managing super-sovereign currency in the world. In other words, the ECB sets a unified monetary policy for all countries in the Eurozone, which is implemented by Eurozone central banks. Meanwhile, the ECB is independent of political interference and not subject to member states′ supervision. Moreover, it has the exclusive right to the issuance of Euro banknotes. When the Euro was launched on January 1, 1999, the member states were stripped of power to design their own monetary policies, instead, they had to abide by the monetary policy set by the ECB. The power to design monetary policy and laws of the Eurozone central banks was transferred to the ECB. The independence of the ECB is critical to ensure the price stability, mainly represented in the fields such as structural and personnel independence, economic and fiscal independence to set regulations and punishment and monetary policy independence.

The prospect of the Euro is full of uncertainties ranging from a sovereign currency to the regional currency, from counting and settlement to the circulation of Euro banknotes. One of the decisive factors of the uncertainties is the effect of the unified monetary policy in the Eurozone. If the opportunity cost is less than the yields from the Euro under the unified monetary policy, Euro is sure to embrace a bright future; if not, the prospect is quite gloomy. Therefore, the effect of the unified monetary policy is one of the key factors to the economic stability and development in the Eurozone. Contradiction is inevitable for the ECB coexists with the governments of member states. Since the Euro came into being, the sound functioning of the unified monetary policy in the Eurozone has demonstrated, to some extent, its success in the initial stage. Yet, if the internal uncertainties and hidden contradictions were not noticed, it would impose adverse impact on the future development in the Eurozone.

From mid1990s to the launching of the Euro, the economic situation in Germany and other member countries was more or less the same, creating an enabling external environment for the launching of the Euro. After the Euro came into being, fast growth and high inflation appeared in countries such as Ireland, but the economic performance in major countries such as Germany, France and Italy was desirable, which to some extent covered the contradiction in the economic cycle. However, the contradiction had appeared. Eurozone member states faced an asymmetric impact, making it difficult for the ECB to make a plan to satisfy all because countries with slow growth preferred expansionary monetary policy to stimulate their economy while countries with fast growth looked forward to tight monetary policy to curb inflation. In the practice, it was hard for the ECB to coordinate with a unified monetary policy. If expansionary monetary policy was adopted, the inflation in countries with fast growth would exacerbate while if the ECB turned to tight monetary policy, the economy in countries with slow growth would deteriorate. The contradiction in the economic cycle made it almost impossible for the ECB to adopt a unified monetary policy.

Furthermore, the internal flaws in the ECB′s unified monetary policy led to an array of problems in practice, such as the vague responsibilities and obligations of the ECB, the contradictory monetary policy strategies in practice and the differences in powers of the ECB and member states.[12] The ECB has the central power to set the aims and tasks, which are implemented by Eurozone central banks in line with the Principle of Subsidiarity under which the Eurozone central banks are distributed maximum power for their own management. The practice of central power coexisting with the distributed power is sure to lead to two contradictions. On the one hand, the ECB with the central power sets the monetary policy in accordance with the weighted average inflation of the member states. Yet given the fact that there is a severe imbalance among the shares of GDP of member states in the Eurozone, the unified monetary policy can hardly help those countries keep the inflation at a moderate level. On the other hand, the power distributed to the central banks is uneven. If the ECB′s policy often favors certain member states (such as Germany), it will inevitably affect economic growth and competitiveness of other members and will, to some degree, produce beggar-thy-neighbor policy. This demonstration effect will encourage other members to pursue policies for self interest and eventually they will fall into the prisoner′s dilemma in the theory of games. Thus, the ECB must further improve its balance mechanism of power and try its best to minimize the conflicts among the member states so as to promote economic stability and development in the Eurozone.

Compared with the past, the unified monetary policy deprives the member states of the autonomy to make respective monetary policies which allows each country to adopt counter-cyclical macro control through independent fiscal policy when there is an asymmetric impact. The achievement of the expected goal of the unified monetary policy of the ECB is inalienable to the fiscal policy cooperation of member states, yet the decision making process of the two is not unified. The governments of the member states, which coexist with the ECB, are often contradictory with each other mainly in the following two aspects. The spill-over effect of member states′ fiscal policy interfere with the unified monetary policy: the weakened effect of the counter-cyclical fiscal policies of member states and the differences in the fiscal policies shake the foundation of the unified monetary policy.

One of the critical conditions that the counter-cyclical macro control of the fiscal policies of member states can put into full play is to prevent the accumulative growth of government debt and to alleviate the negative spill-over effect of fiscal deficit. In a country with an independent monetary and fiscal policy, the central bank can reduce the inflationary pressure from fiscal deficit by restructuring asset portfolios. But with a unified monetary policy, when the member states issue government debt to finance deficits, the interest rate will be under pressure to go up, unavoidably resulting in the increase of debt in other countries which will be forced to adopt tight fiscal policy, leading to the economic recession and rising unemployment. If so, the rational choice of these countries is to turn to expansionary fiscal policy. Then, the fiscal policy will fall into a dilemma.

[12] Li Yang, ***The impact of Euro on Global Finance***(Shanghai: Shanghai Foreign Language Education Publishing House, 2004).

Therefore, for the overall interest of the Eurozone, it is important to limit the scale of fiscal deficits in each country and prevent the negative spill-over effect. It is also necessary to provide further guarantee for the ECB′s implementation of an independent and unified monetary policy through the unified fiscal discipline.

With a highly open economy and unified monetary policy, a Eurozone member state is likely to be exposed to a greater risk of the spill-over effects of fiscal policies in other member states. The more interdependent they are, the greater the spill-over effects would be. In a closed economy, to adopt an expansionary fiscal policy is to stimulate the "domestic demand", while in an open economy, such a policy will also stimulate the "external demand", i.e., such a policy has spill-over effects. With an unified monetary policy in the Eurozone, fiscal policies adopted by the member states will have less influence on the "domestic demand" and will have more spill-over effects. Different from the closed economy, to achieve the same economic expansion, the Eurozone member states have to run up larger deficits, thus bringing about greater spill-over effects on other members. This is not conducive to the stability and development of the member states and the Eurozone as a whole, and makes it more difficult for the member states to keep their budget deficits below 3 percent of GDP. Long troubled by high unemployment, the member states will either call for less restriction on the common fiscal discipline, or to force the ECB to adopt an expansionary monetary policy. Either way will lead to rising inflation in the zone, which has been proven in recent years. Besides, it is also important that the member states coordinate their relatively independent fiscal policies. The member states tend to lower their tax rates to attract foreign investment, so as to prevent foreign capital from flowing into other countries as a result of improper tax competition to attract international investment. In the non-cooperative game, this is bound to cause problems for the tax system, thus affecting the economic stability, and making it more difficult to implement unified monetary policy. Therefore, the unified monetary policy will make the independence of the fiscal policy become null and void. Only through a high coordination and, ultimately, moving towards unified policy, can the disturbance on the monetary policy be reduced. Then, through the unified monetary policy and the coordinated fiscal policy, the economic stability and development in the Eurozone can be achieved.

From the ECB′s practice, the above issues do exist, but were not, as theoretically described, in an irreconcilable contradiction (the conflicts between the unified monetary policy and the relatively independent fiscal policy in particular), which would eventually push Europe into peril. In recent years, the smooth operation of the unified monetary policy is attributable to the facts that the member states have synchronized their business cycles, similar economic development level and structure, and the "perish together" mechanism imposing fiscal constraints on the member states. By implementing the unified monetary policy, the ECB has basically solved the issues of the central banks′ failure to cooperate or opportunistic non-cooperation, and has improved the efficiency of resources allocation. However, due to the relatively independent fiscal policy and the pursuit of maximizing effectiveness, it is difficult for the member states to take into account the interests of others when formulating the fiscal policy. From the perspective of the fiscal constraints on the member states, formulating the fiscal policy is a "cooperative game"; from the perspective of pursuing their own interests and making the best financial decision, it seems to be a "non-cooperative game", a dynamic game subject to the logic of collective action. European economic integration is a gradual process, i.e., from a customs union to a single market, and then to a single currency. From the perspective of the inherent logic of the spill-over effects in the theory of economic integration, the successful cooperation between the central banks of the member states will promote further cooperation between other competent departments. Thus, the Eurozone member states will strive for an early breakthrough in fiscal policy coordination, so as to further synchronize their economic cycles, and to create a more favorable external environment for the effective functioning of the unified monetary policy. In the long run, the member states will develop from adopting a unified monetary policy and a coordinative fiscal policy to pursuing a unified counter-cyclical economic policy and the fundamental interests of all member states, thus establishing the Economic and Monetary Union in a real sense.

III. The Trend of Financial and Monetary Integration of the GCC Countries

On September 10, 2006, the UAE′s Gulf News reported that Sultan Nasser al-Suweidi, the Governor of the UAE Central Bank, announced that six GCC countries would launch the common currency from January 1, 2010 as scheduled.[13] In February 2008, it only took more than half a year for the finance ministers from the GCC countries to pass the draft of the Agreement of the Arab Gulf Monetary Integration, after Qatar′s Prime Minister Al-Thani had once again put forward the idea that the Gulf region should have its own currency; thus the world began to pay increasing attention to the financial and monetary integration of the Arab Gulf countries. Although the draft is yet to be approved by the GCC summit, the fundamental trend remains unchanged, and the process of monetary integration has been accelerated. However, a full realization of the financial and monetary integration cannot be achieved overnight. As Governor Suweidi of the UAE Central Bank once said, to establish a single currency in the Arab Gulf States is a long-term goal; the whole process of establishing a monetary union should be carried out in different phases and the specific and concrete steps should be adjusted in line with the economic and financial development of the member states.

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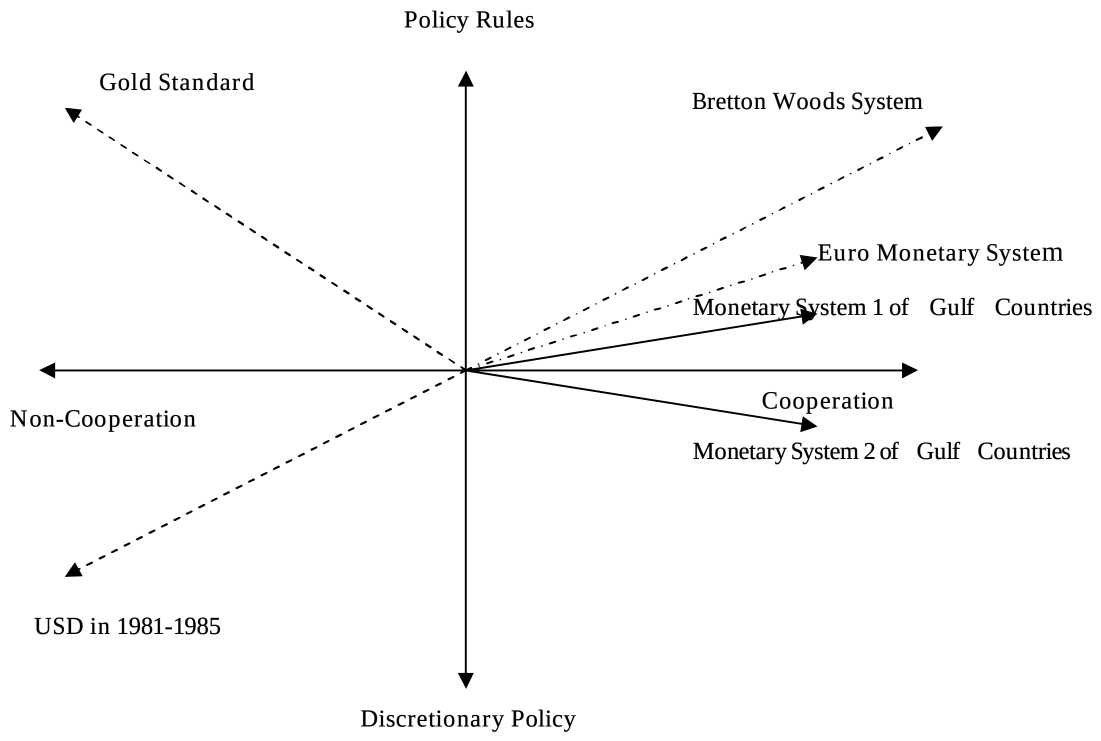
[13] “The Six Gulf Nations Including Saudi Arabia Hope to Issue Single Currency; Middle East Petro-Dollar Emerges!” http://www.cat898.com/Infolook.asp?bclass=2&id=68141(2008-06-19).

Therefore, this article explores the trend of financial and monetary integration of the Arab Gulf countries based on the experience of the Euro.

The practice of the Euro proves that monetary integration is related to changes in economic fundamentals and institutions, whose effect can be summarized as micro and macro effect. Micro effect means that unified currency saves the cost of exchange and currency risk aversion. To enterprises, lower costs of exchange help them to reduce operating cost. The aversion of currency risk enables enterprises to avoid changing the price of products due to exchange rate fluctuation. It benefits the free flow of resources and gives further scope to market mechanisms and makes resource allocation more rational in super-national regions. The free flow of capital assists enterprises to increase investments and reduce internal frictions so as to enhance their international competitiveness and facilitate further trade expansion. In sum, the utilization of a single currency helps the market to be more unified and improves the microeconomic benefit. The establishment of the single currency system in Arab Gulf countries is expected to achieve the above micro effect. The macro effect of monetary integration has two factors. It addresses the inefficiency caused by exchange rate fluctuation. Member states conduct broad cooperation and collective management on macro policy, give up their internal exchange rate policy tools, unify their foreign exchange rate and monetary policy, and formulate disciplined fiscal policy so that problems such as cooperation failure and opportunistic non-cooperation are completely resolved. Monetary integration and monetary policy coordination are helpful for economic growth. Part of the financial and monetary sovereign demise member states can bring about financial system stability within the region as well as each member state so as to fend off and resolve financial risks institutionally. The single currency disables member states to adopt discretionary monetary policy independently. Thus, the transparency of the monetary system and the creditability of the monetary policy are greatly enhanced. Due to the monetary policy and exchange rate policy demise of member states, their decision makers might have low efficiency in the face of the asymmetric effects because of limited choices of policy tools. Once member states with financial and monetary integration transfer their own powers of monetary policy making to the super-national central bank, they only have decision-making power of fiscal policy. However, there are strict similar regulations on each member state's fiscal condition, which to some extent restrict their fiscal leeway. Moreover, since the conduction mechanism of monetary policy has different channel and transmission speed, unified monetary policy will have different affect on each member state, so capital will flow to regions with high return. The enhancement of labor force mobility requires not only culture coordination but also welfare system collaboration. Therefore, the expected monetary integration in Arab Gulf countries should give full scope to the positive factors of macroeconomic effects among the design of institutional framework, should try to overcome and mitigate negative factors in an effort to achieve economic stability and promote economic growth.

Currently, research on the possibility of financial and monetary integration in Arab Gulf countries mainly focuses on two issues. First is the issue of standard currency and reserve currency. Member states can set up a Gulf Central Bank and Gulf Monetary Council and can issue the single currency according to the practice of the ECB and Euro. The related economic indicators such as inflation rate, interest rate and fiscal deficit can be decided with reference to the supervisory indicators set in the Treaty of Maastricht(1992) and Stability and Growth Pact of the European Union(2009) as well as the practice in Arab Gulf countries. If Gulf countries can establish a unified currency alliance, pressures on those governments to revaluate their currency or give up the pegging to US dollar will be mitigated. UAE Central Bank governor Sultan Nasser al-Suweidi said that inflation would delay the monetary integration in Arab Gulf countries, which reflects the importance and urgency to set up the unified currency alliance in the region. Second is the issue of policy rules and discretion. This is one of the crucial factors that determine whether the regional monetary system in Arab Gulf countries can be successful or not. The reform of the international monetary system can be explained in chart 1-2.[14]

Charter 1-2 Choice of Different International Monetary System



[14] David K. Eiteman, Arthur I. Stonehill & Michael H. Moffett, ***Multinational Business Finance***, Addison Wesley, 2007.

All international monetary systems have to address the trade-off between the policy of rule and discretion, cooperative game and non-cooperative game. In chart 1-2, the upward vertical axis represents strict government intervene (rules), the downward vertical axis means that government can decide whether, when and how to intervene into the financial market (discretion). The horizontal axis shows the extent to which countries are cooperative. The left side means countries are non-cooperative and the right side means they are highly cooperative. During the time of the gold standard, countries did not need to cooperate with each other once they abide by the same rules and make purchases and sales in line with gold parity. Under the 1945 Bretton Woods System, the gold standard is no longer the "rule". Member states have to be highly cooperative so as to safeguard the international monetary system whose core is the USD. The European monetary system is the result of the combination of member states′ cooperation and policy rules.

Strictly speaking, Gulf Cooperation Council countries can only choose Monetary System 1 in the above chart. As they decide to set up the Gulf Central Bank and Gulf Monetary Council and issue the single currency, that means the financial and monetary integration is the same as the practice of the Euro which is the result of policy rules. However, policy rules can be tightened or relaxed. The more relaxed the policy rules are, the more likelihood that the financial and monetary system in Gulf countries would be in the position of the Monetary System 1. But they might choose the Monetary System 2 in the transitional period. When the axis of Monetary System 2 starts a counter clockwise rotation about the origin, member states are committed to close cooperation. Member states then must pursue the unified goal of social and economic development and financial stability. After years of efforts, their economic development goals are similar and their financial and monetary system is getting closer to Monetary System 1. When it is above Monetary System 1 or even above the European monetary system, member states will shift from unified monetary policy to a unity-seeking countercyclical economic policy. In this way, member states have similar fundamental interests and will set up the real Arab Gulf countries′ economic and monetary alliance.

In conclusion, Gulf Cooperation Council countries will not face technical problems in setting up single currency and implementing unified monetary policy, considering the present success of the Euro and Eurozone. The difficulties lie in the contradiction between centralized power of supranational central bank and power distribution among member states, and between unified monetary policy and other relatively independent macro economic policy. In essence, these contradictions reflect the interests of member states. Therefore, coordinating their conflict of interests becomes the crucial element of financial and monetary integration in Arab Gulf countries. Member states must collaborate closely, and coordinate fully among various conflicts. Only by doing this will they be able to create necessary conditions for upgrading the level of financial and monetary integration in Arab Gulf countries.