The Gulf Cooperation Council: A New Global Force?

Mohsin S. Khan, former director for the Middle East and Central Asia department at the International Monetary Fund, assesses the Persian Gulf countries' prospects for a monetary union and a repository of dollar reserves generated by oil.

Steve Weisman: This is Steve Weisman at the Peterson Institute for International Economics. Our guest on Peterson Perspectives is Mohsin Khan, senior fellow at the Institute, who has come here after serving at the International Monetary Fund, most recently as director of the Middle East and Central Asian department. Welcome, Mohsin.

Mohsin S. Khan: Thank you very much, Steve.

Steve Weisman: You've written a very interesting paper about the Gulf Cooperation Council, which is emerging with new dilemmas, new challenges, and new opportunities as a monetary force, an energy force, and a political force. For listeners and readers less familiar with the subject, what is the Gulf Cooperation Council?

Mohsin S. Khan: The Gulf Cooperation Council is basically six Gulf countries that decided in the early 1980s to form, if you like, a common market. It was part of regional integration. They wanted to integrate before, and they decided that they would form a common market, which they did at the beginning of 2008, eventually leading to a Gulf Cooperation Council Monetary Union in which they would have a single currency. The date that they had set for the single currency was 2010, and basically they have been working toward that date. It's unclear now whether in fact that particular date will be met. But the idea was essentially on the one hand, economic integration, to basically diversify their economies for economic development. Some of these countries, by the way, are very small. The big player in all this is Saudi Arabia. They're all basically oil producers and so there seem to be a lot of the sort of elements there that could transform themselves into one unit more easily than perhaps others. I mean, they share a common history, they share a common language, they share a common culture. So it made a lot of sense to do that.

Steve Weisman: Is this a healthy development for the global economy and especially the energy economy?

Mohsin S. Khan: I think it's a healthy development for the global economy in the following sense. These are jointly very large oil producers. Instead of them having to make decisions on their own or via OPEC about pricing, about production, about investments, etc., they can make them jointly.

Steve Weisman: Is there an opportunity for them to produce a global currency rivaling the United States dollar or the Chinese renminbi or the euro?

Mohsin S. Khan: I think that would be a very ambitious goal. I don't think they're thinking of it that way. I think they're just thinking that within the Gulf, it would make a lot of sense to have a single currency. In some sense, one can argue that they have that already. All of them, with the exception of Kuwait, are pegged to the dollar. So in a sense, they're pegged to each other. Their currencies are acceptable in each other's countries. GCC citizens can travel wherever they wish within the Gulf. They can work wherever they wish within the Gulf.

There's a story that if somebody came down from Mars and landed in the Gulf, would they think that this was one country with six states or six different countries? One can make an argument that it's just one country. What my paper was dealing with was what kind of exchange rate arrangement they should have once they form the union and have a single currency.

Steve Weisman: You feel that it's not such a bad idea for them to be pegged to the dollar.

Mohsin S. Khan: They've been pegged to the dollar for a long time now. You must remember they're a special case, these countries, and the reason is that they are in fact oil producers. Most of their earnings are in dollars because the oil market prices oil in dollars. So for them, the dollar is a very important currency and they've maintained this peg for two or three decades. They're very comfortable with it. They know how it works. They invest a lot in the United States. One of the reasons they do that is because the United States is still the biggest capital market in the world.

In my paper, I look at several different exchange rate arrangements. There are pros and cons in all of them. But on balance, I actually do come out saying that continued pegging to the dollar for the monetary union, for the single currency, makes a lot of sense because from the export side, as I've just mentioned, everything is priced in dollars. On the import side, they don't have the institutions and markets so that they could hedge exchange rate risks. Suppose they were floating or something like that or even had a basket. They can't hedge exchange rate risk. But if they're pegged to the dollar, they can use the dollar markets and futures markets in dollars to in fact hedge. So all in all, it does make a lot of sense for them to continue pegging to the dollar.

Steve Weisman: But one of the disadvantages of pegging to the dollar, as I understand it, is that they lack control over monetary policy. They have to be tied to whatever monetary policy the United States is adopting.

Mohsin S. Khan: That's true. To have a truly independent monetary policy, they would have to be floating. And not many people have argued that they should have flexible exchange rates. The strongest argument that I've heard, and I think there's a lot of merit to it, is that they should peg to a basket of currencies. But in the simplest case, pegging to the dollar and the euro, you don't gain, you don't buy monetary policy independence by doing that.

I did a simple calculation, which I report in the paper, which is that last year, for example, Saudi Arabia, by pegging to the dollar and importing US monetary policy, had an interest rate around 2 percent, between 1 and 2 percent, as the United States lowered its interest rates. If they had been pegged, for example, to the SDR, the special drawing rights of the IMF, they could have been pegged to that, which is a basket of currencies, and their interest rate would have been 3 percent. I mean, you don't really buy too much by just pegging to a basket. On floating, they would have independent monetary policy, but there again you have to balance between the advantage of having an independent monetary policy and the disadvantage of having tremendous fluctuations in your exchange rate, primarily because oil prices fluctuate.

Steve Weisman: Let's talk about two things that people always think of when they think of the Gulf countries. One is of course oil and the other is the huge amount of dollar reserves they have. First on oil, where does the GCC fit in with OPEC's policies on oil production and prices?

Mohsin S. Khan: I think the GCC all along has played, if you like, a moderating force in OPEC. And the reason for that of course is the presence of Saudi Arabia. Saudi Arabia is the only country that can really expand oil production and oil exports substantially. So they can in fact influence the market much more than any other country. They have played a moderating role; if they think prices are getting too high, they start pumping more. If prices are getting too low in their mind, they can reduce output much more than any other country. I think the fact is that in OPEC discussions, there are hawks, who were concerned more about higher oil prices. Then there are the moderates, which are the Gulf countries essentially.

Steve Weisman: Who are the hawks then?

Mohsin S. Khan: The hawks would be certainly Iran, to some extent Algeria and Libya, and Venezuela, certainly, at this point. And the moderates are Saudi Arabia, the United Arab Emirates, and Kuwait.

Steve Weisman: It would be in the interest of the United States to encourage the moderates. Does that mean that the United States would encourage the greater monetary and economic integration along the lines you've just been describing?

Mohsin S. Khan: I think the United States has been very supportive of the Gulf Cooperation Council and the monetary union and the integration of these economies. We've been talking about the economics of the Gulf Cooperation Council. The Gulf Cooperation Council originally was formed, as I said, for the purposes of integrating their economies. But it also had underlying it a security issue. And the security issue basically was one of the things that, if you had a larger grouping of countries in the Gulf, the small countries, from a security standpoint, it would be to their advantage to join together. And the United States always supported that.

Steve Weisman: Right. And now, is the GCC still seen somewhat as a security arrangement in contradistinction to Iran or other threats?

Mohsin S. Khan: Oh, absolutely. I think right now certainly, they are viewed as, if you like, again, a moderating influence on security issues in the region too.

Steve Weisman: And finally, Mohsin, dollars: You pointed out to me the other day when we were chatting that the GCC countries have reserves that rival the largest reserves of dollars in the world.

Mohsin S. Khan: The GCC official reserves are about a trillion dollars and I would estimate that something like 75 percent are held in dollars. These are official reserves, so they're basically being held in US treasuries, in fixed-income assets, very liquid, very short-term liquid assets. That's the official reserves, so they have been basically holding their money in US dollars. And so that's roughly about half of China's reserves, and you must add to that what the sovereign wealth funds hold.

These are also government funds and they could be drawn on should the governments need the money, if they ever do. Some are pension funds, some are, if you like, intergenerational funds for the future. Some are just funds parked in longer-term assets. People used to estimate prior to the financial crisis that these could be somewhere in the region of $2 trillion. So that would make the GCC roughly holding $3 trillion worth of assets, a lot of it held in dollars.

Now, that's not necessarily held in the United States in dollars. For example, one often finds that a Gulf sovereign wealth fund would be holding Lebanese bonds, but they're denominated in dollars, or euro bonds, which are denominated in dollars. So they're still sticking to the dollar and they haven't really made a major move out.

I just did a paper for the book that Peterson is about to release, The Euro at Ten. In that, I tried to look a little more at the composition of what the GCC and the Middle East in general are holding in terms of euros versus dollars, and whether the euro is growing. The evidence is mixed. There has been some growth in the use of euros, but not as much as one would expect. Dollars still dominate and I suspect will continue to dominate for a long time. We come down to the fundamental reason: If your major product is priced in that currency, you tend to be pegged and you tend to be in that currency.

Steve Weisman: The United States should be glad about that prospect, given the amount of dollar-denominated debt that's coming down the pike with all the borrowing the US government has to do.

Mohsin S. Khan: I'm sure that any sort of signal that the Middle East oil producers and particularly the Gulf are moving out to dollars would have a very sharp effect on the value of the dollar and on interest rates in the United States. The US would have to look elsewhere to sell its treasury bills, and right now there is no elsewhere.

Steve Weisman: On that note, Mohsin Khan, thank you very much for joining us on Peterson Perspectives.

Mohsin S. Khan: My pleasure, Steve. Thanks a lot.