Critical Advantages and Disadvantages of Exchange Rate Regimes: The Case of Gulf Cooperation Council (GCC)

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ABSTRACT

This study examines different theoretical perspectives in choosing exchange rate regimes as well as providing empirical evidence on the macroeconomic performance of each regime. A fixed exchange rate regime may have better performance for some countries, while a flexible exchange rate regime may be better for other countries. So it cannot be said that fixed or flexible is better all the time and in every country. Therefore, the characteristics of economic are significant to choose right exchange rate regimes.

This paper attempts to examine the main advantages and disadvantages of fixed exchange rate regime in the Gulf Cooperation Council (the United Arab Emirates, the State of Bahrain, the Kingdom of Saudi Arabia, the Sultanate of Oman, the State of Qatar, and the State of Kuwait). The characteristic of GCC economy will be examined in order to estimate whether the fixed exchange rate regime is appropriate for GCC countries or not. The study concludes that the GCC states would benefit more from fixed exchange rate regime, because they will be able to use monetary policy to resolve internal and external balance.

Keywords: Gulf Cooperation Council (GCC), Exchange rate regimes, Currency

INTRODUCTION

An exchange rate between two countries determines how much one currency is worth in terms of the other. Exchange rate policy is one of the most important aspects in international economics. Since the 1970s the choice exchange rate regime has been a well debated subject and some developing countries have moved to either pegging their currency to fix to the USD or adopting a more flexible exchange rate regime (Levy Yeyati and Sturzenegger, 2005).

Changing the value of domestic currency affects several areas of the economy. A weak currency make a country‘s exports cheaper on world markets, while, a strong currency makes imports cheaper when compared with domestic goods and services. In general, there are two types of exchange rate regimes: fixed regimes and floating regimes. Fixed rate regimes have lost credibility while floating regimes has gained in popularity. The arguments regarding contrasting these two types of exchange rate regimes have come to be known as the corners debate.

At the end of nineteenth century the international monetary system had begun to operate under the gold standard. Domestic currency was pegged to a fixed value for gold, but after the Bretton Woods‘s conference a fixed exchange rate regime pegged to the US dollar was introduced instead of gold. However, in the beginning of 1970s this system broke down, after that the exchange rate regime shifted from a fixed to a floating regime and most developing countries continued to peg their currencies to the dollar, these countries included the Gulf Cooperation Council (GCC) countries and most South East Asia countries, and any other hard currencies, such as the French Franc, which some African countries had pegged their local currencies to, such as Chad, Cameron and Mali (Huang and Malhotra 2004).

In 1975 nearly most of developing nations had pegged their currencies to hard currencies, but by the mid-1990s this percentage had dropped to less than 50% (Calvo and Reinhart, 2002). From the 1990s several developing countries changed their domestic currency from a fixed regime to a flexible regime, because they faced financial crisis, examples of this are Mexico in 1994, South East Asian in 1997, the Turkey crisis in 2000 and Argentina in 2001. Those crises were the result of exchange rate policy. Therefore, management of the exchange rate does not only stabilize the external price of the currency, but it also considers the internal price level. Therefore, the choice made in exchange rate regime by developing nations is one of the most important factors to protect themselves from speculative attacks and currency crises, as well as the achievement of long-term growth.

This paper investigates the advantages and disadvantages fixed exchange rate regime in the GCC countries. The GCC countries have not followed the general trend worldwide in their choice of exchange rate regimes. Despite high income per capita in the region, the GCC countries are counted as developing countries (Merza and Cader 2009). All members of the GCC countries have pegged their currencies to the US dollar. This strategy has been guided by the broad objective of minimizing the risk of currency crisis and tries to create stability in the exchange rate. In 1974 nearly 65% of countries in the world were operating under fixed exchange rate regimes, whereas by 2000, just 42% of countries were doing so. Over the last two decades, a small number of Middle Eastern countries, such as Egypt and Turkey, have progressively moved forward from fixed regimes to flexible regimes, but the GCC states still maintain fixed rate regimes. The GCC states have always guaranteed considerable stability in their exchange rates (Ali et al,; 2024). The huge revenues from oil and natural gas exports are the main factor to accumulate a significant foreign reserve (which is about $35 billion) in order to counteract any variation in currency (Hebous, 2006). The production of these materials makes up half of the Gross Domestic Product (GDP) and three quarters of the export volume for the region. Therefore, under this economic characteristic the local currency in the GCC countries is currently pegged to the US dollar (Yaqub 2024).

LITERATURE REVIEW

The fresh thinking regarding alternative exchange rate regimes that has followed the crises of the last 20 years is a controversial issue for countries integrated or integrating themselves into international capital markets (Huang and Malhotra, 2004). To examine what the impact is of changing alternative exchange rates in these countries, alternative exchange rate regimes need to be analyzed (Bauer and Herz, 2009). Over the past thirty years the debates regarding choice of exchange rate has become a big argument, particularly in developing countries. An inappropriate exchange rate is a major factor to contributing to the global debt crisis. Choice of exchange rate regime is a significant policy issue for developing countries. Reducing the cost of international transactions is significant in achieving sustainable private sector-led growth. For these countries the tides of globalization and regional integration have pushed the choice of exchange rate to the forefront of the policy agenda (Yaqub et al,; 2024).

In this paper, the applicability and classification of the different kinds of exchange rate regimes will be critically examined and the theory and evidence regarding the choice of suitable exchange rate policy will be examined (Rafique et al; 2024). In addition to analysis of the advantages and disadvantages of different types of exchange rate regimes will be given. The experience of policy implementations in the exchange rate regime allows us to make some generalizations regarding the conditions under which various regimes would function reasonably well, though there are many exceptions.

Different Types of Exchange Rate Regimes

In general, there are two kinds of exchange rate regime; fixed exchange rates and flexible exchange rates. However, between fixed and flexible regimes, there are many different types of exchange rate, such as the basket of currencies. According to the (IMF), exchange rate regimes are grouped into three categories.

A) Fixed exchange rate regime. This regime contains currency board, dollarization and monetary unions. In this regime the value of local currency is fixed to the anchor currency and the domestic currency could be converted easily into the anchor currency at that exchange rate (Yaqub 2024). However, the issue of local currency depends on the availability of foreign reserve in the central bank. The Central Bank guaranteed to provide its currency at a fixed exchange rate. For instance, Saudi Arabia adopted a fixed exchange rate regime. The anchor currency for Saudi Arabia is US One USD was equal to 3.75 Saudi riyals. If the central bank of Saudi Arabia had US dollar reserves of 100 billion, then it could issue 350 billion Saudi riyals.

B) Flexible exchange rate regime. Under this regime there is no intervention by the Central Bank in foreign the exchange market (Kneller and Young, 2001). The value of local currency against foreign currency is determined by the interaction between the supply of money and the demand for money. However, the exchange rate can still be affected by monetary policy to reach special exchange rate targets (Calvo and Reinhart, 2002).

C) Intermediate exchange rate regime. Such as the basket peg, under the basket peg, a country fixes its exchange rate to a basket of currencies (Levine et al, 2000). A basket of currencies may contain many major currencies such as the US dollar, the Japanese yen and the euro. The band under the conventional fixed peg exchange rate was within ± 0.1% (Aghion et al, 2009). The central bank can intervene directly in the foreign exchange rate by adjusting the interest rate.

Advantages and Disadvantages of Alternative Exchange Rate regimes

Fixed Exchange Rate Regime,

The term fixed exchange rate denotes the buying and selling of foreign currency against domestic currency in a fixed price regime, and promises that there is an unlimited amount of both foreign and domestic currency to buy or sell at the same rate; this is done by the Central Bank. Foreign trade is encouraged under fixed exchange regimes because in fixed regimes traders are not concerned about appreciation or deprecation of the local currency that lead to the promotion of foreign trade (Hallwood and MacDonald, 1986). Beardshaw et al, (2001) argued that the main argument in favor of fixed exchange rates is about certainty in economics, for most of small countries where a large proportion of their GDP comes from trade, certainty is significant, particularly for both importers and exporters because it needs to not fluctuate in the prices of traded goods and services (Ahmed et al,; 2023). It should remained stable over time by pegging the currency to a stable currency like the dollar.

Moreover, Feldstein and Horioka (1980) pointed out that global integration and free trade under fixed regimes may be less vulnerable in facing an economic crisis, since the goods and services which they produce are traded globally; therefore any economic shock incidence outside the domestic economy has no impact on local economic activity. Furthermore fixed exchange rates prevent inflation of currency and will help to restrain local inflation pressures and the rate of inflation. Under fixed exchange rate regimes this is much lower than under intermediate or flexible exchange rates. This is as a result of greater confidence in the domestic currency and lower monetary growth in the fixed exchange regime. Thus advocators of fixed regimes believe that they are more suitable than floating regimes, particularly for small economies (Daly, 2007).

However, fixed exchange rates can create many problems for economies, for example under fixed exchange regimes monetary policy is inflexible to respond to changes in terms of trade when economic activity faces crisis, for example, in 1990 the devaluation of the British pound against the Deutsche Mark led to a decrease unemployment rate to 6%, while, the unemployment ratio in France was stabilizing at the same percentage of 10% as a result of unchanging exchange rates in the same year. A is one of the most risky aspects of fixed exchange rate regimes, because speculative attack might have a significant, negative impact on stabilization in the value of domestic currency, this occurred in the mid-1990s in many South East Asian countries. Fixed regimes may become a central factor to transmitting changes in macroeconomics from the anchor country to

the pegging country, for example, when the United States faced an inflationary crisis in 1994, the Federal Reserve tried to resolve this and took some economic policies to avoid the crisis. However, those policies in turn, affected the Mexican economy as the local currency was pegged to dollar and so this brought about a damaging of the balance of payment of both household non-financial business and the banking system in Mexico.

If the economy faces a crisis by the real factors in an economy with a fixed regime, then the demand for local currency falls and the central bank is pressured into absorbing the excess supply of domestic currency in exchange for foreign currency (Krugman and Obstfeld, 2003). If the central bank cannot respond to the excess demand, this in turn leads to a loss of confidence in the domestic currency and eventually the hard peg contributes to an increased depth of economic recession.

Fixed exchange rate regimes may also be the main reason to incur a higher incidence of banking crises. Under pegs, the exchange rate may become resources of overvalued or weakening the financial system; without lending of last resort capabilities, the monetary authorities may not be able to deal with certain home financial crises. Under the fixed exchange rate, the sudden withdrawal of capital flows leaves the domestic financial sector vulnerable to severe distress, simultaneously, the commitment to an exchange rate target limits lending of last resort operations (Caballero, 1991). If the demand of foreign currency is larger than the domestic currency, it will create problems for the Central Bank to provide foreign currency and the panic withdrawal which results from this can lead to a self-fulfilling crisis as foreign currency reserves are depleted (Obestfeld and Rogoff, 1995). This is what happened in Argentina. Argentina‘s massive collapse is a cautionary tale of how some of these forces can contribute to the unravelling of even a hard peg.

Despite the fact that hard peg regimes provide maximum stability and credibility for domestic currency, and also low transaction costs and interest rates, it still suffers from a lack of ability to lend funds as a lender of the last resort role of the Central Bank (Edwards and Levy Yeyati, 2005). On the other hand, soft peg regimes are able to maintain and stabilise economies and decrease transaction cost as well, but soft peg regime is not suited to open countries to or to international capital flow because it would be vulnerable to currency crisis. Bleaney and Fielding (2002) argued that a fixed exchange rate regime is symmetrical. Under a fixed rate regime, domestic currency is pegged to one of the hard currencies, for example the US dollar. In this situation the country has little power to increase or decrease its money supply (Hancock et al, 2007).

Flexible Exchange Rate Regime

In this regime the value of the currency is determined by the interaction between the demand and supply of money in the stock exchange. It means that this does not involve intervention by the government or the Central Bank in the money market (Huang and Malhotra, 2004). In flexible exchange rates, the Central Bank does not need to hold a significant amount of foreign currency to defend the domestic currency; instead the central bank can use this reserve in more productive sectors (Beardshaw et al, 2001). The advantages of a floating regime are the same as the advantages of flexible prices and free markets in general: floating regimes help to secure an efficient allocation of foreign exchange.

Moreover, flexible regimes help to create scope for an independent monetary policy, such as interest rate determination, in accordance with the economic and political needs at home, for example, Canada, New Zealand and Australia all have open economies which have allowed their currencies to float over long periods of time and they have benefited from the resulting flexibility and independence of monetary policy. Flexible exchange rates would allow countries to select their own long-term rate of inflation. Theoretically flexible regimes give nations the ability to revalue their domestic currencies in the face of foreign inflation and to shelter themselves from persistent foreign inflation (Bauer and Herz, 2009). Advocates of flexible exchange rate regimes argued that floating rates would eradicate these problems, allowing exchange rates to be decided symmetrically by foreign exchange markets, However, floating regimes can cause uncertain situations in economic activity, because changing the value of the local currency will create problems for both foreign and domestic investors. Speculation under floating regimes can occur for a short time because

the Central Bank does not intervene in effecting a demand for money and the supply of money, thus speculation can take over the price of the exchange rate and create large profits. If the Central Bank does not intervene in the money market, any imbalance between the supply and the demand for money will lead to a crisis.

Moreover, the rate of inflation deteriorates under flexible exchange rate regimes. The results indicate that fixed regimes have the lowest rate of inflation, approximately 2.5% per year lower than for countries with intermediate regimes; on the other hand, flexible exchange rate regimes experience inflation that is nearly 8% per year more than intermediate exchange rate regimes (Levy-Yeyati and Sturzenegger, 2005). Floating regimes are more generally related to increased nominal exchange rate volatility which may damage the real economy unless the financial sector could absorb exchange rate shocks and provide agents with suitable hedging instruments. Therefore, economies must have a well-developed domestic financial system to obtain the benefit from a floating exchange rate regime.

Intermediate exchange rate regime

The idea of an intermediate exchange rate regime draws on the latest theoretical and empirical literature on behavioral finance and currency market structures. The intermediate exchange rate regime is located between hard pegs and floating rates (soft pegs) (Rogoff et al. 2003). Beardshaw et al, (2001) pointed out that an economy with diversified trade would do better to peg to a basket of currencies, which would have a roughly stable effective exchange rate, instead of to a single currency, because when trade is diversified that means there are many trade partnerships involving many different currencies. For example, Iran has a better performance under an intermediate regime because its trade partners are divided amongst many countries with many currencies (Levy Yeyati and Sturzenegger, 2005). Calvo and Reinhart (2002) argued that an intermediate regime will continue to be a practical option because this regime is more complicate in the process of transaction between different currencies, they believe that intermediate regimes can be a useful alternative for countries that want to balance credibility and flexibility in their exchange rate system, or for those countries in transition to a monetary union or a flexible exchange regime. However, intermediate regimes are suited to some developing countries and other emerging markets with relatively strong financial sectors and strong macroeconomic policies (Krugman and Obstfeld, 2003).

On the other hand, Bird and Rowlands (2009) found that intermediate exchange rate arrangements tend to be harder for foreign investors to monitor than fixed or fully flexible regimes. In addition, an intermediate exchange rate regime makes the economy more vulnerable to currency crises, because it provides insufficient incentives for both policy-makers and private agents. Djennas et al, (2010) found in their study that, under an intermediate exchange rate regime, the chance of having a currency crisis was three times higher than under a fixed regime in developing countries and five times higher for developed and emerging market countries (Yaqub 2019).

The key Factor of Choosing Exchange Rate Regimes

In the literature, the choice of exchange rate regime (ranked between hard pegged and freely floating) has clearly been a significant issue between economists. Choosing an exchange rate regimes depend mostly on the characteristics of the country, as well as the nature of the crisis affecting the domestic economy. Huang and Malhotra (2004) found that a floating exchange rate regime would be an appropriate choice for medium and large industrialized countries, because those countries are more financially developed and their economy more diversified. In addition to this, some developing countries have diversified production and trade; therefore they have chosen flexible exchange rate regimes (Bird and Rowlands, 2009). While a fixed exchange rate regime is more appropriate for relatively small countries, in a small undiversified country it is necessary to offset the fluctuation in export receipts in order to decrease the effect of erratic price fluctuations in the main export (Calvo and Reinhart, 2002).

Moreover, Obestfeld and Rogoff (1995) argued that fixed regime is suitable for countries with a history of monetary disorder, countries suffer high rate of inflation, whereas, soft peg is appropriate for those countries

limited links for global capital market, countries less diversified economic, stabilizing from high and protracted inflation under an exchange rate-based stabilization program. Evidence from developing countries showed that most developing countries have little access to international capital markets.

Therefore fixed regime is much more durable and helpful to achieve relatively low inflation. Additionally, external factors determined between 30% and 60% of the exchange rate and reserve changes in 10 Latin American countries (Daly, 2007). The level of global financial integration is very significant to making the right choice of exchange rate regime. Global capital accounts are under pressure under fixed exchange rate regime (Levy Yeyati and Sturzenegger, 2005). Zhang (2001) found that countries with high efficiency in financial intermediaries and capital markets prefer to adopt flexible exchange rate regimes. He pointed out that the availability of financial instruments affects a country‘s choice of exchange rate regimes. Krugman and Obstfeld (2003) pointed out that the degree development in a financial sector may influence a country‘s choice of exchange rate regime. Less developed financial sectors are associated with fixed exchange rate regime.

ANALYSIS OF THE ADVANTAGES AND DISADVANTAGES OF THE FIXED EXCHANGE RATE REGIME IN GCC COUNTRIES

Pegging to the USD has positive points as well as negative points. The GCC countries have got benefits from pegging to the USD for two decades. The GCC states have a balance of economic activity and they were away from any currency crises in the past. But problems with the balance of payments in the US economy led to unsustainable exchange rates for those countries that fixed their currencies to the US dollar. For example, fixed exchange rate regimes in Mexico failed as a result of changing monetary policy in the US, which transferred to Mexico and destroyed the Mexican financial sector. However, GCC countries still prefer to peg their currencies to the US dollar in order to stabilize economic activity in general (Arslan 2024).

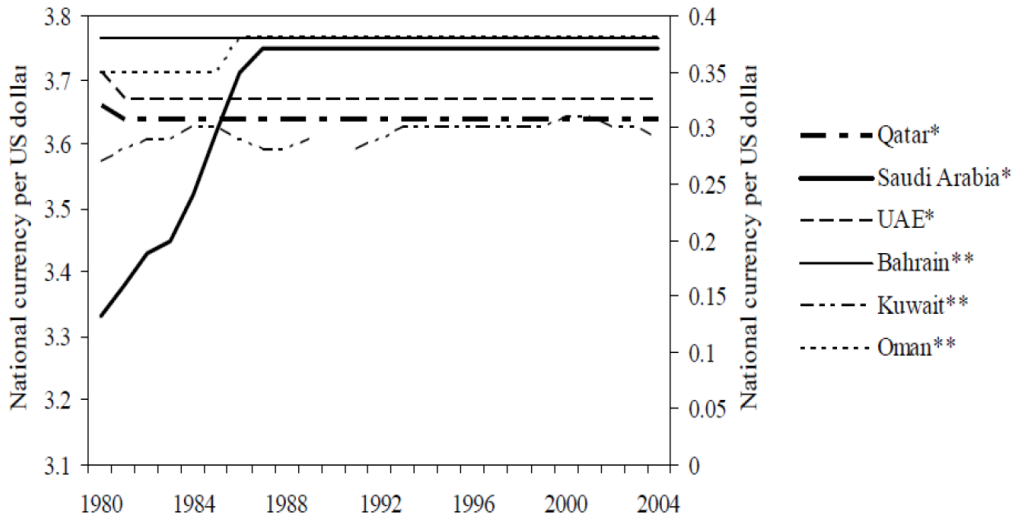
Therefore, GCC monetary policy follows US monetary policy. This policy is implemented by the Federal Reserve to resolve the US economy, but it may create a source of problem for GCC countries. Low, and in some cases negative, real interest rates risk laying the basis for future trouble. More recently, the weak dollar has made it more difficult for the GCC countries and brought instability in both internal and external balances for GCC countries. Transferring a high inflation rate is one of the most obvious problems that the GCC states faced during a weak US dollar. The question has been raised, should GCC states maintain fixed exchange rates to the US dollar or should the GCC allow their local currencies more flexibility in the money market?

Exchange Rate Policy in the GCC Countries

Accounting to the IMF, local currencies from Bahrain, Qatar, Saudi Arabia and UAE fluctuate around the value of the Special Drawing Rights (SDR) within margins of up to 7.25%. However, because of the maintenance of a relatively stable relationship with the US, they decided to peg to the US dollar (Krueger et al, 2009). It is seen from Figure 1 that the GCC states have always guaranteed to stabilize exchange rates. Exporting a large amount of oil and natural gas has allowed those countries to accumulate huge foreign reserves and to use it as backing for their local currency. With full convertibility of currencies and a dollar peg, therefore, monetary policy in GCC countries follows US monetary policy. However, fiscal policy in the GCC countries has been the only instruments can GCC countries use to promote economic activities (Djennas et al, 2010). Karam (2001) pointed out that the fixed exchange rate regime for GCC countries might suit them because of political instability; therefore, pegging the local currency is important to stabilize the balance of economic activity, particularly the external balance. Hebous (2006) found that a fixed exchange rate regime in the GCC has positively affected external stability and promoted competitiveness; he argued that a fixed regime for the GCC region is better than other exchange rate regimes. Fixed exchange regime has served well because the region mainly depends on exporting natural resources (Looney, 2008).

However, Whittaker (2010) argued that following US monetary policy may not be appropriate because the characteristics of GCC economies are different to the US economy, so the US may use some monetary policy that may not be appropriate for the GCC countries. Aleisa et al, (2008) found that, under a flexible exchange rate regime, an economy will not import inflation from the anchor economy because domestic monetary policy can be used by the monetary authority to reduce inflation via an increase in interest rates. For flexible regime, the most important merit is that it dynamically adjusts when faced with economic fluctuation. It can smooth the business cycle of GCC countries and, in addition, break its dependency on the US economy (Nauira et al, 2009).

Figure 1: Exchange rates in the GCC States; National Currency per USD



Source: Arab Monetary Fund, Monetary Fund, Economic Indicators, Money and Credit, 2004

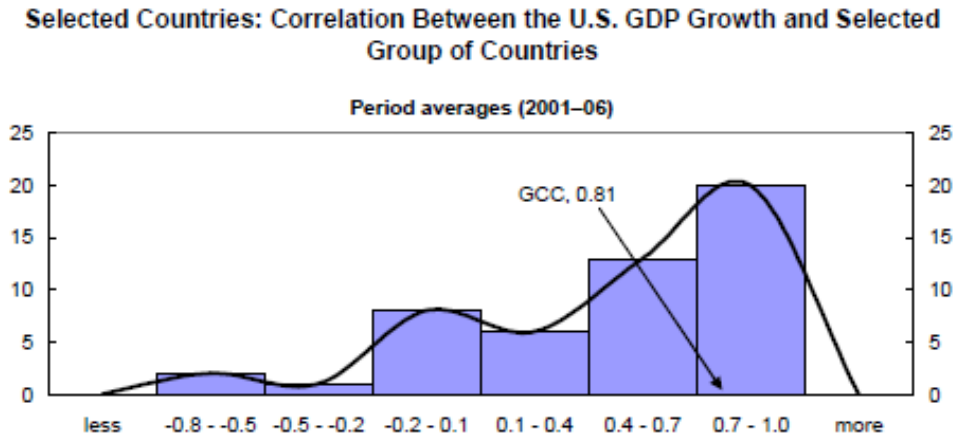
Recently, the GCC states have been recording large current account surpluses as a result of increased oil prices; in 2007 this surplus made up about 26% of GDP. Aleisa et al. (2008) argued that, under a fixed exchange rate, the surplus in balance of payments cannot be resolved because, when the surplus happens, the exchange rate could not appreciate because it is already fixed by the central bank. This is what happens in GCC countries, particularly after oil price increases. Daly (2007) pointed out the GCC countries are awash with a high volume of liquidity as a result of the price of oil but, because the GCC states follow US monetary policy interest rates in the region are kept low which is not suitable for GCC economy. Therefore the authorities cannot use open market operations in order to issue bonds to decrease liquidity.

Weshah and Bentour (2009) said that the surplus in external balance for GCC countries resulted from increasing the price of oil, this led to enlargement of the money base at the same time as an increased supply of money in its broadest definition led to an increase in internal tensions in the region, and this in turn influenced the stock market and real estate market. But it is argued that, under a flexible exchange rate, the surplus in balance of payments can be evened-out. When a surplus happens in GCC countries, the local currencies appreciate against foreign currencies; this led to an increase in the price of goods and services for foreigners and eventually leads to a decrease in or completes removal of the surplus automatically. Looney (2008) argued that the GCC countries mainly depend on oil and the price of oil is relatively inelastic, so under fixed exchange rates, they could not absorb surplus in balance of payment when the price of oil increased. However, under a flexible exchange rate, GCC countries can use monetary policy to reduce external and internal stability. In general, a flexible exchange rate is more appropriate to respond to shocks than a fixed rate. Therefore, the characteristics of an economy should be considered when choosing an exchange rate regime.

With increased capital movement, more trade and openness, and economic diversification, the attractiveness of maintaining the peg to the U.S. dollar has declined, particularly if increased openness leads to increased

volatility. Therefore, a floating exchange rate regime would have the advantage that it could provide another tool for adjusting to shocks and managing oil price-related volatility. The maintenance of an official fixed exchange rate to the USD by GCC countries has resulted in the accumulation of a significant amount of foreign reserve. Trade in GCC countries has contributed significantly to the economic activity. Despite the fact that a fixed exchange rate regime has brought with it strong guarantees of exchange rate constancy, it is suggested that a more flexible exchange rate may be better in terms of economic performance, creating an opportunity for GCC countries to become more economically diverse.

Figure 2: Correlation between the U.S. GDP Growth and GCC GDP Growth



Source: IMF, World Development and Financial Survey, 2009

Figure 2 shows that the fixed exchange rate regime in the GCC has not been costly. The degree of cyclical synchronicity is used to measure the correlation between the rate of economic growth in GCC countries and the rate of economic growth in the US. From 1980 to 2006, the correlation between growth of GDP in the GCC countries and the US was about 0.16; however, during 2000-2006 the correlation was 0.81–this is one of the highest correlations among developing countries.

The main factor that could explain this strengthening of cyclical synchronicity between US and GCC countries is globalization, which has raised significantly the synchronization of several countries business cycles with that of the U.S. economy, given its dominant size. Another argument made in favor of pegs to the USD is about preventing the impact of fluctuations in the oil price on exchange rates. During the last fifteen years, the price of oil has fluctuated significantly from $15 per barrel to $80 per barrel. But this fluctuation has not influenced the value of the exchange rate in GCC countries because they have already fixed their currencies to the USD. For example 3.75 Saudi Riyals has equaled $1 since 1986. If the GCC countries had adopted a flexible exchange rate, the domestic currencies in the region would have appreciated significantly when the price of oil increased and depreciated when it declined. This would have led to damage in whole economy and would have created instability in exchange rates. Figure 2 in Chapter Three shows the nominal exchange rate and that it is a straight line without any fluctuation of the value of the currency even during fluctuations in oil price. This is the greatest advantage of a fixed regime for GCC countries – they have not faced any fluctuation in the value of their currencies.

The impact of a stabilized nominal exchange rate has also positively affected FDI. A stable economy in general and, particularly, a stable exchange rate is one of the most important conditions to attract FDI; this stability has been created via fixed exchange rates in GCC countries and has made the region free from any currency crisis. In addition, monetary authorities in GCC countries have guaranteed to convert domestic currencies to the USD any time at a fixed price. This is a big encouragement to FDI in the region.

The advantage of a fixed exchange rate in keeping inflation in a low rate has worked well for a period of time in GCC countries. The fixed exchange rate helps to keep the rate of inflation low, particularly if the rate

of inflation in the anchor country is low. In the case of GCC countries pegging to the USD, it has worked well for nearly two decades in terms of keeping the rate of inflation low.

Table 1, Inflation Rate (%) in the GCC Countries, 1992-2000

Country	1992	1993	1994	1995	1996	1997	1998	1999	2000
Bahrain	1.5	0.9	0.8	-0.2	2.5	0.9	2.7	1.2	-0.7
Qatar	2.6	3.4	3.9	2.8	2.2	1.9	2.5	3.1	1.7
UAE	2.4	3.1	2.2	3.7	1.9	1.5	2.3	2.7	1.4
Saudi A	1.2	1.8	0.6	0.4	-0.6	1.3	1.9	2.1	-1.1
Oman	1.4	0.9	1.2	2.2	2.5	1.6	1.3	0.8	-1.2
Kuwait	1.3	2.3	1.9	0.6	-0.9	2.1	1.4	0.7	1.6

Source: World Bank, World Development Indicators, 2010.

In the 1990s the US economy recorded strong performance and the USD got stronger against other major currencies and appreciated as well; in addition, the trade deficit was not significant. This improvement in the US economy was mainly as a result of low oil prices during the 1990s. Therefore, the GCC countries could use the USD to import goods and services from abroad. The price of goods and services is relatively cheaper in those countries and regions that have flexible exchange rates with the USD. In this situation, it is normal to have low inflation rates in the GCC countries where their currencies are fixed to the USD. Nearly 70% of GCC imports are from EU and Asian countries, so the inflation rate was kept low.

Table 1, shows the rate of inflation in the GCC countries during the 1990s. It shows that the rate of inflation is relatively low, even negative in some cases. In Saudi Arabia the average rate of inflation during the 1990s was less than 1%, which is the best record on inflation in the region. However, the largest average rate of inflation was in Qatar at about 2.7%. Therefore, we see that the GCC countries got a significant advantage from pegging their currencies to the USD.

Disadvantages of Fixed Exchange Rate regime

Under a fixed exchange rate, the GCC countries have experienced stable economies and external and internal balances until the mid-2000s; this is most important benefit from this regime. Importing instability in economic activity from the anchor country (US) is the most obvious disadvantage of a fixed exchange rate in the GCC countries during the last seven years. The most obvious disadvantage of a fixed exchange rate regime is a lack of ability to use monetary policy, as domestic monetary policy should follow anchor monetary policy (Khan, 2010). So under a fixed exchange rate, the rate of interest should be the same as the anchor country‘s GCC countries should follow US monetary policy because they have fixed their currency to the USD.

Figure 3 emphasizes the fact that the interest rate in GCC countries has followed the US rate during 1984-2004. For instance, the interest rates in Bahrain and Saudi Arabia Almost coincide with that of the US. This is as a result of fixing their currencies to the US dollar. As a consequence, the difference between the highest

and lowest interest rates in the GCC area is quite small (Hebous, 2006). The GCC countries use monetary policy only for stabilizing the external balance, for instance, the interest rates follow the US interest rate instead of being determined according to the domestic economy.

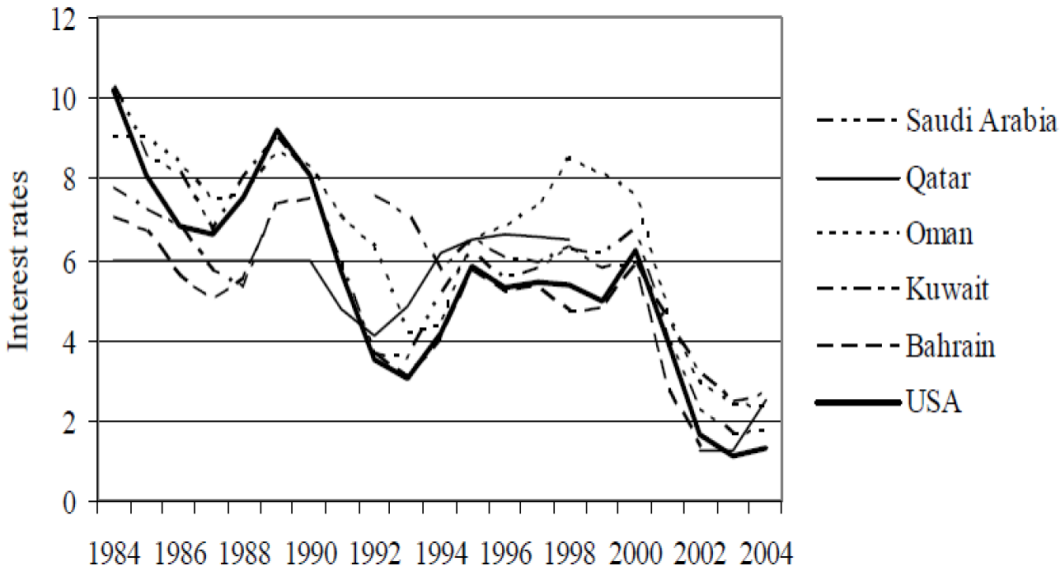
As long as the US imports 25% of all imported oil in the world, so increases in oil price significantly lead to deficits in the US trade balance, which in turn lead to devaluation of the US dollar against major currencies such as the Japanese yen or the Euro (Khan, 2010). The monetary authority in the US decided to decrease the rate of interest in order to resolve an imbalance in the balance of payments. However, high oil prices and the depreciating US dollar caused inflation to increase and real interest rates to be persistently negative for GCC countries, particularly the UAE and Qatar (Razzak, 2007).

But how could GCC countries have a negative real interest rate? This happens when the rate of inflation increases in GCC countries as a result of depreciation in the US dollar, and the GCC countries desperately follow the US interest rate because they have pegged their currencies to the US dollar; for instance, in 2004 the inflation rate in Qatar was about 7% and the interest rate 2%, which means that there was a negative interest rate of -5%.

Therefore, in this situation, it led to a long-term increase in capital outflow particularly portfolio capital and a decrease in investment, particularly in non-oil products, eventually leading to a decline in economic growth. The negative real interest rates for both the UAE and Qatar persisted for years, whereas Oman's rate only became negative in 2007-2008. The other GCC states have very low real interest rates.

In terms of inflation rate, for nearly 25 years all GCC countries were successful in keeping inflation at a the lowest average compare with other countries because they could create strong credibility with a long-standing exchange rate pegged to the US dollar. In general, a fixed regime has worked well in GCC countries to stabilize their economies. However, recently, after the US external imbalance has significantly affected the GCC economies, this has caused Inflation to transfer from the anchor country to the GCC countries (Merza and Cader, 2009).

Figure 3, GCC Nominal Interest Rates, 1984-2004



Source: Arab Monetary Fund (2004) Monetary Fund, Economic Indicators, 2004

The high price of imports has significantly contributed to increases in the rate of inflation in recent years. As a result of a big trade balance deficit in the US economy, the US dollar has deprecated against major currencies like the yen or euro (Willett et al, 2009). The devaluation of the US dollar led to increased prices of US imports and GCC imports from those countries whose currencies are flexible with respect to the US

dollar, like the euro and yen. This means all goods and services which are imported by the GCC countries from Asian and European countries have become more expensive, eventually leading to increases in general prices since nearly 70% of GCC imports come from EU and Asian countries. This transfer of inflation from the US economy to the GCC countries occurs as a result of pegging GCC currencies to the US dollar and the lack of flexibility in monetary policy in GCC countries. In regard to differences in inflation rates between GCC countries, most reflect differences in the pace of rise in public expenditure and investment (Djennas el al. 2010).

Table 2, Inflation in the GCC Countries, 2000-2008

country	2000	2001	2002	2003	2004	2005	2006	2007	2008
Kuwait	1.6	1.4	0.8	1.0	3.3	4.1	4.8	5.6	6.2
Bahrain	-0.7	-1.2	-0.5	1.7	3.3	4.6	4.9	5.9	5.7
Qatar	1.7	1.4	0.2	2.3	6.8	8.8	11.8	10.7	10.2
Oman	-1.2	-0.8	-0.3	0.2	3.7	4.2	4.9	3.8	4.5
UAE	1.4	2.7	2.9	3.2	5.0	6.2	9.3	8.6	9.4
Saudi Arabia	-1.1	-1.1	0.2	0.6	1.4	2.7	3.2	4.1	4.7

Source: IMF, World Economic Outlook Database, 2009.

The fixed exchange rate regime in the GCC countries therefore affects their rate of inflation because their interest rates must follow the interest rate in the US. If the GCC countries had not done decreased interest rate, investors around the world would have invested in GCC countries because the region would have offered a higher yield as a result of pegging their currencies to the US dollar.

Cutting the US rate of interest was a very good policy for the US as its economy weakened, but it was a terrible policy for the GCC countries because their economic circumstances did not need a decline in the rate of interest (Looney, 2008). A decrease in interest rate is good for those economies that suffer from recession, or have a high deficit in external balance, or low demand for goods and services, but the GCC countries have a surplus in balance of payments, which means that they need to use monetary policy – increasing interest rates – to reduce the rate of inflation. But they desperately followed the US interest rate, which created more inflationary pressure. Therefore, it is argued that GCC countries could adopt a more flexible exchange rate in order to use monetary policy and inflation targeting as a stabilization tool.

Over the last two decades here has been substantial price stability. But during the second half of the 2000s, the inflation rate has increased rapidly. The average rate of inflation, measured by the consumer price index, increased from 1.2% in 2000 to nearly 6.1% in 2008. Qatar has the highest rate of inflation inthe region (11.8%) in 2006, the UAE, Oman and Kuwait were (6.2%), (4.9%), (6.2%) respectively; however, in Saudi Arabia the inflation rate was significantly lower (under 1%) until 2003, but since 2006 when the price of consumer goods increased, the rate of inflation has increased to 4.7%.

On the other hand, the decline in the value of the US dollar against major currencies (Japanese yen and euro) means depreciation in the GCC currencies, which has depressed the real incomes of millions of low-income workers in the region. Therefore, reducing the value of the US dollar also means declines in the value of the remittances that a great numbers of foreign workers send home to their families in countries such as India and Pakistan. Since foreign workers make up nearly three-quarters of the total workforce in the GCC countries, this decrease in currency values has led to a decrease in the number of foreign workers in the region and created an imbalance in the labor market, eventually leading to an unstable internal balance.

CONCLUSION

This study has sought to examine fixed exchange rate regime by considering economic conditions in the GCC countries, and it is trying to answer these questions: What are the costs and benefits of alternative exchange rate regimes? Which type of exchange rate regime is the most appropriate in the GCC countries? Should the GCC countries adopt a more flexible regime, follow a more flexible system or keep following a fixed regime?

In the literature review, the theory and evidence about alternative exchange rate regimes has been shown, and the exchange rate regimes have been divided into two types–fixed exchange rate and flexible exchange rate. The choice of exchange rate depends on the characteristics of an economic structure. Therefore, if a fixed exchange rate is suitable for some countries, it may not suitable for others. Evidence suggests that countries with a more developed financial system, diversified economy and a high level of capital account should adopt flexible exchange rates. On the other hand, countries with an underdeveloped financial sector, a small economy, or who depend on natural resources and primary sectors should adopt fixed exchange rates.

There are some advantages and disadvantages to both fixed and flexible exchange rate regimes. Evidence shows that, under fixed exchange rate regimes, foreign trade is promoted. The inflation is low and the economy more stable with less fluctuation in economic activities. However, lack of ability to use monetary policy under a fixed regime rate is the most critical disadvantage, in addition to a high degree of vulnerability to currency crises (Yaqub 2024).

On the other hand, flexible exchange rates can absorb sudden shocks when the economy faces crisis; in addition, under this regime monetary policy can be used to resolve any economic problems. Some evidence suggests that floating exchange rate regimes can favor export growth, because a flexible exchange rate regime is less likely to generate conditions for persistent misalignments. However, the cost of this regime is not small; speculative attacks can happen, which creates uncertainty for both foreign and domestic investors. The terms of trade are not promoted and imbalance between supply of money and demand for money may happen because the central bank does not intervene in the money markets; this may create volatility in the exchange rate.

The GCC countries depend mainly on exporting oil; their economies are relatively open, their exports are not diversified and the contribution of non-oil exports to total exports is still relatively small. Hence, under a fixed exchange rate, the GCC countries have not been able to diversify economically. However, the GCC countries have achieved the main objective of external stability without a great sacrifice in the competitiveness of non-oil exports, so the current exchange rate regime between the GCC countries and the United States is an anachronism. The present operation of macroeconomic policy in the United States is unlikely to meet with the macroeconomic policy needs in the GCC countries, because the US dollar is unlikely to start moving with the oil price. Those oil exporting states that lack the institutions to conduct an autonomous monetary policy should adopt flexible regime for their currencies. This research has found that more flexibility in the exchange rate regime would reduce the need for domestic prices in oil exporting economies to rise and fall along with the price of oil, as well as creating additional room for monetary policy to reflect the domestic conditions of the GCC countries rather than an anchor condition. It also found that such a regime would assist the GCC economies to manage the large swings in government revenue that accompany large swings in oil prices.

After the trade deficit in the US economy, the GCC countries faced many problems, particularly in interest rates and inflation rates. As it is analyzed in Chapter Four, rates of interest in the GCC countries became negative as a result of following US monetary policy because they were pegged to the US dollar. The dollar peg makes the GCC states unnecessarily exposed to swings in oil price, rapid increases in the rate of inflation as a result of the weakness of the dollar against other major currencies. Fixed exchange rate regimes may create disequilibria in monetary systems, particularly in terms of importing inflation from an anchor country. The interest rate at desired levels is often undermined, particularly when a monetary authority has to

intervene in the foreign exchange market as a result of changes in monetary policy in the anchor country. As we have seen, interest rates in the GCC countries recently became negative which will create a weakening in economic activity for a long time.

To conclude that many argued that the GCC countries may benefit from flexible exchange rate regime such as using monetary policy to stabilize the internal balance, not importing inflation and promotion of non-oil output (Abu-Bader and Abu-Qarn, 2006). Adopting more flexible exchange rate regimes would also allow the countries to absorb real shocks more easily than with a fixed regime. As a result of economic globalization, economic liberalization in the GCC countries and free trade with the rest of the world will be the most important factor in moving to a more flexible exchange rate in the region. A flexible regime would eliminate the effects of imported inflation because, under flexible exchange rates, the central bank can use monetary policy to control inflation via inflation targeting, in addition to preventing inflationary pressure by an anchor country. In addition, as GCC countries diversify their foreign trade, pegging one‘s currency may be costly for the government, so it is much better to join a more flexible exchange rate regime.

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