GCC Countries: From Oil Dependence to Diversification

Ugo Fasano and Zubair Iqbal

©International Monetary Fund. Not for Redistribution

© 2003 International Monetary Fund

Cover design by Luisa Menjivar-Macdonald
Production: IMF Multimedia Services Division

Cover photo of a shopping mall in Riyadh.
© AFP PHOTO/Abdel Aziz

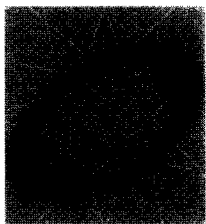
A shorter article on this topic appeared in the March 2003 issue of the IMF's *Finance & Development.*

ISBN 1-58906-233-7

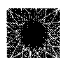
To order IMF publications, please contact:

International Monetary Fund, Publication Services
700 19th Street, N.W., Washington, D.C. 20431, U.S.A.
Tel: (202) 623-7430 Telefax: (202) 623-7201
E-mail: publications@imf.org
Internet: http://www.imf.org

©International Monetary Fund. Not for Redistribution



ver the past three decades the member countries of the Cooperation Council of the Arab States of the Gulf (GCC)—Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates—have witnessed an unprecedented economic and social transformation. Oil proceeds have been used to modernize infrastructure, create employment, and improve social indicators, while the countries have been able to accumulate official reserves, maintain relatively low external debt, and remain important donors to poor countries. Life expectancy in the GCC area increased by almost 10 years to 74 years during 1980–2000, and literacy rates increased by 20 percentage points to about 80 percent over the same period. Average per capita income in the GCC countries was estimated at about $12,000 in 2002, with their combined nominal GDP reaching close to $340 billion (more than half the GDP of all Middle Eastern countries; see Table 1). With very low inflation, overall real economic growth has averaged 4 percent a year during the past three decades, while the importance of non-oil economic activities has grown steadily, reflecting GCC countries' efforts at economic diversification. Moreover, central bank international reserves alone in some GCC countries are equivalent to about 10 months of imports. This progress has been achieved with an open exchange and trade system and liberal capital flows, as well as open borders for foreign labor. The GCC area has become an important center for regional economic growth.



©International Monetary Fund. Not for Redistribution

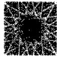


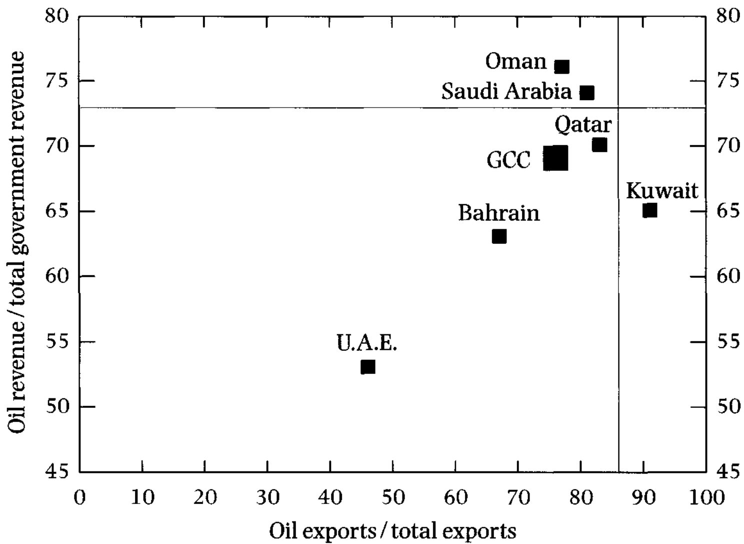
Table 1. GCC Countries: Selected Economic Indicators, 2002

Country	Nominal GDP (Millions of U.S. dollars)	Nominal GDP (Per capita in U.S. dollars)[1]	Population (Millions)[1]	Overall Fiscal Balance (Percent of GDP)[2]	Total Government Gross Debt (Percent of GDP)	Proven Oil Reserves (Years)[3]	Central Bank Foreign Assets (Months of Imports)[4]	External Current Account Balance (Percent of GDP)
Bahrain	8,506	11,619	0.7	0.8	30.3	15.0	2.7	0.3
Kuwait	33,215	15,098	2.2	20.6	32.9	134.0	10.7	20.9
Oman	20,290	7,515	2.7	3.7	16.0	16.0	4.8	10.0
Qatar	17,321	28,362	0.6	5.1	58.2	15.0	2.7	13.8
Saudi Arabia	188,960	8,567	22.1	–5.3	93.8	85.0	12.9	4.7
U.A.E.	71,187	19,613	3.6	–9.3	4.5	124.0	4.7	5.5
GCC	339,479	11,979[5]	31.9	–2.7[5]	66.6[5]	83.7[5]	7.6	6.9[5]

Sources: National authorities; and IMF staff estimates.
[1]Including expatriates.
[2]Including investment income of government foreign assets.
[3]Based on current production.
[4]These figures are not an accurate reflection of the country's foreign assets position because data on government foreign assets are partial in some GCC countries.
[5]Weighted average.

©International Monetary Fund. Not for Redistribution

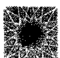
Figure 1. GCC Countries: Oil Dependency[1]
(Average in 1998–2002; percent)



Sources: National authorities; and IMF staff estimates.
[1] Total government revenue includes investment income, and total exports include reexports.

With monetary policy directed at maintaining a stable exchange rate and controlling inflation, fiscal policy has been the primary instrument to achieve other economic objectives, including growth, employment, and equity. But fiscal policy has been constrained by the heavy dependence of government revenues on volatile oil export receipts (see Figure 1). In addition, in many of these countries, a large and rising wage bill and, in a few cases, high domestic debt service payments have also diminished fiscal policy flexibility.

The completion of major infrastructural projects has reduced the role of government spending in non-oil growth. And the large public sector means that private sector investment, though growing, remained relatively low as a percent of GDP.



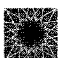
©International Monetary Fund. Not for Redistribution

New challenges are emerging. High population growth in the past two decades, together with the rising participation of women in the labor force, is translating into a rapidly growing national labor force. Indeed, the local GCC workforce has been growing at more than 4 percent a year over the past decade—a pace that is likely to be maintained over the foreseeable future, since about one-third to one-half of the GCC population is now under the age of 15. Given limited room for further employment in the government sector, unemployment among national workers has started to increase in most GCC countries. The governments recognize that a sustained pickup in non-oil growth along with investment in human capital and institutional reforms to integrate the labor market are critical to address emerging unemployment pressures.

The GCC countries are implementing policy reforms to accelerate non-oil growth and create employment opportunities for a rapidly increasing labor force in a sustained fashion, while reducing vulnerability to oil price shocks. They are aware of the need to adjust to the challenges from regional integration and the globalizing world economy, which they realize will not be painless. This pamphlet reviews the steps taken so far by the GCC countries and the role that the ongoing regional economic and monetary integration can play in reinforcing structural reforms.

Current Setting

The GCC countries share many economic characteristics. Oil contributes about one-third to total GDP and three-fourths to annual government revenues and exports. Together, these countries account for about 45 percent of the world's proven oil reserves and 25 percent of crude oil exports (Saudi Arabia is the largest world oil exporter), and possess at least 17 percent of the proven global natural gas reserves (Qatar has become the fourth-largest exporter of liquefied natural gas). The exchange rate has been effectively used as a nominal anchor, with GCC currencies pegged at fixed rates to the U.S. dollar (de facto for several

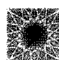


©International Monetary Fund. Not for Redistribution

decades and officially since early 2003), in some countries under a currency board–type of arrangement.

GCC countries are highly dependent on a large expatriate labor force, reflecting the small (but rapidly growing) size of the domestic workforce and the limited domestic supply of adequate skills. Expatriate workers now account in most GCC countries for about three-fourths of the total workforce. These countries have maintained an open-door policy to attract expatriate labor since the 1970s, and this has played an important role in the diversification of the production base and development of the service sector. The availability of imported skills at internationally competitive wages has been crucial to keeping the cost of production down. Most of the national labor force has been employed in the government sector with higher wage expectations than the expatriate workers. As a result, the labor market has remained segmented by sectors of employment, wages, nonwage benefits, and skills.

Given that the hydrocarbon wealth accrues entirely to the government, an extensive welfare system is in place in all GCC countries. Government services in many GCC countries are provided free or at highly subsidized prices, particularly water and electricity, while non-oil taxation is low, consisting mainly of income tax on foreign corporations—except in Oman, where local corporations are also taxed. Some of these countries have recorded overall fiscal deficits over the years, reflecting volatile global oil prices and relatively high levels of current expenditure (see Figure 2). In the process, in a few of these countries government domestic debt has increased considerably. All GCC countries share sound and well-supervised banking systems. Banks are well-capitalized and profitable. Their supervisory framework has been strengthened and is largely compliant with international standards and codes. Moreover, GCC countries have gradually taken a number of steps toward implementing a market-based monetary policy, though direct instruments (such as interest rate and credit ceilings) continue to play a role in a few of these countries.



©International Monetary Fund. Not for Redistribution

Figure 2. GCC Countries: Selected Indicators

(Average in 1998–2002; unless otherwise indicated)

Inflation (percent)

2.5
2.0
1.5
1.0
0.5
0
–0.5
–1.0
–1.5

Saudi Arabia Bahrain Oman Qatar Kuwait UAE

Real non-oil GDP growth (percent)

8
7
6
5
4
3
2
1
0
–1

Kuwait Saudi Arabia Oman UAE Bahrain Qatar

Overall fiscal balance[1] (percent of GDP)

25
20
15
10
5
0
–5
–10

UAE Saudi Arabia Qatar Bahrain Oman Kuwait

Non-oil fiscal deficit (percent of GDP)

0
–5
–10
–15
–20
–25
–30
–35
–40
–45

Bahrain UAE Kuwait Qatar Saudi Arabia Oman

External current account balance (percent of GDP)

25
20
15
10
5
0
–5

Bahrain Saudi Arabia Oman Qatar UAE Kuwait

Total government gross debt[2] (percent of GDP)

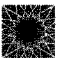
120
100
80
60
40
20
0

UAE Oman Bahrain Kuwait Qatar Saudi Arabia

Sources: National authorities; and IMF staff estimates.

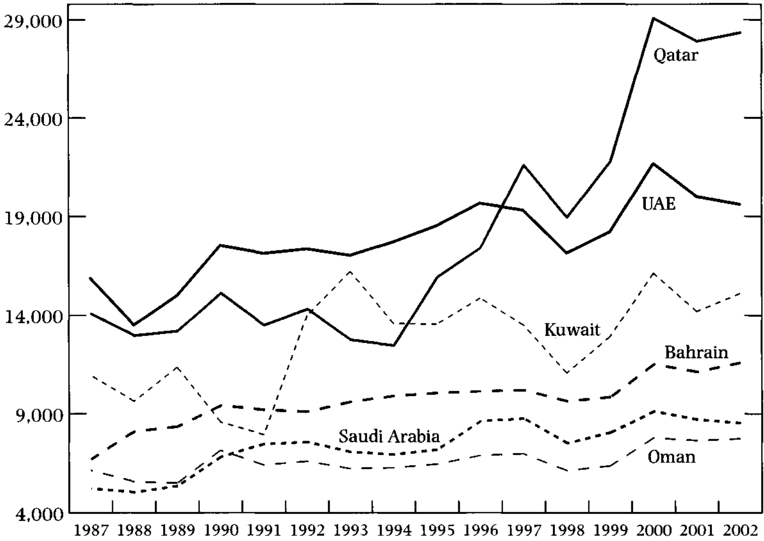
[1]Including investment income on government foreign assets.

[2]Gross external and domestic debt at end-2002.



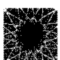
©International Monetary Fund. Not for Redistribution

Figure 3. GCC Countries: Nominal GDP Per Capita, 1987–2002
(U.S. dollars)



Sources: National authorities; and IMF staff estimates.

There are, however, important differences among the GCC countries. Per capita income ranges from less than $8,000 in Oman to $28,400 in Qatar (see Figure 3). The structures of GCC economies and the composition of their exports are also changing. The weight of the manufacturing sector has been growing very rapidly in Saudi Arabia, as has entrepôt trade and related activities in the United Arab Emirates, while the banking and insurance sector is by far the single most important sector in Bahrain. In Qatar, natural gas is well on the road to bypassing oil as the key sector in the economy, and in Oman the growth strategy centered on developing its natural gas resources and tourism has just begun to bear fruit. Reflecting these trends, non-oil growth has varied across the GCC area (see Figure 2). Domestic inflation—albeit low—has differed across countries, leading to diverging paths for real effective exchange rates. Differences also remain in bank regulatory practices, particularly regarding entry restrictions, liquidity requirements, and loan classification and provisioning. Notwithstanding progress toward economic



©International Monetary Fund. Not for Redistribution

diversification, growth of the non-oil sector has remained weak relative to the growth of the domestic labor force in most of the GCC countries.

Looking Forward

A well-sequenced reform strategy to implement comprehensive structural reform over the medium term would help reallocate resources consistent with market signals underpinned by a structural strengthening of the fiscal position and, thus, facilitate sustained rapid growth. Such a strategy, already under way in GCC countries, includes the following elements.

- Fiscal consolidation and structural strengthening of the budget to ensure long-term fiscal sustainability in line with intergenerational economic objectives, insulate the economy against terms of trade shocks, and improve incentives for private sector growth. This would require reducing and targeting subsidies, improving tax administration, adopting a modern tax system, reducing current outlays, and redirecting expenditures toward capital formation, both human and physical. Moreover, fiscal policy must be cast in a medium-term framework assuming a conservative oil price; this approach will likely reduce the reliance of expenditure on short-term oil revenues, building in precautionary savings to face external shocks. In the process, domestic debt would be put on a sustained downward trend, thus providing greater fiscal space for productive spending. Given the close interdependence of the public sector and the budget, speedy structural reform and privatization of state enterprises would help reduce subsidies and enforce market competition.

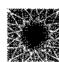
- Expansion of the private sector through legal and institutional reforms along with the privatization of state enterprises. This would require several steps, including (1) further reduction in controls and restrictions on private sector investment, common treatment of all investors—including foreign investors—and guaranteed property rights to help

©International Monetary Fund. Not for Redistribution

establish a well-functioning competitive market system; (2) a well-defined framework for the privatization of state enterprises to ensure market confidence; early correction of the divergence of input and output prices—including of utilities, long-term financing, and other services provided by the public sector—from market-based prices in order to reduce and appropriately target subsidies; and (3) liberalization of restrictive domestic trade and competition practices, which may have discouraged private sector investment.

- Liberalization of restrictions on foreign capital inflows so that the needed capital and associated technologies are available to support privatization and private sector development. Steps toward such liberalization could address three specific constraints: (1) the discriminatory rules and regulations governing such flows relative to those for domestic investment; (2) the lack of a level playing field for domestic and foreign investors, as reflected, for instance, in different tax treatment despite recent efforts to narrow this difference; and (3) the relatively undeveloped capital markets in the GCC countries. Initiatives to address these constraints—including further increasing the efficiency of the financial system both at the national and regional levels—would help meet the increase in private sector demand for credit and services. An accompanying stronger regulatory and supervisory framework would be particularly important in the development of open and diversified financial markets.

- Labor market reforms to prevent unemployment pressures from derailing the reform effort. To avoid weakening competitiveness, this challenge may have to be addressed through a long-term strategy to develop the necessary skills in the labor force. Jobs need to be created for national workers entering the labor market, including those possibly displaced by state enterprise reform, while integrating the presently segmented labor markets. The long-term objective should be addressed by revamping the education and training policies and redirecting government expenditures toward building



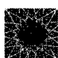
©International Monetary Fund. Not for Redistribution

human capital. For the near term, steps should be considered to reform the labor market by progressively eliminating market segmentation. These could include ending the de facto policy of guaranteed employment to national job seekers in the public sector, bridging the remuneration gap between the public and private sectors for national workers, and expanding the information banks to bring together job seekers and private sector employers.

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

Countries' Experiences Vary

Following the sharp drop in oil prices in 1998–99 and the associated financial pressures, the authorities in the GCC have reinforced their structural reform programs along the lines of the strategy set out above (see Table 2). Since the programs are driven by specific pressures in each country, they are at different stages of implementation. In all GCC countries, progress has been made over the past few years toward fiscal consolidation, lessening the budgets' vulnerability to terms of trade shocks from oil price volatility. Some countries have made progress in separating public expenditure decisions from the short-term developments in oil revenues, including (as in Kuwait and Oman) through formal oil savings and stabilization funds. Attempts to raise non-oil revenues have met with mixed results; they are expected to be more successful in the medium term. Moreover, containment of public expenditure has proven to be harder than expected: reducing public sector employment and curtailing the scope and budgetary impact of subsides have been difficult and the generous welfare systems have remained largely



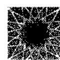
©International Monetary Fund. Not for Redistribution

unchanged. More steadfast attempts to structurally strengthen the budget, including through the implementation of fiscal rules with strict transparent reporting and accounting procedures, would be useful.

The restructuring and privatization of utilities and related services have been placed at the top of the agenda in many GCC countries. Oman, Qatar, and the United Arab Emirates are presently relying on the private sector and foreign direct investment to fund and manage infrastructure projects in the energy and water sectors, while Saudi Arabia has moved aggressively to privatize telecommunications. The state enterprise reform and privatization can be sustained by a more sequenced approach, including establishing a process-monitoring system, further reducing regulation, offering common treatment of investors, implementing time-specific programs to improve the efficiency of state enterprises, and gradually increasing energy and water tariffs to recover costs.

New incentives have been recently adopted in all GCC countries to attract foreign direct investment. These include the establishment of regulatory, institutional, and legal frameworks to govern foreign capital inflows under a generally liberal exchange and trade system. In fact, 100 percent foreign ownership of companies has been allowed in most non-hydrocarbon sectors. Corporate income tax on foreign corporations has been reduced substantially, administrative steps for investment approval streamlined, and foreign investors' access to local stock markets improved.

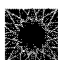
More significantly, the banking systems of all GCC countries have remained resilient to the volatility in oil prices, as high capitalization and strengthened prudential oversight, together with cautious monetary policies, have helped preserve the quality of banks' assets. Steps have also been taken to deepen the financial system through the promotion of capital and equity markets in a number of GCC countries.



©International Monetary Fund. Not for Redistribution

Table 2. GCC Countries: Recent Key Structural Reforms

Financial Sector	
Bahrain	Issued the first Islamic government bills to complement the working of the Islamic financial institutions; took steps toward improving prudential regulations for Islamic banking; ratified anti-money laundering legislation in 2001; and enforced Bahrain Stock Exchange rules and regulations.
Kuwait	Adopted a foreign investment law allowing foreigners to own and trade shares of joint-stock companies listed on the Kuwait Stock Exchange, subject to specific limits.
Oman	Expanded repossession facilities to the interbank market; implemented a capital market law to restructure the Muscat Securities Market into three separate bodies dealing with regulations, trading and exchange, and depository registration; and adopted a new banking law in 2000. The central bank has reactivated the issuance of certificates of deposits to manage liquidity, and implemented measures to reduce the risk of over-lending to individuals, corporations, and their related parties. Oman has taken steps toward full compliance with the Financial Action Task Force (FATF) recommendations on money laundering and combating the financing of terrorism. The central bank is also strengthening risk-management assessment.
Qatar	Removed interest ceilings on local currency deposits in February 2001; strengthened bank supervision, resulting in tightening of nonperforming loan criteria; and introduced a new scheme to enhance liquidity management. Under this scheme, commercial banks can deposit their excess liquidity with, or borrow from, the central bank at rates determined by the central bank, which are fixed on a daily basis.
Saudi Arabia	Allowed foreigners to trade on the stock market through open-ended mutual funds and approved a new capital markets law to deepen the financial markets and strengthen the stock market. Enforced recommendations in line with FATF guidelines relating to the prevention of money laundering.
United Arab Emirates	Established formal stock markets in 2000, and regulatory body for capital markets; enacted a new Securities Law to address volatility and malpractices that plagued security markets in 1997 and 1998, and adopted comprehensive anti-money laundering legislation along with combating the financing of terrorism in January 2002. The central bank is implementing a comprehensive pilot risk-management module for banks.



©International Monetary Fund. Not for Redistribution

Foreign Direct Investment	
Bahrain	Eased rules on non-GCC firms to own buildings and lease land; established a one-stop shop to facilitate licensing procedures; and permitted foreign ownership to increase from 49 to 100 percent of businesses in all but a few strategic sectors (e.g., oil and aluminum).
Kuwait	Passed a law allowing foreigners to own 100 percent of Kuwaiti companies and reduced corporate taxes from 55 percent to 25 percent. Established Foreign Investment Capital Office to process foreign direct investment applications.
Oman	Allowed 100 percent foreign ownership of companies in most sectors; reduced income tax disparity between Omani and foreign companies by raising the single rate for the former from 7.5 percent to 12 percent and lowering the rates for the latter from 15–50 percent to 5–30 percent; redefined "foreign" company as one with more than 70 percent foreign ownership instead of currently 49 percent; and allowed foreign, non-GCC, firms to own buildings and lease land. Opening up the service sector to full foreign ownership in line with WTO agreements, starting in 2003 with the information technology sector.
Qatar	Allowed 100 percent foreign ownership in agriculture, industry, health, education, and tourism sectors, and streamlined investment approval procedures. Reduced maximum corporate tax from 35 percent to 30 percent.
Saudi Arabia	Enacted a new Investment Law and established the associated investment authority (SAGIA) to facilitate foreign direct investment processing, including the establishment of a one-stop shop. Allowed for 100 percent foreign ownership of business in most sectors, including gas, power generation, water desalination, and petrochemicals. Cut the highest corporate income tax on foreign investment from 45 percent to 30 percent. Permitted non-Saudis to own real estate for their business or residence, except in the two holy cities.
United Arab Emirates	Launched several new free trade zones intended to establish the emirate as a global center for trade in gold bullion, research and development of technology, and financial activities. Relaxed restrictions for foreign investment in specific real estate projects.

©International Monetary Fund. Not for Redistribution

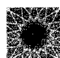
Table 2 (*concluded*)

State Enterprise Reform and Privatization	
Bahrain	Privatized the Public Slaughter House and the capital's waste collection and incineration. Other privatizations are under way, including the public transport company (bus) and tourism facilities. The telecommunications and postal services sectors are being liberalized.
Kuwait	The privatization law, approved by the Finance Committee of the National Assembly, established a comprehensive framework for large-scale privatization, identified areas and modes of privatization, and set up a pricing mechanism and safeguards against job losses. The government plans to offer for sale to the private sector most of the 62 public sector entities still under its control.
Oman	The power sector is at the forefront of privatization efforts, with three power plants now under construction by foreign investors under a build-own-operate basis. Existing government power plants are being restructured for their future privatization. Oman has also recently privatized the management of airport services. Other services to be privatized in the near future include water distribution, waste water network, postal services, and telecommunications. The government also plans to gradually sell its participation in the few remaining non-oil public companies listed in the local stock market.
Qatar	Partially privatized the Telecommunications Company at end-1998. Corporatized the electricity and water sector and sold most of the government's power generation plants to Qatar Electricity and Water Company, which is majority-owned by the local private sector. Construction is under way of the first independent power and water plant, which is majority-owned by a foreign developer. Sold 60 percent of the government's stake in a recently created company—spun off from Qatar Petroleum—to take over the local distribution of gasoline.
Saudi Arabia	Announced in June 2002 a new privatization strategy under which autonomization of management would be followed by deregulation (corporatization) and ultimately private ownership. Twenty sectors are presently identified for privatization, including telecommunications, electricity, industrial parks, postal services, water, railroad, education, and air transportation. Saudi Arabia has recently privatized 30 percent of the Saudi Telecommunications Company. Eight regional electricity companies have been merged into the Saudi Electricity Company, and a regulatory authority was established to set tariff rates and regulate market access to new entrants.
United Arab Emirates	Embraced utility privatization, embarking on new power projects through joint ventures with foreign investors, and selling some existing assets.

©International Monetary Fund. Not for Redistribution

Labor Market Reform	
Bahrain	Recently developed a new National Employment Strategy that includes providing fiscal subsidies for training nationals in the private sector and financial aid for the unemployed. Introduced measures to improve general education standards, and vocational and technical training programs, and increased employment quota of Bahrainis in small and medium-sized companies while abolishing the "free visa" system to expatriate labor force.
Kuwait	Established Manpower and Government Restructuring Program (MGRP) in July 2001 to implement the labor law, provide unemployment benefits to unemployed Kuwaiti nationals, and provide training and facilitate employment of Kuwaiti nationals in the private sector. Approved, in September 2002, quotas for the proportion of Kuwaitis that private companies must employ; companies that fail to meet this target would be subject to a fine and sanctions such as exclusion from bidding for government contracts.
Oman	Introduced measures to improve vocational and technical training programs, and set a uniform minimum wage for Omanis at RO 100 (plus RO 20 as transportation allowance) instead of the previous two-tiered (skilled/unskilled) minimum wage. The authorities are also modernizing the educational system at all levels. A new ministry of manpower was created in 2002 and a new labor law adopted in May 2003.
Qatar	Formally ended the policy of automatic employment for Qatari graduates. Now assists job seekers by maintaining information on job openings and by counseling and training. Established a department in the ministry of civil service with responsibility for this function.
Saudi Arabia	Created the Human Resources Development Fund (HRDF)—with financial participation of the private sector—to provide training of Saudi labor force in skills required by the private sector, and development of a database for matching and placement of Saudi workers in the private sector.
United Arab Emirates	Established the National Human Resource Development and Employment Authority to help improve skills of U.A.E nationals looking for jobs; and established a national labor market database to facilitate nationals' job searches.

Source: Fasano and others (2003).

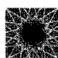


©International Monetary Fund. Not for Redistribution

The labor market challenges differ across GCC countries. The rapid expansion in the number of young nationals in the labor market, particularly in Bahrain, Oman, and Saudi Arabia, combined with downward rigidities in reservation wages—while expatriate workers are available at internationally competitive and flexible wages—has created the potential for strong unemployment pressures. The authorities are aware of the pitfalls of a quick "nationalization" of the labor force and are appropriately focusing on long-term structural solutions while taking interim steps to ease the transition to a market-based system in which wages reflect labor productivity. In fact, all GCC countries have initiated ambitious programs for retraining and educational reforms to meet the medium- and long-term skill demands, particularly in the private sector. More concerted steps to reorient local labor toward the private sector, including by abandoning the de facto policy of government-guaranteed employment, would be welcome. Similarly, an appropriately targeted social safety net would be a better tool to ensure equity than generalized differentiated wages for the public sector employment. A combination of price and institutional measures will be needed to reduce high wage expectations to market levels, raise output, and increase employment. However, for this strategy to be effective, national and expatriate workers have to be made more fungible.

Regional Perspective

Regional integration efforts in the GCC countries have recently gained momentum and will help coordinate and strengthen the numerous structural reforms. Indeed, significant progress toward regional integration has already been achieved since the GCC was established about two decades ago. Barriers to free movement of goods, services, national labor, and capital have been largely eliminated, prudential regulations and supervision of the banking sector are being gradually harmonized, banks are now allowed to open branches in member countries, individuals



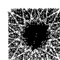
©International Monetary Fund. Not for Redistribution

and corporations of GCC countries have been granted national treatment for tax purposes, and nationals have been permitted to own real estate and invest in the stock markets of all GCC member states.

A GCC single common external tariff (CET) is now in place. Also, imports originating from GCC countries are exempt from duties if 40 percent of their value added is from the region. However, differences in regulations on foreign investment, ownership, capital markets, and integration with the global banking system remain and have militated against the development of an enlarged regional common market.

The planned monetary union of GCC countries by 2010—an initiative to cap the integration effort initiated in the early 1980s—will reinforce the beneficial efforts of ongoing structural reforms and related macroeconomic polices. The monetary union is likely to promote policy coordination, reduce transaction costs, and increase price transparency, resulting in a more stable environment for investment. In particular, the introduction of a common currency is likely to enhance growth prospects by contributing to the unification and development of the region's capital markets and improving the efficiency of financial services. However, these countries will need to make fundamental choices in designing an effective monetary union. These include:

- Adopting a common code of fiscal conduct, consisting of clear criteria for fiscal convergence, a common accounting framework for public accounts, and adequate budgetary procedures;
- Determining a common exchange rate policy, including pooling of official foreign assets and the irrevocable fixing of bilateral conversion rates;
- Developing institutions, such as a common central bank, to support the monetary union, as well as a common set of



©International Monetary Fund. Not for Redistribution

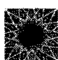
instruments to ensure that monetary policy operations have a similar effect throughout the GCC monetary area; and

- Establishing adequate data quality and common standards to assess progress toward convergence criteria and adherence to policy objectives.

The economic and monetary integration under way among GCC countries is also likely to help these countries face the external challenges imposed by the rapid pace of globalization, which is transforming all aspects of economic and financial activity. In addition to addressing external challenges, integration should also help the GCC countries to face together their internal challenges, in particular increasing strains in the labor market and still-high oil dependence.

In Sum, Diversification and Increased Prosperity

In sum, GCC countries have come a long way since concerted attempts at economic transformation were initiated more than two decades ago. Their standard of living has continued to rise despite heavy dependence on volatile oil revenues and rapid population growth. The GCC countries have also played a salutary role in assisting other developing countries in the region through financial support, employment opportunities, and maintaining liberal exchange and trade systems. However, new challenges have started to emerge. The rapidly increasing domestic labor force calls for a sustained increase in non-oil growth, investment in human capital, and institutional reforms. At the same time, reduction in vulnerability to volatile oil receipts requires a prudent fiscal policy and strengthened structural reform to spur diversification. Moreover, continued growth will be crucial for a sustained resurgence of the regional economy. The authorities are pursuing a comprehensive reform strategy underpinned by fiscal consolidation to address these challenges.



©International Monetary Fund. Not for Redistribution

Bibliography

Barnett, Steven, and Rolando Ossowski, 2002, "Operational Aspects of Fiscal Policy in Oil-Producing Countries," IMF Working Paper 02/177 (Washington: International Monetary Fund).

Fasano, Ugo, 2001a, "With Limited Oil Resources, Oman Faces Challenges of Economic Diversification, Structural Reforms," *IMF Survey* (July 30), pp. 254–57.

———, 2001b, "Sluggish Growth, Declining Oil Resources Prompt Qatar to Diversify Economy Away from Oil," *IMF Survey* (November 26), pp. 382–84.

———, 2002a, "With Open Economy and Sound Policies, the U.A.E. Has Turned Oil 'Curse' into a Blessing," *IMF Survey* (October 21), pp. 330–32.

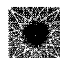
———, 2002b, "Testing the Relationship Between Government Spending and Revenue: Evidence from GCC Countries," IMF Working Paper 02/201 (Washington: International Monetary Fund).

Fasano, Ugo, and others, 2003, *Monetary Union Among Member Countries of the Gulf Cooperation Council*, IMF Occasional Paper No. 221 (Washington: International Monetary Fund).

Fasano, Ugo, and Qing Wang, 2001, "Fiscal Expenditure Policy and Non-Oil Economic Growth: Evidence from GCC Countries," IMF Working Paper 01/195 (Washington: International Monetary Fund).

———, and Zubair Iqbal, 2002, "Common Currency," *Finance & Development* (December), pp. 42–45.

Goyal, Rishi, 2003, "Non-Oil Growth, Competitiveness, and the Labor Market," in *United Arab Emirates: Selected Issues and Statistical Appendix*, IMF Country Report No. 03/67 (Washington: International Monetary Fund), pp. 41–58.



©International Monetary Fund. Not for Redistribution