



Benchmarking the Gulf Monetary Union

The withdrawal of the UAE and Oman has taken some fizz out of the proposed Gulf Monetary Union. **Deborah Ciervo** gives an indexer's perspective on the events.

As the Arab world debates the creation of a single Gulf currency, one important consideration is the effect that this regional monetary union will have on the flow of global capital as it gives rise to new financial instruments and investment vehicles. For a market index provider such as Dow Jones Indexes, this potential new currency agreement opens doors to the development of new pan-regional indexes, sub-indexes, sector indexes, specialty indexes and related market measures. In turn, these indexes can be applied to benchmarking tools and new financial instruments, enabling more efficient and transparent investment capital flows both within the region and from outside sources.

As the European experience with the development of the euro demonstrated, in addition to serving as benchmarks for portfolios, a combined currency serves as a basis of new tradable regional products for local investors in each country. This concept is attractive because it offers the

opportunity for locals to invest in more diversified products with more liquidity at attractive prices and without exchange rate risk. However, it also faces some unique challenges.

A brief history of the GCC

The GCC was formed in May 1981 to encourage policy coordination and integration among six member states that shared similar political systems and common objectives. Adopting the view that countries with fewer disparities in their economic structures are more likely to achieve economic integration, Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the UAE eventually recommended organising a monetary union.


At the GCC's 22nd summit in Muscat, Oman in December 2001, members signed an agreement to establish the Gulf Monetary Union. One of the objectives was the introduction of a single Gulf currency and a targeted start date of January 2010.

In December 2006, Oman withdrew from the union when it became clear that the original convergence criteria, modelled after the introduction of the euro, would not be met in time. In May 2009, the UAE withdrew following the union's decision to locate the proposed unified central bank in Riyadh, Saudi Arabia.

Providers of indexes look at these developments with great interest. History tells us that such unions provide opportunities for market index tools. While we do not know where the Gulf Monetary Union will lead, it is useful to look at the European model as a case study.

The European experience

The euro was established by the provisions in the 1992 Maastricht Treaty. In order to participate in the new European currency, member states of the European Union had to meet strict criteria such as a budget deficit of less than three per cent of the GDP, a debt ratio of less than 60 per cent of the GDP, low inflation



more interesting with new pan-regional indexes. Out of some 130,000 indexes that Dow Jones Indexes calculates today, more than 10,000 are in Europe. An increase in the volume of benchmarked assets indicates that a single currency, when adopted by multiple nations, can possibly lead to an increase in the flow of regional and global capital.

Benefits and challenges

Low-fee, indexed products have always been popular with institutional and retail investors, and they are even more relevant now when markets are so volatile. More and more investors are looking for low-cost, diversified and reliable financial products that simply track the market. This suggests a large potential for a single Gulf currency and for new pan-regional indexes that will come with it.

The Gulf Monetary Union would potentially represent the Middle East's largest and most liquid capital market. As the European experience with the euro demonstrated, this would have a number of direct benefits. The proposed currency would be a part of a natural, evolutionary process indicative of the maturation and cohesiveness of markets in the region.

By eliminating exchange rate risk, a single currency would bring greater exchange rate flexibility and encourage interconnected investors who would no longer have to take on currency conversion costs and risks. Consequently, foreign and local institutional investors would be able to target the Gulf market as a whole and portfolio managers and private investors would be able to take on greater exposure to the region. Also, new pan-regional indexes would be created that will allow for easier aggregate cross-market comparisons between the Gulf and the world's major markets.

On the regional level, a single currency could boost trade and promote economic convergence among the Gulf Monetary Union's member states. It would also increase transparency in pricing and simplify cross-border operational issues, leading to improved business competitiveness.

The Gulf Monetary Union's major challenge is presented by the withdrawal

of Oman and the UAE from what already was a relatively small union of six countries. With the current Gulf Monetary Union membership of four out of the six GCC states, the single currency would be adopted by 66 per cent of the members. By comparison, the euro was initially adopted by 12 out of 15, or 80 per cent, of the European Union members.

The UAE's recent withdrawal renewed questioning of the point of a single currency, which was initially driven by the desire to eliminate exchange rate risk. Some have questioned the feasibility of the project without the UAE and Oman. The UAE contributes one-fourth of the combined GCC's GDP and its decision to abandon the single currency project poses a volume problem. From an indexer's perspective, a pan-regional index calculated without one of the region's major players would be of less utility to foreign investors.

Not being part of the GCC might have other implications as well. Using the European Union as an example, regulations created or eliminated by the establishment of the European Union and the euro helped make cross border transactions in the region easier and allowed the number of deals to grow.

Without Oman, the Gulf Monetary Union loses a key regional trans-shipment hub and a major ally in introducing the new currency into the global capital flow. Oman is the largest of the two Gulf nations, the second being Bahrain, that signed a Free Trade Agreement with the US. The nation's total volume of trade under the FTA in 2008 was at US\$1.38 billion, compared with a little over half of that amount – US\$779 million – for Bahrain.

Since we know the region well, we are prepared for what may come of the Gulf Monetary Union. If Oman and the UAE rejoin the project for a single currency, we will transition the Dow Jones GCC Indexes to the new currency. However, without these two states signed onto the project, a new pan-regional index will likely be introduced for the Gulf Monetary Union currency zone.

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and interest rates close to the European Union's average.

As the European Union switched to the euro, Dow Jones Indexes, in partnership with Deutsche Boerse and SIX Swiss Exchange, developed and launched a series of pan-regional indexes, which over time helped attract indexed investments to the euro zone. While European indexes existed before the introduction of the euro, the Dow Jones EURO STOXX 50 became the first index that measured the performance of companies in the euro-participating countries. The index attracted new investors as it was calculated in a single currency and freed portfolio managers from having to deal with the cost of currency conversions.

Although the introduction of the euro in 1999 initially had only a moderate effect on the uptick in interstate trade, it facilitated the introduction of new investment vehicles such as index funds and exchange-traded funds, which were

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