Gulf union: Oasis dream or desert mirage? Al Arabiya, Dec 2013

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The 34th Gulf Cooperation Council summit ended with leaders applauding Iran's "new direction," while sidestepping the divisive issue of Gulf union by saying talks are "continuing," despite Oman's public rejection of such a proposal.

The promised formation of a unified military command structure was one of the key outcomes of the summit, with the communique also voicing concern over Iran's plans to build more nuclear power plants on the Gulf, saying these "threaten the environmental system and water security."

Pending details, one of the positive outcomes is the endorsement of a number of unified rules regarding the integration of financial markets of the member states, which could lead to deeper and more liquid capital markets.

Where is the GCC heading?

The Arab Spring highlighted relative stability in the GCC nations. However, they have not been immune to the firestorm, with its immediate political and security challenges.

The council continues to grapple with multiple and growing challenges, including high youth unemployment, limited economic diversification, fiscal sustainability threatened by bloated government spending, oil revenue dependence and price volatility.

All this amid continuing reverberations from the financial crisis, which underlined the region's over-dependence on Western markets and vulnerability to spill-over and contagion

effects.
In the immediate future, there will be more challenges from the Arab Spring, as well as Iran's growing regional and global footprint, and consequently its impact on the Organization of Petroleum Exporting Countries' future and decision-making. In principle, these challenges should lead the GCC to seek deeper modes of cooperation.
The promises of closer union offer the benefits of greater trade, a common market, labor mobility, economies of scale, increased competition and potential specialization.
This is in contrast to the status quo of six countries with inefficient economic size, similar production structures, and limited international economic, financial and political power.
History is a clear testimonial that the GCC has not known how to benefit from crises to come together for collective action.

GCC performance below expectations

Economic and political unions require that the benefits outweigh the costs for individual members joining, and that the union be sustainable. For an optimal solution, it is necessary that "gainers" from the union can compensate "losers." Typically, unions have emerged as a result of crises, and rarely from the perceived benefits of joint action or cooperation.
Game theory, describing strategic bargaining among multiple actors, is a better guide to understanding the limited progress in "cooperation" toward GCC union than macroeconomic theories such as optimal currency area theory, debt sustainability analyses, or other equilibrium modelling exercises (policies that were extensively discussed in the formation of the European Union).
In all types of "games" in which the policy of one country affects the variables making up another country's welfare function, better outcomes are possible with a cooperative rather than a non-cooperative strategy.
When it comes to monetary or political union, the efficiency

of the coordination process and the effectiveness of its outcome depend critically on the gradual reinforcement of the regulatory and institutional set-up.
It may often be the case that national leaders are rational and calculating, but they cannot be sure of the future behavior and commitments of their counterparts during integration. Hence, leaders might choose a sub-optimal choice of the security of self-sufficiency or insecurity they can control themselves, as opposed to a scenario of uncontrolled insecurity during the process of integration.

Obstacles to integration

Politics and governance issues continue to plague the progress of GCC economic integration, monetary union, and the more recently proposed Gulf federation. The latter needs political will and leadership around a common vision (the EU, for example, came about due to strong Franco-German cooperation after World War II).
The vision underlying a Gulf union has not been clearly defined or widely discussed. Membership is an example. Given its proximity, strategic location and abundant labor force, Yemen would complement the GCC economies, but its membership is not contemplated and its workers face discrimination.
To achieve consensus around strategic objectives requires confidence-building measures and a step-wise approach by establishing common institutions for cooperation and collective action, and investing in "deeper integration" (standardization of laws, regulations, establishment of a functioning customs union, effective labor and capital mobility, integrated capital markets, competition, banking and monetary union), prior to moving toward political union.
Union in its various forms requires a trade-off between diminution or loss of sovereignty, and the benefits of collective action and institutions. This has yet to be convincingly demonstrated for Gulf union, which requires broader participation and political representation for

collective and sustainable decision-making.
Even the EU, with its broad parliamentary political process and representation, finds difficulty in achieving consensus on deeper union. For the GCC, the concentration of power without visible and constitutional checks and balances implies a collection of unelected sovereigns, each with potential veto power, rather than ‘equal partners’ representing broad domestic consensus.

Saudi dominance

Saudi Arabia, which is dominant in terms of size and resources, acts like a dominant player and can earn a larger payoff regardless of what other players do. The other GCC members will require constitutional rules and governance frameworks that ensure Riyadh will not abuse its power. Saudi Arabia will have to compensate other members for any perceived loss of sovereignty in decision-making or in payoffs.
Absent governance and institutional safeguards, it is not surprising that Oman would not join or endorse a Gulf union. Not only is it one of the smaller nations by size, but even in the political domain – and unlike Saudi Arabia, which is locked in a decades-long rivalry with Iran – Oman maintains good relations with Tehran, with whom it shares the world’s most strategic oil route, the Straits of Hormuz.
In the same vein, the GCC customs union is yet to be fully implemented, despite being in operation since 2003, as the revenue-sharing agreements are still perceived as skewed in favor of Saudi Arabia. Reforms are required. Strengthening and widening the mandate and independent executive power of the GCC secretariat and its other institutions could be a confidence-building measure on the road to greater integration.
Similarly, the creation of a fairly-governed fund and budget of sufficient size for significant collective action and GCC-wide projects and institutions would be part of such compensatory mechanisms.

The recent case of the Gulf Central Bank, with Saudi Arabia insisting that it be headquartered in Riyadh, provides another illustration of political and governance issues. This resulted in the United Arab Emirates and Oman refusing to join a Gulf monetary union. Apart from the political and governance issues, Oman said its economy was not ready.

The grievance is justified, given the structure and composition of Muscat's international trade. Its oil exports are largely to Asia, particularly Japan and China. The latter accounted for nearly 58% of the sultanate's total oil exports in Jan-Oct 2013.

From the point of view of Oman and the UAE, greater engagement with Asia (and not the United States) would be in their best interests. In this regard, strategic monetary linkages with the Japanese yen and the Chinese renminbi would benefit the Omani riyal more than its current peg to the U.S. dollar, which would most likely continue post-monetary union.

Common currency

The ongoing debate about the GCC common currency is in the doldrums. Though the U.S. peg eases the way toward a monetary union by generating Gulf cross-exchange rate stability, a continued peg to the dollar – and hence to U.S. Fed monetary policy – does not serve the economic interests of the region.

The global shift in economic geography towards the dynamic emerging-market economies has led to Asian countries – notably China and India – becoming the main trade partners of the GCC. With only 6.9% of the council's trade conducted with the United States in 2012, the case for a hard dollar peg is weak.

The GCC should move to a currency basket that has appropriate exposure to the euro and includes the renminbi. Council members need to pursue independent exchange rate and monetary policies directed at dealing with the business cycle conditions of their main trade and investment partners, rather than being wedded to an archaic linkage to the U.S. dollar, a policy vestige of a bygone era of economic relations.

The road to Gulf economic integration and union will be long, bumpy and tortuous. It requires strengthened leadership and common vision, political will and good governance, consensus-building, and compensatory institutions and mechanisms.