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THE IMPACT OF GLOBAL ECONOMIC IMBALANCE ON MIGRANT WORKERS AND ECONOMIES OF THE GULF COOPERATION COUNCIL

OLGA MARZOVILLA*

Abstract

The GCC countries are characterized by a high incidence of foreigners in both the overall population and the labour force as well as by deep inequalities in social and economic terms. These features have influenced the labour market and fuelled mutual tensions and grievances between nationals and foreigners. Consequently, these countries need to reconcile the demands of economic growth with those of social stability. The latter requires more stable economic dynamics, which prevent the redistributive effects of inflation.

The experience of the new millennium has shown that the dollar peg, which characterizes the exchange rate regime of the GCC countries, has been a major vehicle of inflation for the Gulf economies and suggests that it should be amended. The alternative proposed in this paper is to anchor the national currencies to a basket of strong currencies that mirror the direction and intensity of commercial and financial flows on the international market and in which there is also the euro.

JEL Classification: F22; F31; F32; F33; E31

Keywords: GCC countries; exchange rate regimes; basket peg; dollar peg; inflation; migration; labour market

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1. Introduction

In May 1981, Saudi Arabia, Bahrain, the Union of Arab Emirates, Kuwait, Qatar and Oman set up the Gulf Cooperation Council (GCC) in order to achieve closer co-operation and integration in all sectors. In the economic sector, the integration process included the following milestones: setting up of a free exchange area in 1983; creation of a customs union in 2003; start of a single market in January 2008. The latest is the introduction of a single currency on European Monetary Union model. This step was initially scheduled for January 2010 and was subsequently postponed due to divergences and conflicts that arose between the GCC members.[1]

Geographically speaking, the six countries make up an area that is dominated by Saudi Arabia - which includes over 68% of its population, estimated at about 40 million people, and 83.6% of its surface.

Despite the small size of most GCC countries and the prevalence of unusable land in Saudi Arabia - due to the hot climate and the large extension of desert land - the Gulf economies have become major actors in the international global arena during this new millennium. This can be explained by two main reasons:

a. the GCC area includes 40% of world oil reserves as well as 23% of natural gas reserves, which makes it one of the leading producers and exporters of hydrocarbons;

b. thanks to foreign exchange reserves piled up over the new millennium, following the growth in the world's oil demand and the standing increase in oil prices from 2001 to the first half of 2008, the GCC countries can impact considerably on international financial markets. At the end of 2008, they ranked second after China as net capital exporters. Indeed, 13.6% of the world's net capital exports could be traced back to Kuwait, Saudi Arabia, and the Emirates - compared to 23.4% of China and 12.9% of Germany (IMF, 2009a). Additionally, three of the leading sovereign wealth funds currently operating on international markets belong to this area - namely, the Qatar Investment Authority (QIA), the Abu Dhabi Investment Authority (ADIA), and the Kuwait Investment Authority (KIA).[2]

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[1] In December 2006, Oman declared its inability to join the Union by 2010 as it considered the tax constraints envisaged by the latter to be excessively stringent; in May 2007, Kuwait relinquished the dollar peg and anchored its currency to a currency basket; in May 2009, the Arab Emirates withdrew from the agreement after the Council's decision to locate the headquarters of the Gulf's Central Bank in Riyadh rather than in their territories.

[2] As estimated by the Institute of International Finance, they managed about 630 billion of US dollars in 2008 – which amount rises to about 1.1 trillion if one includes the reserves managed by the Saudi Arabian Monetary Agency (SAMA) (IIF, 2009).

The above considerations help explain why the GCC area continued growing at a mean yearly rate of 6.4% even in 2008, while null or negative rates featured in the rest of the world following the explosion of the international economic and financial crisis (IMF, 2010a).

In fact, the Gulf countries would appear to have been affected only indirectly and any case to a limited extent by the financial crisis that started spreading worldwide from the second half of 2007. Conversely, they were markedly affected by the global economic imbalance that kept worsening throughout the new millennium and was ultimately the cause of the financial crisis.

The importance attained by these countries as leading actors in the world economic arena, along with the possible impact that their domestic developments may produce on the international milieu, point to the appropriateness of re-considering the effects of the said imbalance in the light of some characteristics that feature in the GCC members - so as to outline some possible guidance for the future, especially with a view to the monetary union they have planned.

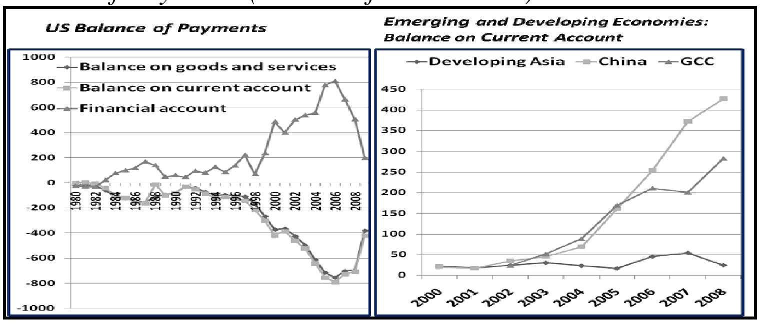
2. The Global Economic Imbalance in the Dollar Area

The global economic imbalance was the subject of a lively debate in economic literature, including contributions from, amongst others, Mc Kinnon (2005, 2006, 2007), Bernanke (2005), Dooley, Folkerts-Landau and Garber (2003, 2004), Bhide, Phelps (2005), and Cooper (2005). Although there is no consensus on its causes, it is generally agreed that it impacts on the structure of the balance of payments of the main world economic actors - with particular regard to those of the dollar area.

Over the last decade, the growing deficit of the US current account balance has been accompanied by the growing surplus of various emerging economies.

Since 1983, the US balance of payments has been characterized by the dual presence of a current account deficit and a systematic and growing surplus in the financial account. However, the opposite imbalances of the two sections of the external accounts have expanded further during the new millennium and found their counterpart in the rising current account surpluses of the GCC countries, China and developing Asian countries (Fig.1).

Figura 1- *Balance of Payments (billions of U.S. dollars)*



Source: U.S. Department of Commerce, Bureau of Economic Analysis; IMF, *World Economic Outlook,* April 2010; IMF, *Regional Economic Outlook: Middle East and Central Asia,* Oct. 2009.

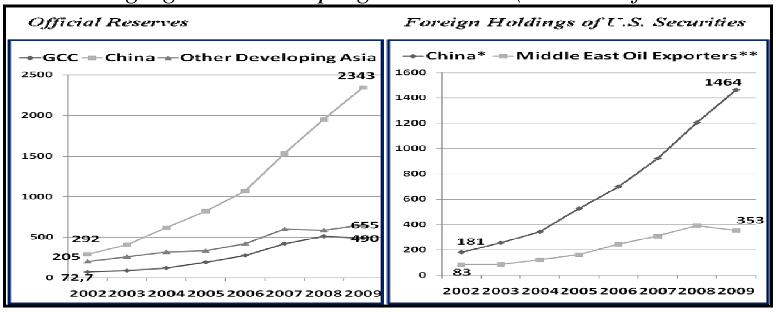
On different grounds, these countries have shown major surpluses in the balance on goods and services. While the successful export-led policies, as fostered by the major inflow of direct foreign investments, may account for the growing surplus of developing Asian economies, the increase in oil prices and exports underlies the surpluses shown by oil producers as well as by GCC countries.

In both cases the surplus has facilitated the creation of official reserves, most of which have been used to acquire foreign financial assets - in particular, US assets. Accordingly, these economies have become major holders of US financial securities (Fig.2).

More specifically, China overtook Japan in 2009 as the leading holder of US assets, while GCC countries quadrupled their assets in the 2002-2009 period and now rank seventh on the list of foreign holdings of US assets - after China, Japan, the United Kingdom, Cayman Islands, Luxembourg, and Belgium (US Treasury Department, 2010).[3]

[3] In fact, these data underestimate the actual financial holdings of GCC countries. While in the 1970's petrodollars were deposited with the international banking system and invested directly by the latter, most proceeds from oil surpluses are currently re-cycled via other financial markets, which hide the ultimate identity of the individual investors and also makes it more difficult to monitor and quantify the actual capital flows targeted abroad. This is why the assessment of the foreign assets actually held by these countries requires taking also account of the securities to be referred to the UK, Luxembourg, Switzerland, and the Cayman Islands.

Figura 2 - *Official Reserves and Foreign Holding of U.S. Securities of Some Emerging and Developing Economies (billions of U.S. dollars)*



Sources: IMF, *World Economic Outlook*, April 2010; IMF, *Regional Economic Outlook*, May 2010; U.S. Department of the Treasury, *Foreign Portfolio Holdings of US Securities Historical Data.*

* Excludes Hong Kong , Macau, and Taiwan. ** Includes GCC Countries, Iran and Iraq.

These processes have contributed to reinforcing the US status as the world's leading debtor, with net capital imports amounting to 43.4% of the world's imports in 2008 (IMF, 2009a); while China and the GCC countries have become the main creditors.

This is an abnormal development, pointing to deep-ranging imbalances in the international economic system. Indeed, the efficiency logic predicates that capitals should flow from richer countries - where they are more plentiful and their yield is lower - to poorer countries - where they are scarce and more profitable. Conversely, the current situation would appear to show that the strongest economy in the world is subtracting savings from countries that have yet to complete their growth process, fast-paced as the latter may be, in order to finance its own high consumption standards.

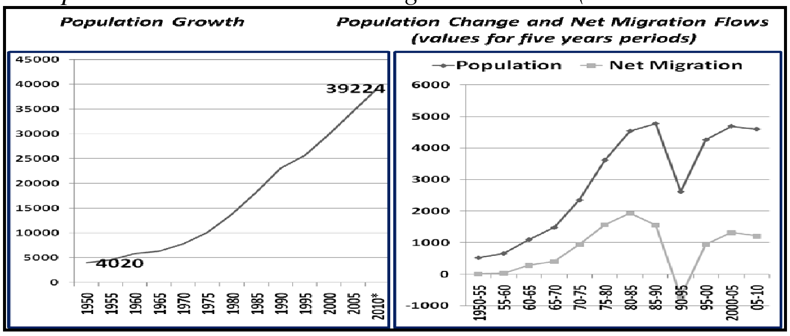
As regards the Gulf countries, the opposite imbalances in their balances of payments and the US, have produced considerable effects due to their interaction with three major features of their economies, namely:

1. population dynamics;
2. labour market structure;
3. exchange rate regimes.

3. Population Dynamics and Migration Flows

As shown in Figure 3, from 1950 to the end of the first decade in the new century the population of the GCC countries rose from 4 million to about 40 million people - with a growth rate that was among the highest in the world and was favored not only by the natural population growth rate, but also by significant net migration flows.

Figura 3 - *Population Growth and Net Migration Flows (values in thousands)*



Source: United Nations Population Division, *World Population Prospects: the 2008 Revision Population* Database.
* Estimates

The high dependence of the Gulf area on hydrocarbons production and exports played a key role in its population dynamics as well as in the labour market structure. Indeed, the small population of the GCC countries, the lack of specialised labour, the high inactivity rate and widespread illiteracy resulted in the imbalance between the offer of domestic labour and the increasing demand related to the development of oil sector. This gap has been bridged by importing foreign workers since the 1930's, when major oil fields were discovered and the first extractions began.

Although the flows changed in connection with the events occurring in the hydrocarbons market as well as following the conflicts that have ever been a feature of the Middle East area, migration inflows have become a particular feature of the GCC region so much so that it has become one of the leading destination regions for migration flows. In the 1950 - 2010 period, net migration flows of foreign workers in the individual five-year spans were always positive, the sole exception being the 1990-1995 period when the Gulf War took place.

The migration flows that have featured in the Gulf area since the first half of the past century can be broken down into three sub-periods as a function of the foreign workers' countries of origin as well as of their sector-related utilization.

- One first sub-period covers the years from the oil discovery in the 1930's up to the first half of the 1970's. This period featured the inflow of foreign workers mainly from the Arab region. The conflicts and tensions that were rife in those years, including the many Arab-Israeli conflicts, fuelled major migration flows of Palestinians, Yemenites, Egyptians and Lebanese towards the Gulf economies.

They were mostly unskilled workers that met the demand for growth of the oil sector and were accepted easily in the various destination countries because of their language, cultural and religious similarities that seemed capable of ensuring respect for individual national identities. These flows grew consistently throughout this period and peaked in period from 1970-1975 - which include the first oil shock - when about 1 million workers moved to this area.

- The flows increased further in the second sub-period, ranging from the half of the 1970's to the end of the 1990's. In particular, over 4.5 million of foreign workers entered the Gulf countries in the 1975 - 1990 period in order to meet both the growing demand for manpower, due to the expansion and modernization of the oil sector and the requirements arising from the diversification of production processes that had started in the early 1980's. Indeed, major changes have started to surface in these years, increasing their importance in the 1990's as well as in the third sub-period. These changes have to do with the diversification of the employment sectors of the workforce, the increased demand for skilled workers and the origin of migration flows.

The experience gathered in the 1970's and 1980's - when the major oil revenues piled up after the 1973 and 1979 oil shocks were depleted in a few years' time and the external surplus, along with the budget surplus, turned into a deficit - raised awareness of how transitional the positive effects produced by the increased oil revenues were and led the GCC countries to implement policies that were targeted at diversifying production activities so as to reduce the dependency of their economic growth on the ebb and flow of oil prices. These policies also ultimately resulted in fostering the creation and growth of the private sector, since they were supported by the introduction of privatization and liberalization processes.

These developments fuelled the demand for manpower and can account not only for the major flows observed in this period, but also for the more diversified sector-related distribution of foreign labour along with the increased demand for skilled, highly-specialised workers (technicians, engineers, architects, medical doctors, managers, etc.).

However, the most striking changes have to do with the origin of migration flows. Indeed, the remarkable growth in the incidence of foreign workers of Arabian origin led to some concern both in political and in social and economic terms. As for the former, there were fears about the possible spread of extremist and radical positions within the framework of a pan-Arabist ideology whereby the union of all Arab countries was to be regarded as the solution for the under-development caused by colonialism. As for the latter, the concern was mostly focused on the expectations of Arab migrants to remain indefinitely in the Gulf countries, where they usually also took their families. Conversely, Asian workers proved less demanding: they accepted lower wages and temporary work; their families stayed in their home countries; they were easier to employ and dismiss given the brokerage function discharged by Asian agencies in their recruitment.[4]

The de-Arabization of labour was accelerated following the first Gulf War in 1991. The invasion of Kuwait by Iraq caused a major gap between Middle-Eastern pro-Iraq and pro-Kuwait countries, which was mirrored by migration flows once the war was over. About 2 million workers from countries that had supported Iraqi claims (Yemenites, Palestinians, Jordanians, Sudanese) were expelled from Kuwait and Saudi Arabia and replaced by many Asian workers from India, Pakistan, Philippines, Indonesia, Bangladesh, and Sri Lanka. Overall, the incidence of the Arab component over the total migrants in the GCC region fell between 1975 and 2004 from 72% to 32%, to the benefit of the Asian component (A.Kapiszweski, 2006).

- The third sub-period, which started with the new millennium, confirmed and emphasized the trends that had already begun during the second sub-period. The diversification of economic structures became the leading feature of this period along with the steady increase of oil prices that fuelled such diversification. Indeed, the oil price rise from 20 dollar/barrel in 2002 to over 140 dollar/barrel in 2008 increased the flow of foreign exchange earnings from exports and allowed financing the investments and fiscal stimulus required by the process of growth in the non oil sector.

However, the fast accumulation of foreign exchange reserves in small economies, where wealth is markedly concentrated and the public sector is under the control of a handful of powerful families, led entrepreneurs to invest mainly in areas where they could be executed more quickly and easily - which caused the unbridled growth of the real estate, building, and services sectors, i.e. of the so-called FIRE (Financial, Insurance, Real Estate) economy. Due to the small domestic population, the feverish diversification process required additional inflows of foreign workers and led to new peak net migration flows - which were estimated to amount to about 2.5 million in the last decade (Fig. 3).

Although it is impossible to gauge the real dimension of this phenomenon,[5] over 10 million of migrant workers are estimated to have entered the GCC region

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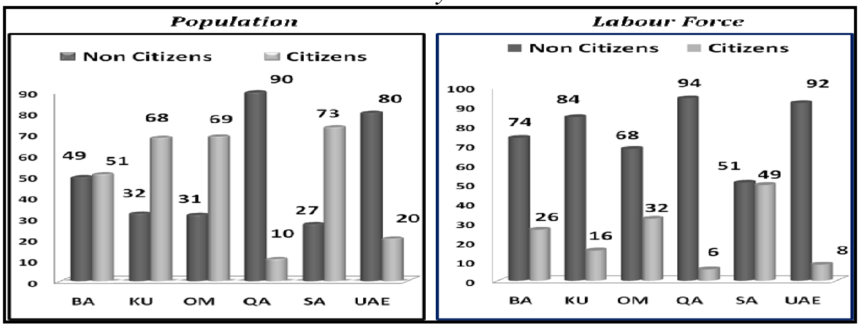
[4] One of the reasons most frequently referred to in order to account for the fast-growing Asian immigration has to do exactly with the initiatives undertaken by the governments in the countries of origin, which have fostered migration in order to reduce unemployment within national borders. To that end, they have relied on specialised agencies that have channelled labour towards companies operating in the Gulf area by way of temporary, low-wage contracts. The number of such agencies has been rising quickly since the end 1970's: they rose from 55 in 1977 to 300 in 1980 in Bangladesh; from 4 to 544 in Sri Lanka; from 850 in 1980 to 1119 in 1985 in India; and from 650 to 964 in the Philippines during the same period (Kouaouci, 2006).

between 1950 and 2008 - whereby foreigners nowadays make up a considerable percentage of the total population and the foreign labour force outnumbers the domestic one in almost all the countries of this area.

Figura 4 - *Percentage Distribution of Population and Labour Force by Nationality[1]: 2008[2]*



Sources: Labour Market Regulatory Authority (LMRA), Kingdom of Bahrain, *Bahrain Labour Market, 2009*; Central Informatics Organization of Bahrain (CIO), *Statistical Abstract*, 2007; Institute of Banking Studies of Kuwait (Kibs), *Economic and Financial Data base for 2009;* Statistics Authority of Qatar, *Labour Force Sample Survey, Results,* December 2008; Saudi Arabian Monetary Agency, *45th Annual Report*; UAE Ministry of Economy, *UAE in Numbers 2007;* UAE Ministry of Economy, Central Department of Statistics, *Labour Force Survey,* 2008.

[1]Legend: BA (Bahrain); KU (Kuwait); OM (Oman); QA (Qatar); UAE (United Arab Emirates); SA (Saudi Arabia). [2]Data of Bahrain and Oman on population refer to 2007; those of UAE refer to 2005 for population and to 2006 for labor force.

As shown in Figure 4, the incidence of migrants on the total population ranges from 27% in Saudi Arabia to about 80% and 90% in the UAE and Qatar, respectively - while the foreign labour force rates are higher, being in excess of 80% in Kuwait (84.4%), the UAE (92%) and Qatar (94%).

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[5] The difficulties here have to do with the poor quality of the statistics available from the countries in this area – which tend to downsize the numbers related to foreigners and emphasize those for domestic population – as well as with the impact produced by illegal migration. Although a work visa is necessary to enter these countries along with a permit to stay, many foreign workers enter the individual countries regularly, and then they become illegal migrants as they remain in GCC countries after expiry of the respective contracts – often with their employers' full knowledge thereof. Other major illegal migration channels include ports, such as the one in Oman, as well as pilgrimages to Saudi Arabia: indeed, the latter allow being granted visas that often facilitate illegal migration (P. Cadène, B.Dumortier, 2008).

4. The Impact of Migration on the Labour Market

It is understandable that the remarkable incidence of foreigners on the overall population and labour force has resulted in several problems for the Gulf economies - first and foremost the need to ensure citizens' rights by preserving their cultural identity.

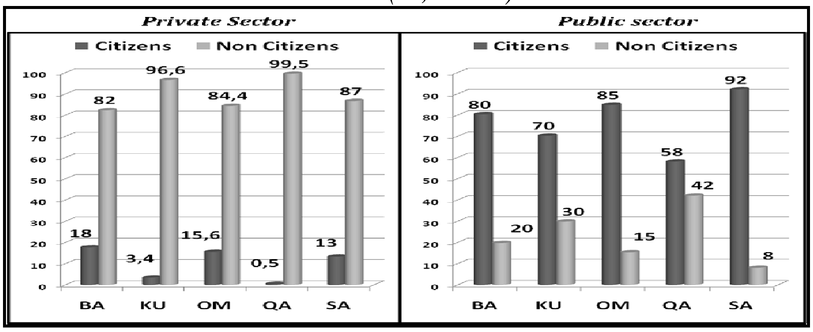
This requirement has led to the adoption of measures since the 1970's in order to ensure that foreigners could only stay on a temporary basis. To that end, they have been excluded from nationality rights, political and ownership rights, and welfare rights. Additionally, highly restrictive conditions have been imposed on family reunion; the duration of employment contracts has been rarely in excess of two years; and a recruitment mechanism has been introduced that relies on a sponsorship system (kafala), whereby any foreigner intending to work in a Gulf country should find a national of that country (kafil) who stands surety for him/her. In this way, the sponsorship system has increased the dependence of foreign workers on private nationals of the GCC countries, allowing the latter considerable influence on composition and amount of migration flows as well as allowing major flexibility in setting salaries and labour conditions - which often borders on exploitation and black market situations, as is the case with permits to stay.

While several constraints limit foreigners' decision-making power, a number of benefits have been granted to nationals - including the right to study and receive medical care; free transportation systems; precedence in public employment and certain private sector activities; high wages and generous retirement benefits; and almost non-existent taxation. Thanks to the bountiful welfare system and the granting of specific rights, these States are enabling their nationals to benefit from oil export revenues.

Thus, it can be argued that, on the whole, the high incidence of migrants on the overall population and labour force in the GCC countries has resulted in the unequal allocation of rights and duties, which has influenced the labour market and ultimately resulted in its segmentation.

One major gap that has opened is the one separating the public from the private sector. The first is where most foreign labour can be found. In all GCC countries the incidence of foreign labour on the total labour force is definitely higher than that of nationals, with rates in excess of 90% in Qatar (99.5%) and Kuwait (96.6%) (Fig.5).

Figura 5 - *Distribution of Labor Force by Nationality in Private Sector and Public Sector (%, 2008[1])*



Sources: Labour Market Regulatory Authority (LMRA), *Bahrain Labour Market, 2009*; Institute of Banking Studies of Kuwait (Kibs), *Economic and Financial Data base for 2009;* Statistics Authority of Qatar, *Labour Force Sample Survey, Results,* December 2008; Saudi Arabian Monetary Agency, *45th Annual Report*; UAE,Ministry of Economy, *UAE in Numbers 2007,* UAE Ministry of Economy, Central Department of Statistics, *Labour Force Survey,* 2008.
[1]Data of Oman refer to 2007.

This can be accounted for by considerations relating both to the demand and to the offer of labour. On the demand side, entrepreneurs prefer foreigners because the recruitment mechanisms can ensure lower wages, longer work hours and higher possibilities for dismissal. On the offer side, the higher competition rate in the private sector makes the latter less appealing to nationals as it impacts on wage levels and labour conditions. Furthermore, the employment positions made available by the private sector are regarded as either excessively menial or inadequate to the formation that nationals have developed, which are essentially humanistic.

The domestic workforce can be found mostly in the public sector, which it finds appealing because of the high wages, generous retirement benefits, favourable work conditions, and the social status that the public employment gives. In all GCC countries there is a high incidence of nationals in the public sector (Figure 5), the highest rates being those found in Saudi Arabia (92%), Oman (84.7%) and Bahrain (80.3%).

Thus, migration flows have created two segments in the labour market that are totally different, not only due to the nationalities involved, but also in terms of their respective flexibility; indeed, the private sector is highly flexible[6], while the public sector is completely non-flexible.

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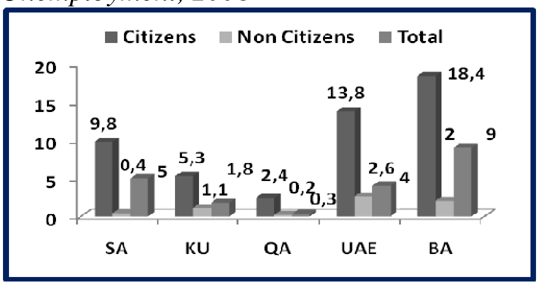
[6] The wage flexibility index as estimated by the World Economic Forum – ranging from 1 to 7 – shows very high values ranging from 5.4% in Saudi Arabia to 6.2% in Qatar;

The rigidity of the public segment in the labour market can account, furthermore, for the paradox whereby high unemployment rates can be found among nationals of several countries in this area (Figure 6) in spite of the high demand for foreign labour. The rigidity in question actually hampers the migration of national and foreign workers between the public and the private sector and thus leads the former towards the public sector, which has by now reached saturation and can no longer absorb adequately the labour force.

The cases of Saudi Arabia, UAE and Bahrain are especially significant in this connection: the unemployment rate is close to 10%, 14%, and 18%, respectively, as regards nationals, while the rates concerning foreigners are very low (0.4%, 2.6%, 2%, respectively) and foreign labour force makes up almost 80% of the total labour force in the private sector. The same applies to Oman, where unofficial sources estimate a total unemployment rate of about 15% (CIA, 2010).

Figura 6 - *Rate of Unemployment, 2008*[1]



Sources: SAMA, *45th Annual Report*; UAE Ministry of Economy, Central Department of Statistics, *Labour Force Survey,* 2008b; Qatar Statistics Authority, *Labour Force Sample Results,* 2008; Institute of Banking Studies of Kuwait, *Economic and Financial Database for Bankers*, 2009; Ministry of Labour and Bahrain Centre for Studies and Research, *Labour Force Survey*, November 2004.

[1] Data of Bahrain refer to 2004; data of UAE refer to 2005.

This problem is compounded if one considers the data relating to youth unemployment rate, which is on average in excess of 30% throughout the area. In fact, the occupational outlook of youths is a very serious issue for the GCC countries, given the high growth rate of national populations - estimated to be in excess of 2% in all countries. Among youths, those aged 0 to 24 years make up over 55% of the total in all countries, and their mainly humanities-oriented

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conversely, the rigidity of employment index – ranging from 1 to 100 – shows very low values ranging from 27% in Saudi Arabia to 13% in Kuwait (World Economic Forum, 2009).

curriculum in both high school and universities does not fit in with the occupational requirements arising from the needs of economic growth.

Faced with the urgent need to cope with this issue, national policies have followed a three-fold approach: a) on the one hand, the production structure has been diversified further to stimulate demand for labour in a way that can meet the requirements of a young, rapidly growing population, which the oil sector is unable to ensure on its own given its capital intensive nature; b) on the other hand, educational and training policies have been implemented to promote skills appropriate to the needs of the labor market; c) thirdly, the nationalization of the labour force has been fostered (Saudization, Omanization, Kuwaitization, etc.).

As for the latter, governments in the GCC countries have tried to increase the incidence of nationals on the workforce by way of various measures, including the ban on recruiting foreigners or the obligation to reserve labour quotas for nationals regarding certain activities; the granting of facilitations to businesses if they employ nationals, coupled with the imposition of taxes in case they recruit foreigners; the extension of the benefits featuring in the public sector to some private sector occupations so as to make them more appealing to nationals.

However, nationalization policies only have proved successful in the public sector. In the private sector market logic has continued to predominate. Indeed, the higher competitiveness of foreign labour in terms of wages, productivity, and work conditions have led companies to ignore the prohibition on recruitment and disregard the facilitations envisaged for the employment of nationals. On the other hand, the fast pace of growth of these economies and their high population growth rates have determined new needs and demands that the national component of the population is unable to meet because it lack the required skills and/or is not interested there in. Additionally, given the marked segmentation of the labour market, nationalization policies actually have increased social segmentation as well.

5. Social Segmentation

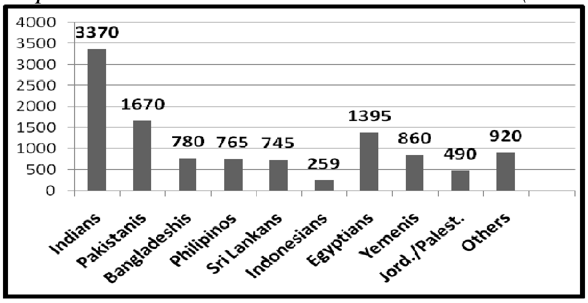
In the presence of a social system featuring the high incidence of foreigners on both the overall population and the labour force, nationalization policies have increased the unequal allocation of rights and duties and fuelled mutual tensions and grievances between nationals and foreigners. The former blame the latter for their unfair competition in the private sector, which makes difficult for them to get access to private employment and worsens the overall work conditions; the latter blame the former for the privileges they enjoy, which are regarded as completely inadequate in the light of their contribution to the fast growth experienced by the Gulf economies.

However, segmentation has affected not only foreigners vs. nationals, but it could also be found among the former - where different segments can be defined depending on nationality, work executed, education levels and skills, and the underlying cultural models. This has translated into a sort of social scale, ranging from Westerners to non-Gulf Arabians up to Asians, as well as in major differences in terms of wage levels and living conditions. In short, a major gap has arisen between Western workers, mainly Europeans and North Americans, and the Asian labour force.

The former are a small minority of the foreign population, practising highly-skilled professions and usually covering high-level positions in the GCC societies. The main reason why they are welcome to Gulf nationals consists in their having chosen to work in their countries on a purely voluntary basis, on account of the high living standards they can afford in those countries. Additionally, their choice is usually a temporary one, given that they ultimately expect to get back to the highly-developed countries they come from. Conversely, for all the other workers, and in particular for Asian workers, the decision to migrate is mostly mandated by the difficult living conditions existing in their countries, which often makes it impossible for them to get back home and obliges them to accept more burdensome and vexatious conditions. It is no mere chance that *contract labourers* are mostly to be found among Asian workers. Those labourers are usually recruited by brokerage agencies in the respective countries of origin. They are unskilled, illiterate workers and usually live in labour camps from which they are taken daily to the places they have to work - mostly construction sites and farms. Given their humble conditions and the recruitment mechanisms, they are especially prone to the risk of exploitation and abuse - including lower wages, forfeiture of their passports, deduction of visa-related costs from their wages, black market trafficking in visas, extended working hours, delayed payment of their wages, dangerous working conditions, and segregation in labour camps as they are prohibited from living in urban areas and/or going to urban areas at night.

Accordingly, the unequal distribution of wealth, rights and duties in a society featuring a large number of foreigners fuels a climate of conflict, not only among nationals, but also among expatriates. Thus, non-Gulf Arab workers believe they are discriminated against compared to Asian workers as regards recruitment, in spite of their language and cultural similarities with the nationals; Asian workers claim they get lower wages and are exposed to unhealthy living conditions; nationals in turn see the massive numbers of foreign workers as a threat for the social and political stability of their countries in terms of loss of cultural identity and captive foreign policy decisions. Against this backdrop, the greatest fears felt by GCC nationals over the past few years have resulted from the fast growth rate of Asians - in particular Indians and Bengalis, who make up the majority of foreigners as well as including most contract labourers (Fig. 7).

Figura 7 - *Main Expatriate Communities in GCC Countries (values in thousands)*[1]



Source: A. Kapiszewski, *Arab versus Asian Migrant Workers in the GCC Countries*, UN/POP/EGM/2006/02, 22 May 2006.
[1]Estimates for various years: Bahrain, Oman, Saudi Arabia, 2004; Kuwait, 2003; Qatar, UAE, 2002.

In a context of a highly unequal, segmented, increasingly conflictual society, the effects of the global economic imbalance were produced. Those effects were increased by the characteristics of the exchange rate regime of the Gulf countries.

6. Exchange Rate Regimes in the GCC Countries

For over thirty years the GCC countries have been formally or informally pegging their currencies to the dollar[7]. However, since 1 January 2003 the Gulf economies have officially adopted a dollar peg regime as a first step towards their full monetary integration.[8]

The reasons which led the GCC members to link their currencies to the dollar are basically two-fold:

1. firstly, one should consider the marked incidence of oil revenues on total exports and public revenues. Since international oil prices are in dollars, pegging

[7] Oman has officially pegged the riyal to the US currency since 1973; while Saudi Arabia, Bahrain, Qatar and the UAE, despite having *de jure* tied their currencies to the SDR until 2001, *de facto* have pegged the dollar at a fixed rate since the eighties. Even the Kuwaiti dinar, which was formally tied to a *basket peg* until 2002, has always shown a pronounced stability against the dollar.
[8] However, Kuwait withdrew from the agreement in may 2007 and re-instated the previous basket peg regime.

national currencies to the US currency can ensure the stability of export earnings and government revenues, reducing foreign exchange risk.

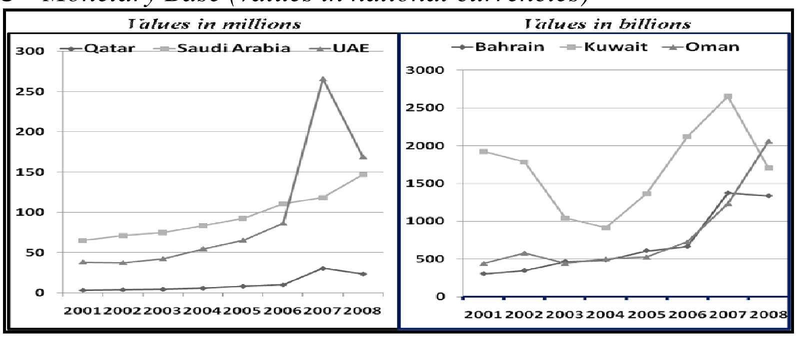
2. secondly, one should consider the delays that still characterize the financial, economic and institutional structures of the GCC countries. These suggest anchoring their currencies to that of a country with strong institutions and traditions of stability in order to import that stability along with the credibility and confidence in their respective economies.

Indeed, the dollar peg allowed the GCC members to keep price dynamics basically stable for over twenty years. Still, the worsening of the global economic imbalance that started in 2002, along with the widening of the gap between the growing deficit of the US balance of payments and the balance surplus of the Gulf countries, ultimately resulted in turning the dollar peg into a vehicle of instability from the anchor country to the GCC economies - via both a liquidity effect and a cost effect.

6.1. *Inflationary Effects Produced by the Dollar Peg: the Liquidity Effect.*

The dollar peg translated the standing surpluses of the balances of payments in the GCC countries - resulting from the increase in the world oil demand as well as in oil prices - into monetary base increases (Fig.8).

Figura 8 – *Monetary Base (values in national currencies)*

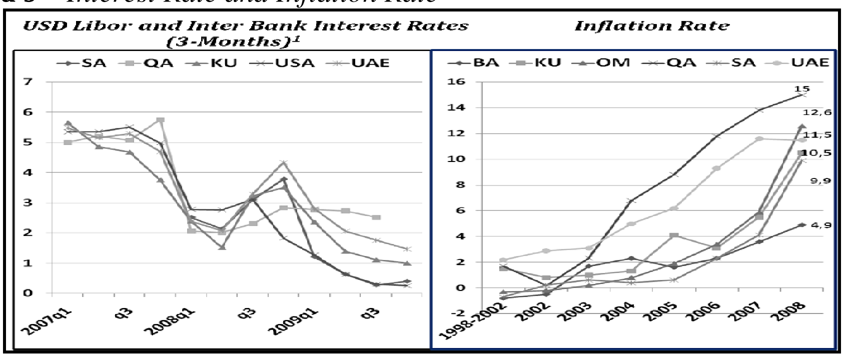


Source: IMF, *International Financial Statistics Yearbook,* 2009b

This led to the well-known dilemma of the so-called *impossible trinity* - i.e. the impossibility to simultaneously pursue the three objectives consisting of internal balance, external balance, and exchange stability in the presence of fixed exchange rates.

In the experience of the GCC countries, the objective renounced was the achievement of internal balance. Indeed, the need to defend the exchange rate and prevent capital inflows made it difficult to keep monetary circulation under control. This led to the alignment of the GCC member interest rates to the lower US rates, at a time when the rapidly growing economies of the area would have required more stringent monetary policies. This can be seen quite clearly from 2007 onwards, when the short-term interest rates of Gulf countries fell in parallel with those of the US, despite the pressure of inflation existing in their economies. The consequences were negative real interest rates, which encouraged borrowing and the expansion of monetary offer in its broadest sense (Figure 9). This fuelled inflation and gave rise to speculative bubbles in those areas where bottlenecks were especially rife - e.g. the real estate sector.

Figura 9 – *Interest Rate and Inflation Rate*



Sources: Qatar Central Bank; Saudi Arabian Monetary Agency; Kuwait Central Bank; UAE Central Bank; www.global-rates.com; *IMF, Regional Economic Outlook: Middle East and Central Asia.*

[1] UAE data refer to the central bank overnight interest rate.

The mean inflation rate as measured from the consumer price index rose in the GCC countries as a whole from 0.2% in 1998-2002 to 10.2% in 2008 - the peak values being recorded in Qatar (15%), Oman (12.6%), and UAE (11.5%). In Saudi Arabia, where inflation was always lower than 1%, consumer prices rose starting from 2006 so that the 2008 inflation rate was as high as 10% (Figure 9).

The peak increase concerned food and housing prices, which impact to a greater extent on the living standards of the poorest part of the population. More specifically, in the 2004 - 2008 period food prices rose by between 24% - 30% in the Gulf countries with peak increases of 29.7% and 30.1% in Qatar and the UAE, respectively. As to the latter, the increase was in excess of 46% in the Emirates

(UAE Ministry of Economy, 2008a) and peaked at 60% in Qatar (Qatar Central Bank, 2008).

Thus, it can be argued that - in the presence of diverging economic cycles in the GCC countries as opposed to the US - the dollar peg translated an inflation process initiated by the increase in the international oil demand as well as in oil prices into the expansion of the monetary base, which ultimately fuelled inflation.[9]

The inflationary effect was actually also due to a cost effect that was fostered by the dollar peg and amplified by the features of the local labour market.

6.2. *Inflationary Effects Produced by the Dollar Peg: the Pass-Through Effect*

The dollar peg converted the depreciation of the US currency, which featured in the 2002 - 2008 period, compared to the currencies of the main GCC countries' trade partners in increased costs, due to the pass-through mechanism. Indeed, it also entailed the depreciation of the GCC currencies compared to the euro, yen, and the UK pound, raising the prices in national currency for imported goods. In this connection, special importance should be attached to the depreciation of the US dollar compared to the euro, since Europe is the main import area for the GCC members.[10]

This effect plays a major role in the Gulf countries, as their economies are: small-sized; open to international trade; highly focused on oil production; with a segmented labour market and a considerable incidence of foreign workers; with limited agricultural production and manufacturing, for which they have to turn abroad to import a large share of their consumer goods, raw materials, intermediate inputs and capital goods.

Special importance should be attached in this context to the fact that these countries are highly dependent on imports of farming produce and food. The latter are a significant portion of their total imports - with peak values recorded in 2008 in Kuwait (16%), Saudi Arabia (13.2%), Oman (10.9%) and Emirates (9.2%) (WTO, 2009b). Indeed, the dry climate, the scarcity of arable land, and the high

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[9] From an econometric standpoint, this conclusion is supported by a study performed by Saidi, Scacciavillani, Prasad and Ali to identify the factors that influence inflation pressure in GCC countries (2009). Based on VAR models of different complexity, they showed that the monetary base changes were the key determinants of the inflationary spiral.

[10] The pass-through effect was recently estimated to range between 25% and 35% (Al-Qudsi, Kaloti, Numan, Obeid, Marar, 2008). Accordingly, if a 10% depreciation rate of the US dollar translates into a 3% increase of the inflation rate, the depreciation cumulated by the US dollar vis-à-vis the Euro in the 2002 to 2008 period – amounting approximately to 30% - may have resulted into increasing the inflationary pressure by about 15%.

population growth rates make the internal supply insufficient to meet domestic needs and require these countries to import considerable amounts of food - whose prices markedly impact on the living conditions of working classes and, above all, migrant workers. Against this backdrop, it can be easily understood that - given the dollar peg - any increase in import prices resulting from the depreciation of the dollar can jeopardize the working classes' living standards and fuel demands for wage rises along with social tensions.

In fact, the particular structure of the labour market interacted with the specific features of the exchange rate regime giving rise to a mixed inflationary spiral, in which the pressures on the cost side overlapped with the tensions on the demand side.

7. The Influence of Labour Market Features on Inflationary Dynamics

In the context of a highly segmented and conflictual labour market, where migrants predominate and the allocation of rights and duties is imbalanced, the effects of inflation, initiated by the oil price increase and amplified by the dollar peg in the presence of the global economic imbalance, should be assessed.

The price increases, especially those of food and housing, translated into a reduction of real income for a large section of the population - with particular regard to the poorer migrants - and resulted in wage increase claims among growing tensions.

The highest wage increases were granted in the public sector. From 2005 to 2007, public salaries were repeatedly increased in all GCC members - the peak growth being the one found in the Emirates (125%) (Gulf Talent, 2008). This contributed to enlarging the inequalities existing in a labour market which was already markedly segmented, as it made the public sector employment more appealing and more difficult for the private sector to employ national workers. Accordingly, the private sector's dependency upon foreign manpower increased further at a time of strong wage demands, due to the need to defend the purchasing power of wages. This resulted ultimately in a steady increase in basic salaries: the highest increases were granted by the construction and banking sectors. More specifically, in the 2005 - 2009 period wages rose in the GCC countries as a whole by about 41% - the peak values being recorded in UAE (46.6%) (Gulf Talent, 2009b).

Wage increases were also favored by the effects produced by the dollar peg on the value of migrants' remittances. The dollar depreciation throughout the 2002 to 2008 period could be observed not only with regard to the main currencies, but also in respect of some of the countries from which the main migration flows originate.

In particular, from December 2003 to December 2007 the dollar depreciated by 17% and 33.5% compared to Indian rupee and the Filipino pesos, respectively. Due to the dollar peg, the Gulf currencies also showed the same level of depreciation, which resulted in reducing the value of remittances as calculated in the currencies of the countries of origin of migrants.

This data should not be overlooked, considering the high incidence of migrants on the total population and labour force in the GCC countries. The temporary work contracts and the many obstacles hampering family reunions are leading migrants to send a considerable part of their wages back home[11] and assess their savings in the currencies of their countries (Razgallah, 2007; Nauful, Termos, 2009). In this context, the dollar depreciation contributed to fuelling the claims for wage increases.

The greatest claims came from Indian workers, who are the majority of foreign workers and, in particular, of contract workers. Being increasingly aware of their numbers as well as of the changed conditions in the labour market of their home country - where growth was accompanied by major wage increases - and faced with the exploitation and vexatious recruitment mechanisms they are subjected to, they have staged major strikes and demonstrations that have led their wages to increase in recent years at a faster pace than those of workers from other countries (Gulf Talent, 2008).

In conclusion, the peculiar structure of the labour market in the GCC countries interacted with the exchange rate regime, giving rise to a mixed inflation in which the pressure on the cost side overlapped with those on the demand side.

8. Conclusions: the Need for the GCC Countries to Amend their Exchange Rate Regimes

The GCC countries are characterized by a small indigenous population; the need to import labor from abroad to meet the demand coming from the oil sector and the diversification processes of the production structure; a high proportion of immigrants in the population and in the labor force; a wide-ranging inequalities in social and economic terms. Given these features, it is fundamental for them to reconcile growth with social stability. The latter requires a more equitable allocation of rights and duties along with not only more effective actions in terms

[11] Saudi Arabia's ranks second worldwide in terms of remittances sent abroad, while the remaining countries of the GCC are among the first thirty ones on this list. Still, in terms of percent incidence of remittances on the GDP, these countries rank much higher on the list – Bahrain ranks fourth and Kuwait is the twelfth (World Bank, 2008).

of human rights, but also more stable economic dynamics such as preventing the redistribution effects of inflation from increasing inequalities in income allocation.

The anti-inflationary objective is a priority for the Gulf countries, which entails not only countering the effects, but also removing the causes of inflation.

The experience of the new millennium has shown that the dollar peg was a major vehicle of inflation for the GCC members and suggests that it should be amended. An alternative might consist of a basket peg system, whereby national currencies could be anchored to a basket of strong currencies that mirror direction and intensity of commercial and financial flows on the international market.[12]

Given this context, it would be appropriate to include the euro in the said basket. Indeed, including the euro can reduce the risks related to possible exchange losses, pass-through effect and unwanted liquidity changes due to the exclusive anchorage to the US dollar.

(Exchange Risks) - In small economies such as those of the Gulf countries, which are open to international exchanges, trade relations play a key role and make it especially advisable to rely on an exchange rate regime that can reduce transactional costs as related to currency conversion and the exchange risk. This requires considering direction and composition of trade flows.

As for the GCC countries, oil exports is the main item of their sales abroad, with an incidence over total sales ranging from about 40% in the Arab Emirates to over 83% in Kuwait. Such sales are targeted mainly at Asian countries; conversely, Europe is the main partner of the Gulf countries in terms of their imports, which consist basically in food and manufactured products.

Taking account of this framework, special importance should be attached to the features of the exchange rate regime. The currency revenues related to exports are essentially in dollars, both because oil is quoted in US dollars and because the latter are widely used as transaction currency in Asian countries. Conversely, their imports are paid mostly in euro, given the current practices whereby European countries quote their exports in the respective national currencies. Accordingly, the euro/dollar exchange rate plays a key role in the GCC region and in the past decade it has caused significant currency losses because of the trend towards depreciation of the US currency compared to the euro. This would appear to suggest that greater consideration should be given to the euro in the GCC countries' exchange rate system.

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[12] A more in-depth overview of the benefits resulting from a basket peg to the GCC countries can be found in the following: Nuri Erbas, Guerami (2003); Aleisa, Hammoudeh, Yuan (2008); Habib, Stràsky (2008); Khan (2008); O. Marzovilla (2010); O. Marzovilla, M. Mele (2010). Some studies attempted to determine the appropriate composition of this basket: see Aleisa, Hammoudeh, Yuan (2008); Jen and Bindelli (2008); Saidi, Scacciavillani, Prasad, and Ali (2008).

(The Pass-through Effect) - The importance of imports to the Gulf area from Europe increases the risks related to the pass-through effect. Europe is actually the source of 33.4% of the imports for Qatar; 31.9% of the imports for Saudi Arabia; 28.5% for Kuwait; 22% for the Arab Emirates; and 17.1% for Oman (WTO, 2009b)[13]. Given this framework, the dollar depreciation compared to the euro - as was the case in the 2002-2008 period - entails the depreciation of the Gulf currencies as well and might translate into a major increase in the price of the goods imported from the EU as calculated in national currencies, such as resulting in significant inflationary pressure on the costs side. The latter pressure might be reduced by introducing a basket peg, in which the weight allocated to the euro should mirror its use in trade transactions of the GCC members.

(The Liquidity Effect) - Including the euro in the basket might also reduce the unwanted liquidity changes due to the dollar peg.

The unquestionable predominance of import flows of the Gulf countries from the EU compared to export flows can account for the trade surplus that the European area taken as a whole generally shows respect to the GCC region - unlike the deficits shown by the other major trade partners of the Middle Eastern countries (WTO, 2009a).

This is an important item in order to devise an exchange rate system that can appropriately meet the requirements coming from the GCC members. Indeed, creating links to the currency of an area that - given the structure of its trade relations with the Gulf countries - mostly shows trade surpluses can allow such countries to partly recover their monetary sovereignty by limiting the expansion effects on the monetary base that result from their being anchored to the currency of a country that shows systematic trade deficits respect to them.

(Stabilization of Remittances) - The dollar depreciation that has featured throughout the last decade along with the oscillations observed in the latest part of the decade - including revaluation in 2008, depreciation in early 2009, revaluation in April-May 2010 - has produced destabilizing effects on the value of the remittances from foreign workers, which are the majority of the overall labour force. These continuous oscillations have given rise to uncertainty among expatriates, influencing their families' living conditions and fuelling tensions in the labour market. The basket peg may reduce those uncertainties by enabling greater stability of nominal effective exchange rates.

One may therefore conclude that the advantage of a basket peg including the euro would consist of preserving the benefits in terms of credibility and stability of

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[13] The percent rates related to the US are rather smaller: 13% SA, 11.3% KU, 9% QA, 7% UAE, 5.7% OM.

expectations that arise from the anchorage to currencies with a strong and established reputation. At the same time, it would contribute to stabilizing nominal effective exchange rates along with the value of remittances in the currencies of the migrants' countries, while reducing the risks due to the pass-through effect and restoring some measure of flexibility in monetary policies - which would partly reduce the constraints imposed by their dependency on the US monetary policy.

Although the dollar has appreciated in recent times and uncertainties have focused on the euro, the experience of the past decade shows that the weakness of the US currency - which has prevailed over most of the past decade - may no longer be construed as an episodic event. In fact, it mirrors a world that is no longer as asymmetrical as the one that emerged from World War II. Indeed, the USA are still the world's most powerful economy; however, their leadership is no longer absolute and unquestioned, as it has to come to terms with a new reality that has been developing during this new millennium. It is a reality where globalization is advancing and speculation is on the rise, while the global economic imbalance is worsening and new major players are emerging on the international scene, including several developing countries and a large unified monetary and economic area, i.e. the European Monetary Union.

Given this context, one may not rule out a new trend of depreciation of the dollar in the coming years and, in presence of dollar peg, a new inflationary spiral in the economies of the GCC. The major costs due to inflation in the Gulf countries - given their economic, demographic, and social structures - would point to the advisability of amending their exchange rate regimes by relying on a basket peg.

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