Impact of global economic imbalance on migrant workers and economies of the Gulf Cooperation Council

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

Abstract

GCC Countries are characterized by a high incidence of foreigners on both the overall population and the labour force as well as by deep inequalities in social and economic term. 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 a more equitable allocation of rights and duties along with not only more effective actions in terms of human rights, but also more stable economic dynamics, that prevents the redistributive effects of inflation. The anti-inflationary objective is a priority for Gulf Countries, which entails not only countering the effects, but also removing the causes of inflation.

The experience of the new millennium showed that the dollar peg, which characterizes the exchange rate regime of the GCC Countries, was a major vehicle of inflation for Gulf economies and suggests the advisability for its amendment. The alternative proposed in this article is to adopt 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.

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1. Introduction

In May 1981, Saudi Arabia, Bahrain, 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 step consists in 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 accounted for on two main grounds:

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 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 billions of US dollars in 2008 – which amount rises to about 1.1 trillions 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, whilst null or negative rates featured in the rest of the world following the explosion of the international economic and financial crisis (IMF, 2010).

In fact, the Gulf Countries would appear to have been affected only indirectly and anyhow 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 peculiarities 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

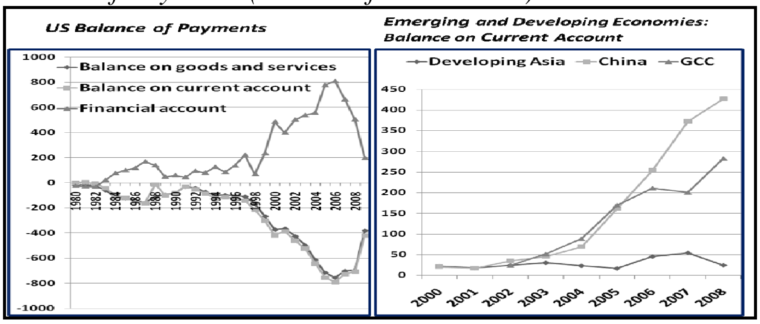
The global economic imbalance was the subject of a lively debate in economic literature, including contributions from, amongst others, Mc Kinnon (2005, 2006, 2007), Bernanke (2005), Dooley, Folkerts-Landau and Garber (2003, 2004), Bhide, Phelps (2005), and Cooper (2005). Although there is no consensus 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 was accompanied by the growing surplus of various emerging economies.

Since 1983, the U.S. balance of payments is 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 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).

On different grounds, these countries showed major surpluses in the balance on goods and services. Whilst 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.

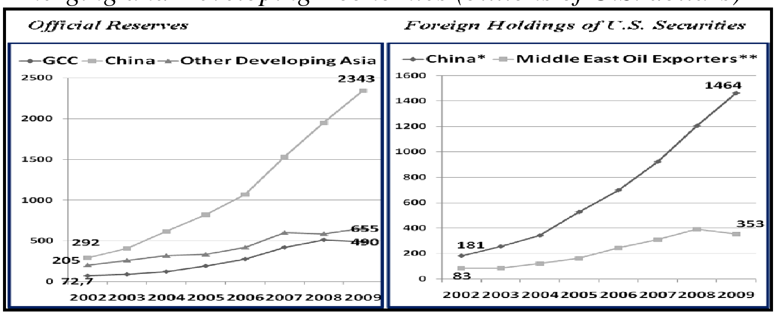
Figura 1- *Balance of Payments (billions of U.S. dollars)*



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

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

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

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

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

This is an abnormal development pointing to deep-ranging imbalances in the international economic system. Indeed, the efficiency logic would predicate 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 as yet to complete their growth process, fast-paced as the latter may be, in order to finance its own high consumption rates.

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

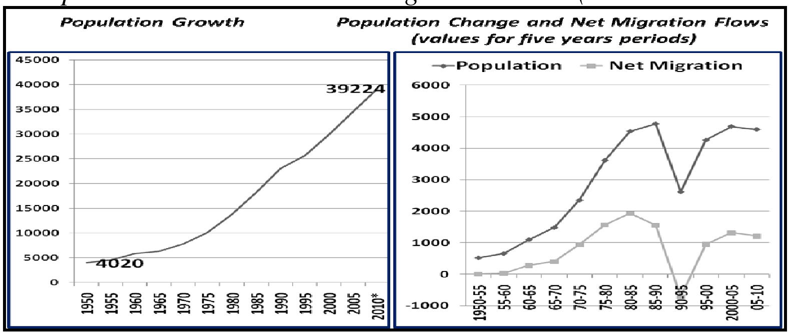
1. population dynamics;
2. labour market structure;
3. exchange rate regimes.

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 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 rate population growth, but also by the significant net migration flows.

[3] In fact, these data underestimate the actual financial holdings of GCC Countries. Whilst 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 allows disguising 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 assets to be referred to the UK, Luxembourg, Switzerland, and the Cayman Islands.

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 Gulf area being highly dependent on hydrocarbons production and exports, this played a key role in its population dynamics as well as in the labour market structure. Indeed, the scanty population of GCC countries, the lack of specialised labour, the high inactivity rate and the widespread illiteracy resulted into the imbalance between the offer of domestic labour and the increasing requirements of the demand related to the oil sector development. This gap could be bridged by importing foreign workers ever 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 flows became a peculiar feature of the GCC area so much so that this area became one of the leading destination regions for migration flows. In the 1950 to 2010 period, net migration flows of foreign workers in the individual five-year spans have ever been 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 ever 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 tension 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 growth demand of the oil sector and were accepted easily in the various destination countries because of their language, cultural and religious similarities that seemed capable to ensure respect for the individual national identities. These flows grew consistently throughout this period and peaked in the 1970-1975 years - 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 millions of foreign workers entered the Gulf countries in the 1975 to 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. In fact, major changes started to surface in these years and were bound to achieve increased importance in the 1990's as well as in the third sub-period. These changes have to do with the diversification of the manpower employment areas, 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 deficit, raised awareness of how transitional the positive effects produced by the increased oil revenues were and led GCC countries to implement policies that were targeted at diversifying production activities so as to reduce their economic growth dependency on the ebb and flow of oil prices. These policies also resulted ultimately into 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. In fact, the remarkable growth in the incidence of foreign workers of Arabian origin led to some concerns both in political and in social and economic terms. As for the former, there were concerns for the possible spread of extremist and/or 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 (A. Kapiszewski, 2006). As for the latter, the concerns were mostly focused on the expectations of Arab migrants to remain indefinitely in Gulf Countries, where they usually also took their families. Conversely, the 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 as many Asian workers from India, Pakistan, Philippines, Indonesia, Bangladesh, and Sri Lanka.[5] 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 come up during the second sub-period. The diversification of economic structures became the leading feature of this period along with the standing 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 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 to invest mainly into areas where they could be performed 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 insufficient 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 millions in the last decade (Fig. 3).

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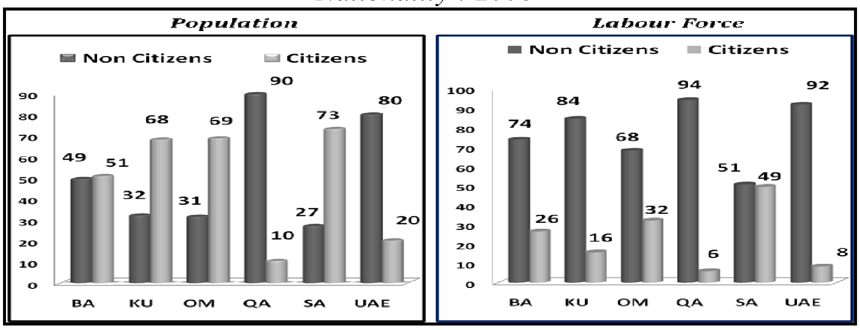
[4] One of the reasons most frequently referred to in order to account for the fast-growing Asian immigration has to do exactly with the initiatives undertaken by the governments in the countries of origin, which have fostered migration in order to reduce unemployment within national borders. To that 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).

[5] In Saudi Arabia there was also a net inflow of over 210,000 Egyptian workers from Iraq, following Egypt's support to Kuwait (A. Kouaouci, 2006).

Although it is impossible to gauge the real dimension of this phenomenon,[6] over 10 millions of migrant workers are estimated to have entered the GCC region 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,

[6] 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 stay permit, many foreign workers enter the individual countries regularly, and then 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).

respectively - whilst the foreign labour force rates are higher, being in excess of 80% in Kuwait (84.4%), the UAE (92%) and Qatar (94%).

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 resulted into several problems for Gulf economies - first and foremost the need to ensure citizens' rights by preserving their cultural identity.

This requirement led to adopting measures ever since the 1970's in order to ensure that foreigners could only stay on a temporary basis. To that end, they were excluded from nationality rights, political and ownership rights, and welfare rights. Additionally, highly restrictive conditions were imposed on family reunion; the duration of employment contracts was rarely in excess of two years; and a recruitment mechanism was 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.[7] In this manner, the sponsorship system ended up ultimately by affording private nationals from GCC Countries 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 stay permits.

Whilst several constraints limit foreigners' decision-making power, a number of benefits were granted to nationals - including the right to study and medical care; free transportation systems; precedence in public employment and certain private sector activities; high wages and generous retirement benefits; and as good as 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 exports revenues.

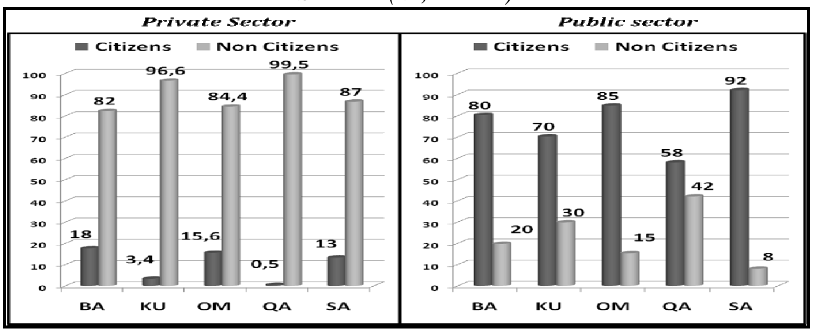
Thus, it can be argued on the whole that the high incidence of migrants on the overall population and labour force in GCC countries has resulted into the unequal allocation of rights and duties, which has influenced the labour market and ultimately resulted into its segmentation.

One major gap that has opened is the one separating the public from the private sector. The former is where most foreign labour can be found. In all GCC

[7] Once the employment is terminated, migrants have to leave the country immediately; by the same token, any worker wishing to change his/her sponsor must leave the country and then return with another kafil.

countries the incidence of foreign labour force 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 periods and higher opportunities for dismissal. On the offer side, the higher competition rate featuring 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 extra-demanding vis-à-vis the skills nationals have developed, which are essentially humanistic.

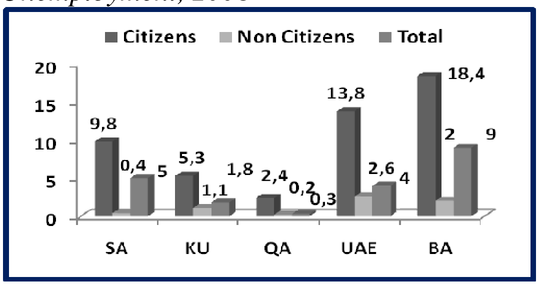
The domestic workforce can be found mostly in the public sector, which it finds appealing because of the high wages, bountiful retirement benefits, favourable work conditions, and the social status that gives the public employment. In all GCC Countries there is a high incidence of nationals in the public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

Thus, migration flows have resulted ultimately into creating two segments in the labour market that are totally different not only on account of the nationalities involved, but also in terms of their respective flexibility; indeed, the private sector is highly flexible[8], whilst the public sector is utterly non-flexible.

The rigidity of the public segment in the labour market can account, inter alia, for the paradox whereby high unemployment rates can be found among the nationals of several countries in this area (Figure 6) in spite of the high demand for foreign labour force. 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 take up labour force to an adequate extent.

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, whilst the rates concerning foreigners are as good as null or 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 non-official 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 GCC countries,

[8] 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; 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).

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 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 need for urgently coping 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 labour demand in a way that could 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 enhanced to promote that skills could be developed such as to meet labour market requirements; c) thirdly, the nationalization of the labour force has been fostered (Saudization, Omanization, Kuwaitization, etc.).

As for the latter, the governments in GCC countries have tried to increase the incidence of nationals on the workforce force by way of various measures, including the ban on recruiting foreigners or the obligation to reserve labour quotas for nationals in respect of certain activities; the granting of facilitations to businesses in case they employed nationals coupled with the imposition of taxes in case they recruited 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 proved only successful in the public sector. In the private sector market logic continued to predominate. Indeed, the higher competitiveness of foreign labour in terms of wages, productivity, and work conditions led companies to dodge the prohibition on recruitment and disregard the facilitations envisaged for the employment of nationals. On the other hand, the fast growth pace of these economies and their high population growth rates brought up new needs and demands that the national component of the population was unable to meet because they lacked the required skills and/or were not interested there in. Additionally, given the marked segmentation of the labour market, nationalization policies actually 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 enhanced 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 it difficult for them to get access to private employment and worsens the overall work conditions; the latter blame the former for the privileges they have been afforded, which are regarded as utterly inadequate in the light of their actual contribution to the fast growth experienced by the economies of their countries.

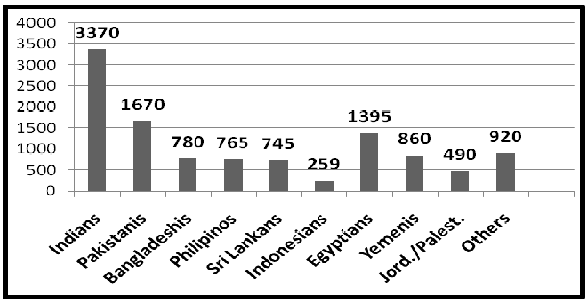
However, segmentation does not only affect foreigners vs. nationals, as it can also be found among the former - where different segments can be outlined depending on nationality, activities performed, education levels and skills, and the underlying cultural models. This has translated into a sort of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

The former make up 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 life 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 life conditions existing in their countries, which often makes it impossible for them to get back home and obliges them to accept more burdensome, at times 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 fields whence they are taken daily to the places where they have to work - mostly building yards and farms (J. Bristol Rhis, 2010). 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 occupational conditions, and segregation in labour fields 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 enhances 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 life 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 laborers (Fig. 7).

Figura 7 - *Main Expatriate Communities in the 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.

The effects of the global economic imbalance were produced in the context of a highly unequal, segmented, increasingly conflictual society. Those effects were enhanced by the exchange rate regime that features in Gulf Countries.

6. Exchange Rate Regimes in GCC Countries

For over thirty years GCC Countries have been formally or informally pegging their currencies to the dollar[9]. However, since 1 January 2003 the Gulf economies

[9] 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* 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.

have officially adopted a dollar peg regime as a first step towards their full monetary integration.[10]

The reasons which led 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 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 GCC countries. These suggest to anchor 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.

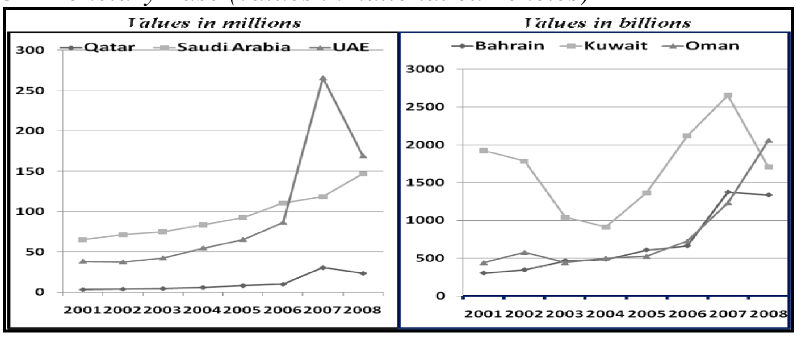
In fact, the dollar peg allowed GCC countries to keep basically stable price dynamics for over twenty years. Still, the worsening of the global economic imbalance that started in 2002 along with the widening of the gap between the growing deficit of the US balance of payments - *which entailed the depreciation of the US dollar* - and the balance surplus of Gulf Countries - *which would appear to suggest the advisability of revaluating their currencies* - resulted ultimately into 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. *The Inflation Effects Produced by the Dollar Peg: Liquidity Effect.*

The dollar peg translated the standing surpluses of the balances of payments in GCC Countries - resulting from the increase in the world oil demand as well as in oil prices - into monetary base increases (Fig.8). Accordingly, this brought up the well-known dilemma of the so-called *impossible trinity* - i.e. the impossibility to simultaneously pursue the three objectives consisting in internal balance, external balance, and exchange stability in the presence of fixed exchange rates.

[10] However, Kuwait withdrew from the agreement in may 2007 and re-instated the previous basket peg regime.

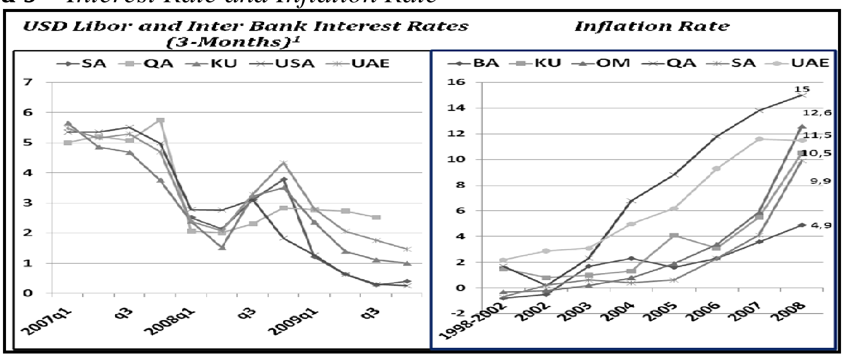
Figura 8 – *Monetary Base (values in national currencies)*



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

In the GCC countries' experience, the objective to be forfeited 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 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 the US ones, despite the inflation pressure existing in their economies. The consequences were negative real interest rates, which fostered borrowing and the expansion of monetary offer in its broadest sense (Figure 9). This fuelled inflation and gave rise to speculation 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 consumption price index rose in 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%, consumption 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 life standards of the poorest part of the population. More specifically, in the 2004 to 2008 period food prices rose by between 24% and 30% in 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 to 60% in Qatar (Qatar Central Bank, 2008).

Thus, it can be argued that - in the presence of diverging economic cycles in 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.[11]

The inflation 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. *The Inflation Effects Produced by the Dollar Peg: The Pass-Through Effect*

The dollar peg translated the depreciation of the US money, that featured in the 2002 to 2008 period, compared to the currencies of the main GCC countries' trade partners into 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 GCC Countries.[12]

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[11] 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.

[12] 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%.

This effect plays a major role in 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, whereby 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 the imports of farming produce and food. The latter make up 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, 2009). Indeed, the dry climate, the scarcity of arable land, and the high 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 life standards 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 following the depreciation of the US dollar can jeopardize the working classes' life standards and fuel demands for wage rises along with social tensions.

In fact, the peculiar structure of the labour market interacted with the specific features of the exchange rate regime by giving rise to a mixed-type inflationary spiral, whereby the pressure on the costs side overlapped with the tension on the demand side.

7. The Influence of Labour Market Features on Inflation 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 inflation effects, 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, in particular as for 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 into wage increase claims among growing tensions.

The highest increases were granted in the public sector. From 2005 to 2007, public salaries were repeatedly increased in all GCC Countries - the peak growth being the one found in the Emirates (125%) (Gulf Talent, 2008). This contributed to enhancing the inequalities that existed in a labour market that was already markedly segmented, as it made employment by the public sector more appealing and made it 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 into the yearly stepwise increase of basic salaries, whereby the highest increases were granted in the building and banking sectors. More specifically, in the 2005 to 2009 period wages rose in GCC Countries as a whole by about 41% - the peak values being recorded in UAE (46.6%) (Gulf Talent, 2009 b).

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

This data should not be overlooked, considering the high incidence of migrants on the total population and labour force in GCC Countries. The temporary work contracts and the many obstacles hampering family reunions are leading migrants to send a considerable portion of their wages back home[13] and assess possible savings in the currencies of the respective countries of origin (Razgallah, 2007; Nauful, Termos, 2009). In this context, the the dollar depreciation contributed to fuelling the claims for wage increases.

The greatest claims came from Indian workers, who make up 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 led their wages to increase over the past four 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 GCC countries has interacted with the exchange rate regime by giving rise to a mixed-type inflationary spiral where the pressure on the costs side overlapped with the tension on the

[13] The considerable number of foreign workers results into Saudi Arabia's ranking second worldwide in terms of remittances sent abroad, whilst the remaining countries 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).

demand side - which actually did not serve to defuse the growing tensions that increasingly result into protest actions by foreign workers.

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

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 incidence of immigrants on the population and on the labor force; a deep-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 of human rights, but also more stable economic dynamics such as to prevent the inflation redistribution effects from enhancing inequalities in income allocation.

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

The experience of the new millennium showed that the dollar peg was a major vehicle of inflation for Gulf Countries, which would suggest the advisability for its amendment.

An alternative might consist in 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.[14]

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, the 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 money flows.

[14] A more in-depth overview of the benefits resulting from a basket peg to 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).

As for GCC countries, oil exports is the main voice 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 to Asian countries; conversely, Europe is the main partner of Gulf countries in terms of their imports, which consist basically in food and manufactured products.

Taking account of this framework, the features of the exchange rate regime should be attached special importance. The currency revenues related to exports are actually mostly 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 GCC region and in the past decade it 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.

(Pass-through Effect) - The impact produced on Gulf Countries by the imports from Europe cannot but enhance 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 Qatar[15] Given this framework, the dollar depreciation compared to the euro - as was the case in the 2002-2008 period - entails the depreciation of 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 to result into 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 by GCC members in commercial and financial transactions.

(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 from the EU compared to export flows can account for the trade surplus that is generally shown by the European area taken as a whole vis-à-vis GCC Countries - unlike the deficits shown by the other major trade partners of 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 GCC members. Indeed, creating

[15] The percent rates related to the US are rather smaller: 13% SA, 11.3% KU, 9% QA, 7% UAE, 5.7% OM (WTO, October 2009).

links to the currency of an area that - given the structure of its trade relations with 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 is structurally bound to show trade deficits vis-à-vis 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 - produced destabilizing effects on the value of the remittances from foreign workers, which make up the majority of the overall labour force. These continuous oscillations gave rise to uncertainty among expatriates, influencing their families' living conditions and fuelling tensions on 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 in preserving the the benefits in terms of credibility and stability of expectations that arise from the anchorage to currencies with a currencies with a strong and established reputation. At the same time, this would contribute to stabilizing nominal effective exchange rates along with the value of remittances in the currencies of the migrants' countries of origin, whilst reducing the risks due to the pass-through effect and restoring some measure of flexibility in monetary policies - which would partly get rid of the constraints imposed by their dependency on the US monetary policy.

Although the dollar has appreciated in recent times and speculation has been targeted mostly to 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, whilst the global economic imbalance is worsening and new major stakeholders are looming on the international horizon in this emerging world - including a large unified monetary and economic area, i.e. the European Monetary Union.

Given this context, one may not rule out the continued depreciation of the US dollar in the coming years, such as to give rise to a new inflationary spiral in GCC economies pending the dollar peg. The major costs due to inflation in 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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