

Infrequently Asked Questions on the Monetary Union of the Countries of the Gulf Co-Operation Council

Jerry Mushin

Victoria University of Wellington
New Zealand

Abstract: This article places the monetary union of the countries of the GCC, which is to be established in 2010, in the context of their recent monetary history and in the context of other monetary unions. It shows that the decision to join (or withdraw from, or re-join) a monetary union is both an economic and a political matter. The principal conclusion is that this new currency arrangement in the GCC countries, although of great importance, is not as dramatic a change as it might appear and, especially, that it is significantly different from the euro zone.

Keywords: monetary unions, fixed exchange rates, Gulf Co-operation Council

The six members of the Gulf Co-operation Council [GCC] have decided to introduce a common currency, pegged to the United States dollar, in 2010. The probable advantages and disadvantages of this new arrangement have been discussed by Abed, Erbas, and Guerami (2003), by Abdul-Qader and Shotar (2006), by Creane, Goyal, Mobarak, and Sab (2004), by Fasano and Iqbal (2003), by Fasano and Schaechter (2003), by Jbili and Kramarenko (2003), by Sturm,

Strasky, Adolf, and Peschel (2008). It is generally accepted that, in appropriate economic conditions, a monetary union can increase efficiency by decreasing transactions costs and decreasing risk. Integration of goods markets and of financial markets is likely to lead to economies of scale. There might also be a decreased risk premium on financial assets. The principal disadvantage is the loss of monetary sovereignty. A member of a monetary union can operate neither an independent monetary policy

nor an independent exchange-rate policy. Its macroeconomic policy must use fiscal instruments and other means. There are also costs that are incurred, by governments and in the private sector, when a monetary union is established.

It is also generally accepted that the economies of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirates are sufficiently similar that it is probable that a monetary union would be of substantial benefit to all of its members. The purpose of this article is not to repeat this analysis but to provide the answers to nine important questions that are not frequently asked but that are relevant to the understanding of this issue. The first four questions deal with the nature and recent experience of monetary unions. The remaining five questions place the imminent monetary union of the countries of the GCC in the context of their recent monetary history.

1. How Does A Monetary Union Compare With Other Exchange-Rate Systems?

A monetary union can be regarded as an extreme type of fixed exchange-rate system. Like countries who join a monetary union, a country that adopts a fixed exchange rate surrenders, in exchange for lower transactions costs and lower risks for businesses, its right to choose its own monetary policy. Of course, fixed exchange rate systems are not all the same. Some are more fixed than others. A monetary union, however, does not allow the currencies of any of its members to be devalued or revalued

separately from the currencies of the remaining members. The loss of monetary independence is a necessary consequence of joining a monetary union. Mushin (2002(a), 2002(b), 2009(b)) has compared the macroeconomic effects of fixed and floating exchange rates. Cohen (2008) has explained the nature and recent experience of monetary unions.

Using data published by the International Monetary Fund [IMF], Mushin (2004, 2008(b)) has described the recent distribution of exchange-rate systems. Most major countries now have floating exchange rates. The members of the GCC are among the significant countries that have fixed exchange rates.

2. Do Other Monetary Unions Exist?

Because of its recent formation, its importance in international trade, and the large number and diversity of its members, the monetary union that is most widely known is probably the euro zone. At its inception in 1999, the euro was adopted by eleven countries. The euro zone now consists of sixteen countries¹. The development of the euro zone, and of earlier attempts at monetary integration in western Europe since the early 1970s, have been analyzed by Mushin (2009(a)).

Other examples of monetary unions are the Eastern Caribbean Currency Union, which has eight members², the *Communauté Financière Africaine* [CFA], which has fourteen members³, and the *Comptoirs Français du Pacifique*, which has three members⁴.

Political unions usually lead to

monetary unions. Recent examples of such political unions, which both occurred in 1990, are the expansion of the German Federal Republic to incorporate the former German Democratic Republic and the merger of the former People's Democratic Republic of Yemen (Aden) and the former Yemen Arab Republic (Sana'a) to form the Republic of Yemen. However, a political union does not necessarily lead to a monetary union. For example, Egypt and Syria did not introduce a common currency when they merged in 1958 to form the United Arab Republic. This political union ended in 1961, but the absence of a monetary union was not the reason for this.

Dollarization, in which a country uses another country's currency, is another type of monetary union. For example, the United States currency is the sole legal tender in seven other countries⁵. Dollarization can involve a currency other than the US dollar⁶. The unofficial use of currencies, especially the US dollar, outside their countries of issue, which occurs in many countries, is not the same as dollarization and is not within the scope of this article.

3. Does The Establishment Of A Monetary Union Necessarily Involve The Creation Of A New Currency?

The establishment, in 1999, of the euro zone involved the creation of the euro, a new currency that did not previously exist. However, not all newly established monetary unions use a newly created currency. A monetary union might decide to use the existing currency of one of its members or it might decide to use the existing

currency of an external country.

The currency of the euro zone was introduced in 1999. The other monetary unions use currencies with longer histories.

4. Have Other Countries The Same Reasons For Forming Monetary Unions As The GCC Countries?

Choosing a fixed exchange rate, or membership of a monetary union, is a complex decision. There is no commonality between the countries (and groups of countries) that have chosen this type of policy. Such countries are of many sizes, have many levels of development, have many types of industry, may be important or unimportant in world trade, may be economically integrated with their neighbors or not, may be net importers or net exporters of capital, and have many types of government. Despite this, the number of reasons why countries choose a fixed exchange rate (or membership of a monetary union) is less than the number of countries that make this decision.

Mushin (2001, 2008(a)) identified eight reasons for countries to adopt a fixed exchange rate (or to join a monetary union):

(i) *Small economy*

Fixed exchange rates are often chosen by very small countries that are (to a significant extent) economically integrated with a dominant neighbor. They may even use the neighbor's currency. Examples are the use of the Swiss franc in Liechtenstein, the Indian-rupee pegs that are operated in Bhutan and in Nepal, and the use of the New Zealand dollar in Niue.

(ii) Historical and institutional connections

A small economy might also fix its exchange rate in terms of the currency of the country with which it has significant historical or political links. This is usually a colonial vestige. Examples are the use of the CFA franc, whose value is guaranteed by the French government, in most of France's former territories (and two additional countries) in Africa, Liberia's fixed exchange rate (until 1997) with the United States dollar, and the rigid link with the British pound of the currencies of Falkland Islands, of Gibraltar, of Guernsey, of Isle of Man, of Jersey, and of St Helena (which is the remnant of the Sterling Area).

(iii) Significant integration with, but not domination by, a larger neighbor

Examples are the fixed exchange rate, until 1979, between the Irish Republic pound and the British pound, the fixed exchange rate between the Brunei-Darussalam dollar and the Singapore dollar, and the monetary union, until 1999 (when it became part of the euro zone), of Belgium and Luxembourg.

(iv) Political integration

Examples are the monetary unions that accompanied the recent political unification of Yemen and of Germany.

(v) Evolving economic integration

Trading blocs that move towards economic integration usually also favor some degree of monetary integration. Examples are the GCC countries and the group of countries that use the euro. However, membership of a trading bloc that is committed to economic integration does not always lead to

membership of a monetary union. For example, the UK is a member of the European Union but is not a member of the euro zone.

(vi) Perceived high risk

Countries that are widely perceived to be actually or potentially unreliable often choose to reduce the economic effects of this by adopting a fixed exchange rate. The causes of the damaging perceptions may be political or economic or both. Recent examples are Hong Kong (in anticipation of, and since, its constitutional change in 1997) and international pariahs such as Iraq and Libya.

(vii) Acute crisis

In an attempt to reduce economic (and therefore also political) instability, fixed exchange rates are often introduced by countries experiencing severe economic and political upheavals. Recent examples are Argentina and Poland.

(viii) Recent independence

A fixed exchange rate is often expedient for newly independent countries (such as parts of the former Union of Soviet Socialist Republics and of the former Yugoslavia) because it may take considerable time to set up independent monetary institutions that command confidence.

Most of these reasons for adopting a fixed exchange rate (or for joining a monetary union) do not apply to the GCC countries. This taxonomy illustrates that there are many justifications for joining a monetary union. The GCC countries are not similar to most of the other countries (and groups of countries) that use this type of exchange-rate policy. The category in this taxonomy that describes the GCC

countries is evolving economic integration [v]. The smaller GCC countries also show evidence of significant integration with, but not domination by, a larger neighbor [iii].

The categories in this taxonomy are not mutually exclusive. Many countries that have chosen a fixed exchange rate (or membership of a monetary union) can be placed in more than one of the categories. For example, San Marino, which has a long history of using the Italian lira (and, since 1999, the euro), is a small economy [i] that has historical links [ii] with Italy. Bosnia-Herzegovina, which had a fixed exchange rate with the German mark since 1996 and has had a fixed exchange rate with the euro since 1999, has recently become independent [viii], is likely to be perceived as a high-risk economy [vi], has recently emerged from an acute crisis [vii], and is seeking economic integration with its neighbors [v].

Further, the categories are not sufficient conditions for the adoption of this type of exchange-rate policy. For example, the political union [iv] of Yemen led to the introduction of a common currency, but the formation of the United Arab Republic did not. Granada, Liechtenstein, Nauru, and San Marino are small countries [i] that have chosen to join monetary unions, and Fiji, Tonga, and Vanuatu are small countries that have not.

5. Is A Monetary Union A New Type Of Currency Arrangement In The GCC Countries?

Most of the GCC countries were part of a monetary union until the

1960s. In five of the six countries, a common currency was used before independence from the UK. The Indian rupee and, from 1959, the Gulf rupee (which was also issued by the Reserve Bank of India) were used in Bahrain (until 1965), in Kuwait (until 1961), in Oman (until 1970), in Qatar (until 1966), and in United Arab Emirates (until 1966). To some extent, these currencies also circulated in Saudi Arabia. The value of the Gulf rupee (and of its predecessor) was fixed in terms of the British pound. The Saudi Arabia riyal, which is descended from the currency that was used before independence in 1916 from the Ottoman Empire, has a different history. Its exchange rate has been fixed in terms of the US dollar since 1951 (although it has been specified in terms of the SDR since 1975).

Until 1972, Bahrain, Kuwait, Oman, Qatar, and United Arab Emirates (but not Saudi Arabia) were part of the Sterling Area, which, although not a monetary union, was a zone of unrestricted capital mobility and of relative stability of exchange rates (in terms of the British pound).

6. Could The Monetary Union Of The GCC Countries Be Ended?

History shows that joining a monetary union is not an irrevocable decision. For example, new currencies were created following the dismembering of Czechoslovakia (1993), of Yugoslavia (1991), and of the Union of Soviet Socialist Republics (1991), and by the separation of Eritrea from Ethiopia (1993). Similarly, the Gulf rupee, which was the common currency

of five of the GCC countries, was replaced, between 1961 and 1970, with newly-established national currencies⁷. In 1966, the East African shilling, a colonial currency comparable to the Gulf rupee, was replaced by national currencies in Kenya, in Tanzania, and in Uganda. If the political and/or economic pressures are sufficient to justify the costs of terminating it, the monetary union of the GCC countries might not be permanent.

7. Is A US-Dollar Peg A New Arrangement In The GCC Countries?

With the exception of Kuwait, which, since 2007, has fixed the value of its currency with respect to a weighted basket of currencies, each of the GCC countries has a fixed exchange rate in terms of the United States dollar (and, hence, in terms of each of the other currencies in the GCC countries). This means that, in five of the six GCC countries, there is, in effect, already a common currency whose value is fixed in terms of the US dollar.

In Bahrain, Kuwait, Oman, Qatar, and United Arab Emirates, the US-dollar pegs started from the sudden contraction of the Sterling Area in 1972. However, these fixed exchange rates were formally specified in terms of the Special Drawing Right [SDR] of the IMF by Bahrain from 1980 to 2001, by Qatar from 1999 to 2001, and by United Arab Emirates from 1978 to 2003. Saudi Arabia formally specified its fixed exchange rate in terms of the SDR from 1986 to 2002. Kuwait specified its fixed exchange rate in terms of a basket of currencies from 1975 to 1990 and returned to this system in 2007. From

1990 to 1991, during the Iraqi occupation, it used Iraqi currency. There have been several changes in the official parities of these countries' currencies since 1972.

8. In The Monetary Union Of The GCC Countries, Are Political Problems Likely In Monetary Policy Decisions?

In the euro zone, responsibility for monetary policy decisions lies with the European Central Bank, which is operationally independent and which is not directly accountable to national governments. There are similar structures in other monetary unions. The intention is to remove political tensions between the members of a monetary union from the determination and administration of its monetary policy.

Political stresses of this kind are not possible in the monetary union of the GCC countries because it has been decided that the common currency will have a fixed exchange rate. Under a fixed exchange rate, there cannot be an active monetary policy. The money supply is necessarily adjusted to stabilize the exchange rate. The current situation in the GCC countries is the same. Each of these countries already has a fixed exchange rate, and so monetary policy cannot be used.

Although its fixed exchange rate will make monetary policy impossible in the monetary union of the GCC countries, and therefore political difficulties related to it cannot occur, disputes between GCC governments related to the allocation of seigniorage, the profits derived from the issue of currency, and related to changes in the

exchange rate between the common currency and the US dollar (or other *numéraire*) are possible.

9. How Would The Initial Exchange Rates In The Monetary Union Of The GCC Countries Be Fixed?

The choice of the initial exchange rates, between each of the GCC currencies and the new currency and between the US dollar and the new currency, will be an important part of the creation of the new currency of the monetary union of the GCC countries. With the exception of Kuwait, each of the GCC countries already has a fixed exchange rate with the US dollar, so these rates could be chosen as the basis for defining the new currency. These five existing currencies already have fixed exchange rates between them. Specifying the exchange rates between the new currency and the Kuwait currency, which is pegged to a basket of currencies, will need more complex political decisions in which all of the other members of the GCC will have an interest. It is also possible that the US-dollar value of the new currency will not be calculated from the existing fixed exchange rates. There may be good reasons for choosing exchange rates that are lower or higher than the existing rates. A lower exchange rate for the new currency (or for any of the six existing national currencies) would increase the income from oil exports (which are priced in US dollars) and increase the competitiveness of other exports, including services and manufactured goods (whose prices are fixed in local currency). A higher exchange rate would decrease the

problem of imported inflation.

Conclusions

The establishment of a monetary union of the countries of the GCC is a significant change in these countries' macroeconomic system. However, this change is not as dramatic as it might appear. Monetary unions are not rare and fixed exchange-rate systems, of which a monetary union is an extreme form, are even less rare. In addition, a monetary union is not an unfamiliar structure in most of the countries of the GCC. Five of them used a common currency, the Gulf rupee, until the 1960s.

The exchange rate of the common currency that is to be introduced in the monetary union of the GCC countries will be pegged to the US dollar. This also is not new in these countries. With the exception of Kuwait, the currency of each of the members of the GCC already has an exchange rate that is fixed in terms of the US dollar and, therefore, to each of the other five GCC currencies that has a US-dollar peg.

The establishment of a monetary union in the GCC countries is probably inspired partly by the introduction of the euro in 1999. However, monetary experience in western Europe is fundamentally different to monetary experience in the GCC countries and caution should be used when drawing conclusions from observations of the euro zone. Despite attempts at increased monetary integration in western Europe from the 1970s, there is, unlike in the GCC countries, no recent history of a monetary union. The economies of the GCC countries are

dominated by the oil industry, but there is no comparable dominance of any industry in the euro zone. Unlike the GCC countries, the members of the euro zone do not have close cultural and historical connections. They do not even have a common language⁸. They were on both sides (and neutral) during the Second World War.

In addition, the euro, unlike the new currency to be introduced in the GCC countries, has a floating exchange rate. This enables the European Central Bank to operate an active monetary policy. The major European countries have not fixed their exchange rates in terms of the US dollar since the early 1970s.

Monetary unions are not always permanent. As in any agreement between sovereign governments, it is possible that there will be tension between the desire to collude for the common good and the incentive for an individual country to pursue its own interests by, for example, changing a fixed exchange rate. There might also be difficulties related to the distribution of seigniorage.

The reasons why countries join (or withdraw from, or re-join) monetary unions are both economic and political. The economic reasons are related to optimal currency area theory, of which a summary is provided by Begg, Dornbusch, and Fischer (2009). The economic case for the establishment of a monetary union of the GCC countries has been presented by other authors and has been accepted by governments. The political arguments for joining, or not joining, a monetary union are more varied and depend on the circumstances and history of each country and group

of countries. The political and economic arguments can lead to opposite conclusions. This point is illustrated by Mushin (2006) who showed that ignoring political and historical information leads to misleading conclusions when attempting to identify the countries in eastern Asia in which monetary integration is likely to be introduced.

The relationship between the currencies of the Irish Republic and the UK is an interesting case study of the interaction of political and economic forces on the development of exchange-rate policy. Despite the non-participation of the UK, the Irish Republic joined the European Monetary System [EMS], an agreement to restrict variability of exchange rates between its members' currencies, at its inception in 1979. The functioning of the EMS has been analyzed by Mushin (1981, 1986). This ended the link between the British pound and the Irish Republic pound that had existed since the establishment of the Irish currency following the partition of Ireland, so that a step towards one monetary union destroyed another. Until 1979, the Irish Republic pound had a rigidly fixed exchange rate with the British pound, and each of the two banking systems cleared the other's checks as if denominated in its own currency. These very close financial links meant that every policy decision of monetary importance in the UK coincided with an identical change in the Irish Republic, including the currency reforms of 1939 (US-dollar peg), 1949 (devaluation), 1967 (devaluation), 1971 (decimalization), and 1972 (floating exchange rate). From 1979 until 1999, when the Irish Republic

adopted the euro (and the UK did not), there was a floating exchange rate between the British pound and the Irish Republic pound. South of the Irish border, the dominant political mood in the 1920s was the need to develop a distinct non-British national identity, but there were perceived to be good economic grounds for retaining a very close link with the British pound. By 1979, although political rhetoric still referred to the desire for a united Ireland, the economic situation had changed, and the decision to join the EMS without the membership of the UK meant that, for the first time, different currencies were used on each side of the Irish border. In both of these cases, political objectives were tempered by economic pressures. Mushin (1980) has analyzed the end of the link between the British and the Irish Republic currencies.

The recent monetary history of five of the GCC countries also illustrates the importance of political and economic pressures. With the exception of Saudi Arabia, the GCC countries had a common currency, the Gulf rupee, until independence (between 1961 and 1970). This currency was a colonial legacy, and it is not surprising that the newly independent countries decided to replace it, especially since they had no special relationships with India, where it was issued. Despite the economic case for a common currency, they replaced the Gulf rupee with individual national currencies, and did not form a new monetary union. The explanation is both political and economic. The political reason is that some of these countries experienced initial difficulties in forming their national identities, and a national

currency was a powerful symbol of sovereignty. In particular, Bahrain and Qatar considered becoming constituents of United Arab Emirates, and Kuwait was aggressively claimed by Iraq. The economic case for separate national currencies, which is also political, is that, even if exchange rates are fixed with respect to the British pound (or, from 1972, to the US dollar), each national currency can be devalued and revalued. However, the exchange rate of a common currency cannot be changed by an individual country. Forty years on, the political context has now changed. Individual countries have become confident of their national identities and can more easily concentrate their attention on the economic and political benefits that can be derived from a monetary union of GCC countries (including Saudi Arabia). Despite this, political tensions between members of the GCC have not disappeared. It is now (November 2009)⁹ unclear whether Oman and United Arab Emirates will participate in a monetary union, and the reasons for this are political.

Following the invasion of 1990, Kuwait had a brief monetary union with Iraq. The reason for this was, of course, political and not economic.

The situation of the five GCC countries that used the Gulf rupee, and of the three countries that used the East African shilling, was also experienced by another group of countries. The outcome shows that, if the political pressures had been different, a common currency could have replaced the Gulf rupee. In 1965, the islands of the eastern Caribbean replaced the British West Indies dollar, another colonial legacy, with a new common currency,

the East Caribbean dollar. Since 1976, the East Caribbean dollar has had a fixed exchange rate with the US dollar.

Although other monetary unions, and other fixed exchange-rate systems, have been operating for many years, it does not follow that the countries that have adopted these policies are similar to the countries of the GCC. There are several reasons for countries to adopt this type of policy and most of these are unrelated to conditions in the GCC countries.

Other authors have shown that there are likely to be substantial economic benefits from the establishment of a monetary union of the GCC countries. This article shows that this type of policy is not as new, either in the world financial system or specifically in the GCC countries, as it might appear. The exchange rate of the common currency in the GCC countries will be fixed in terms of the US dollar, which is also not a new policy in most of these countries. Although the political consequences are more difficult to predict, the economic success of the monetary union appears to be assured.

Postscript

Since this article was written, Oman and United Arab Emirates have confirmed that they will not participate in the monetary union of the GCC countries. The other members of the GCC have postponed the introduction of their monetary union, probably until 2013.

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Endnotes

1. The members of the euro zone are Austria, Belgium, Finland, France, Germany, Irish Republic, Italy, Luxembourg, Netherlands, Portugal, and Spain, which joined in 1999, Greece, which joined in 2001, Slovenia, which joined in 2007, Cyprus (South) and Malta, which joined in 2008, and Slovakia, which joined in 2009. The euro is used in French Guiana, Guadeloupe, Martinique, Mayotte, Réunion, and St Pierre-Miquelon that, as *départements d’outre-mer*, are constitutionally part of France. It is likely that additional countries will join the euro zone. The euro is also used in Andorra, Kosovo, Monaco, Montenegro, San Marino, and Vatican. Fixed exchange rates in terms of the euro are used in Bosnia-Herzegovina, Bulgaria, Cape Verde, Comoros, Denmark, Estonia, Hungary, Lithuania, Macedonia, Serbia, and the members of the *Communauté Financière Africaine* and of the *Comptoirs Français du Pacifique*. Additional countries fix their exchange rates in terms of baskets of currencies that include the euro.
2. The members of the Eastern Caribbean Currency Union are Anguilla, Antigua-Barbuda, Dominica, Granada, Montserrat, St Kitts-Nevis, St Lucia, and St Vincent-Grenadines.
3. The members of the *Communauté Financière Africaine* are Benin, Burkina Faso, Cameroon, Central African Republic, Chad, Congo Republic, Côte d’Ivoire, Equatorial Guinea, Gabon, Guinea-Bissau, Mali, Niger, Sénégal, and Togo.
4. The members of the *Comptoirs Français du Pacifique* are Wallis and Futuna Islands, French Polynesia, and New Caledonia.
5. The US dollar is the sole legal tender in Ecuador, El Salvador, Marshall Islands, Micronesia, Palau, Panama, and Timor-Leste. It is also the sole legal tender in the

- overseas possessions of the United States (American Samoa, Guam, Northern Mariana Islands, Puerto Rico, and US Virgin Islands) and in two British territories (Turks and Caicos Islands and British Virgin Islands).
6. For example, Liechtenstein uses Swiss currency, Cyprus (North) uses Turkish currency, and Kiribati, Nauru, and Tuvalu use Australian currency.
 7. The value of each of the five new currencies was defined, at its inception, in terms of the Gulf rupee (and, therefore, in terms of the British pound):
 - 1 Gulf rupee = UK£0.075 = 0.10 Bahrain dinar
 - = 0.075 Kuwait dinar
 - = 0.075 Oman rial
 - = 1.00 Qatar rial
 - = 1.00 United Arab Emirates dirham
 8. The internet site of the European Central Bank [www.ecb.int] is available in twenty-two languages.
 9. Source: www.gulfnews.com

Contact details

Jerry Mushin [jerry.mushin@vuw.ac.nz]
School of Economics and Finance
Victoria University of Wellington
PO Box 600
Wellington
New Zealand