ERF Policy Brief

Toward Frontier Macroeconomic Institutions in Support of Green-Energy Transition in GCC Countries

Klaus Schmidt-Hebbel

About the authors

Klaus Schmidt-Hebbel is a Professor of Economics at Universidad del Desarrollo.

In a nutshell

- *The current macroeconomic framework of GCC countries has served them rather well until now. However, their future energy and industrial transition toward a greener, sustainable economy will imply a more diversified production structure, which will require a very profound upgrade of institutions that govern their macroeconomic management.*
- *International experience shows that increasing numbers of industrial and emerging-market economies adopt a mix of floating exchange-rate regimes, independent central banks, and inflation-targeting regimes. In addition, many countries have put in place a fiscal framework comprised by ten institutional components, among which an independent fiscal council and a fiscal rule are key.*
- *Systematic empirical evidence shows that all the latter macroeconomic institutions have contributed significantly to higher economic growth and more macroeconomic stability. The world evidence also shows that countries which have not modernized and upgraded their macroeconomic institutions have sacrificed growth and have been subject more frequently to economic and financial crises.*
- *In their transition toward a greener and diversified economy, GCC countries will face much more difficult policy challenges and more frequent, diverse, intensive, and prolonged shocks than those they have faced until now.*
- *The international evidence suggests that GCC countries, in order to manage successfully their green transition, will require more real-exchange flexibility and a more advanced framework of monetary and fiscal institutions and rules, in order to ensure macroeconomic stability and to deal more effectively with foreign and domestic shocks.*
- *GCC countries should evaluate and then adopt a floating exchange-rate regime, combined with a monetary policy based on inflation targeting and conducted by an independent central bank.*
- *Regarding their fiscal policy framework, all GCC countries would do well in considering and implementing different institutional components of a frontier fiscal framework. In particular, adoption of an independent fiscal council and a fiscal rule would contribute to their fiscal stability, transparency, and credibility.*

© The Economic Research Forum, 2024. Policy Briefs communicate clear, research-based views on policy relevant topics. The views they express are entirely those of the author(s) and should not be attributed to ERF, its Board of Trustees or donors.

1. Introduction

The current macroeconomic framework of GCC countries has served them rather well until now. A development strategy largely based on oil and gas exports has led to significant growth and high income levels. Conservative fiscal and monetary policies, tied to fixed exchange rates, have contributed to low inflation and to fiscal surpluses saved into sovereign wealth funds.

However, their future energy and industrial transition toward a green economy will imply a more diversified production structure. To manage successfully this transition will require more real-exchange flexibility and a more advanced framework of macro institutions and rules to ensure macroeconomic stability and deal effectively with foreign and domestic shocks.

What constitutes a world-frontier macroeconomic framework? Which are the main components of such a framework? (Table 1).

Regarding exchange-rate (ER) regimes and policies, international best practice points toward a legal framework that includes a currency conversion law and a law that grants the central bank (exceptionally, the ministry of finance) authority to manage international reserves and exchange-rate interventions. A floating ER system is the preferred choice of many advanced and emerging-market economies, although a sizable subset of the latter favors a fixed ER system. Among floaters, explicit or implicit rules are adopted to allow for frequent or exceptional interventions in currency markets, which determine conditions, duration, intensity, and forms of interventions.

A floating ER system is a necessary condition for exerting an independent monetary policy. A second requirement is central bank independence enshrined in law. Inflation targeting (IT) is the monetary regime choice of most central banks aiming for low and stable inflation. Monetary policy is guided by some version of the Taylor rule for setting the monetary policy rate (MPR), as documented by Carrasco and Schmidt-Hebbel (2024) for both IT and non-IT central banks. The MPR is the policy instrument of when the rate reaches the zero lower bound (ZLB).

The legal framework for an advanced fiscal-policy regime is often comprised by some form of a fiscal responsibility law and a number of complementary laws and regulations that set fiscal institutions and budget management procedures and fiscal policy transparency and communications. Fiscal policy is often governed by fiscal rules, which are defined for quantitative targets for the government balance, public debt, government expenditure and/or government revenue levels.

2. Exchange-rate and monetary regimes and policies

In world experience, fixed (or pegged) ERs offer advantages and disadvantages compared to flexible (or floating) ERs. Under fixed ERs, inflation tends to be low, very similar to the rate of inflation of the country that issues the anchor currency. Nominal ER volatility is nil and real ER volatility is low. However, to reap these benefits requires a strict control over domestic credit issue by the central bank, a conservative fiscal management, and a stable domestic financial sector, in order to avoid speculative attacks on central bank reserves and subsequent financial crises.

Some of the disadvantages of fixed ERs derive from the difficulties faced by many countries to satisfy the

Table 1. A world-frontier macroeconomic framework

	Exchange-rate regime and policy	Monetary regime and policy	Fiscal regime and policy
Legal Institution	Currency conversion law and central bank / ministry of finance authority in ER management	Central bank independence law	Fiscal responsibility law and other laws on budget policy and procedures
Regime	Floating exchange rate (with interventions)	Inflation targeting	Comprehensive fiscal framework
Rule	Free float in normal times; ER interventions in except. times, based on implicit / explicit rule	A Taylor rule version when monetary policy rate (MPR) is not at zero lower bound (ZLB)	Fiscal rules on government expenditure, revenue, balance, and/or debt
Policy	Policy decisions on conditions, duration, intensity, and forms of ER interventions	Setting of MPR; use of heterodox policy at Zero Lower Bound	Government budget, balance, and balance sheet decisions

Source: the author.

strict requirements to maintain fixed parities over time – few countries have been able to do so over decades. In addition, nominal and real shocks that affect the anchor currency lead to undesirable changes of the real ER and hence in international competitiveness. Flexible ERs have two further advantages over pegs. First, nominal ER flexibility allows instantaneous adjustment to nominal and real shocks that affect the economy. Second, a flexible ER allows to conduct an independent monetary policy to counter-act domestic and foreign shocks and attain a domestically-defined inflation objective.

Not surprisingly, a growing number of countries have ditched their inflexible ER regimes in favor of floating ERs during the last three decades, often in combination with a monetary regime based on explicit inflation targeting (IT) (Table 2). Successful ER floating and IT require significant institutional strengths: an independent, transparent and technically-skilled central bank and conduct of monetary policy with fiscal independence (no issue of domestic credit to finance budget deficits). As of 2022, 45 industrial and emerging-market economies – which by-and-large satisfy the latter requirements – have in place a successful combination of a floating ER regime and an IT regime (IMF 2023). In most of the latter countries, monetary policy follows a monetary rule, under which the domestic policy rate is set according to inflation deviations from targets and output gap (Carrasco and Schmidt-Hebbel 2024).

3. Comprehensive fiscal framework

Sustainable and successful management of fiscal policy requires putting in place a comprehensive fiscal framework. World experience shows that such a framework combines ten institutional components, that are based on constitutional, legal, and regulatory requirements that provide the formal underpinnings for their adoption and use (Table 3). Among the latter there are three key institutional components: sovereign wealth funds, fiscal councils (adopted by 105 countries, as of 2021), and fiscal rules (adopted by 52 countries, as of 2021).

Empirical evidence shows that the package of components of a frontier fiscal framework has contributed to sustainable fiscal policy, reflected in low public deficits and stable public debt levels (Schmidt-Hebbel 2018).

4. Empirical evidence on the effects of frontier institutions on macroeconomic performance

A review of the empirical evidence on the contribution of frontier institutions on macroeconomic institutions has documented their impact (Schmidt-Hebbel 2018).

On their effects on GDP growth rates or levels, the effect of the choice of ER regimes is ambiguous. However, in

Table 2. Country combinations of exchange-rate and monetary regimes: selected countries, 2022

Exchange Rate Arrangement	Monetary Policy Framework: Exchange Rate Anchor (81)	Monetary Aggregate Target (25)	Inflation Targeting (45)	Other
No Separate Legal Tender (14)	Ecuador, El Salvador, Kosovo, Panama			
Currency Board (12)	Bulgaria, Hong Kong, Dominica			
Fixed Exchange Rate (102)	Aruba, Bahrain, Congo, Denmark, Honduras, Kuwait, Nicaragua, Oman, Qatar, Saudi Arabia, UAE	Afghanistan, Angola, Bolivia, China, Nigeria, Samoa, Tanzania		Argentina, Egypt, Haiti, Mongolia, Tonga, Pakistan, Venezuela
Floating (66)			Australia, Brazil, Canada, Chile, Colombia, South Korea, Japan, Mexico, New Zealand, Norway, Peru, Poland, Russia, South Africa, Sweden, United Kingdom, Ukraine, Uruguay	Austria, Germany, Belgium, Spain, USA, France, Greece, Italy, Ireland, Luxemburg, Malaysia, Portugal, Switzerland

Notes: (a) this table includes only a subset of the 194 countries classified by the IMF according to their exchange-rate and monetary regimes. The numbers in parentheses identified for each regime correspond to the corresponding number of countries by regime, adding up to 194. (b) GCC countries are identified in bold.
Source: the author, based on Exchange Arrangements and Exchange Restrictions IMF Database (2023).

Table 3. Institutional components of a comprehensive fiscal framework

Components	Description
Fiscal responsability law	Transparency and accountability in budget objectives, instruments, planning, and execution
Financial management of the budget	Legal and administrative powers of the Minister of Finance for efficient budget management
Budget planning horizon	Period over which the budget is planned and executed to ensure transparency, consistency, and sustainability of fiscal policy (preferably a multi-year period)
Rules for the management of assets and/or part of the Government's liabilities	Rules that limit government discretion in managing its balance sheet (at least its financial assets and liabilities)
Sovereign wealth funds	Fiscal surpluses are transferred to (and withdrawn from) sovereign wealth funds, investing in diversified international portfolios
Budget accounting requirements	International accounting and transparency standards
Budget planning, approval and execution	Proposal, approval and execution of the budget by the Minister of Finance, Parliament, and the Budget Director
External control and audits of budget planning and execution	Exerted by Parliament and/or the State's Comptroller General
Fiscal council	Council that monitors budget formulation and execution, evaluates fiscal policy and proposes policy reforms
Fiscal rule	Quantitative rule set for actual or cyclically-adjusted fiscal balance, and/or public debt, government expenditure, and government revenue

Source: the author.

countries that have adopted (independently) central bank independence, IT regimes, and fiscal rules, there is evidence that growth and/or development levels are higher. On the effects of frontier institutions on macroeconomic and financial stability, the evidence is unambiguous and broad. Stability is significantly strengthened in countries that have (independently) adopted central bank independence and IT. The evidence also shows that stability is higher in countries that have in place (independently) sovereign wealth funds, fiscal councils, and fiscal rules.

5. Macroeconomic institutions and performance in GCC countries

The current macroeconomic institutional framework is quite homogeneous across the six GCC member countries (Table 4). All have in place a fixed ER regime, which implies that they lack capacity to conduct an independent monetary policy (and therefore have no monetary rule in place) because their monetary anchor is the exchange rate. On fiscal institutions, they have sovereign wealth funds in place, including three of the largest funds in the world (those of the UAE, Saudi Arabia, and Kuwait). However, all six countries lack two key fiscal institutions: an independent fiscal council and an explicit fiscal rule.

Macroeconomic performance has ranged from acceptable to good across the six countries during the last decade (2014-2023). GDP growth is positive yet not impressive, ranging from an average annual 0.2% (Kuwait) to 2.5% (Bahrain). Inflation has been low, similar to that of the U.S., as their currencies are pegged to the US dollar.

There is a large dispersion of fiscal performance measures across GCC countries during the last decade. Kuwait, Qatar, and the UAE record systematic fiscal surpluses, which imply low-to-moderate levels of public debt. Oman and Saudi Arabia exhibit significant fiscal deficits, but their dent levels are low to moderate. The highest levels of deficits and debt are observed in Kuwait.

6. Policy recommendations

International experience shows that increasing numbers of industrial and emerging-market economies adopt a mix of floating exchange-rate regimes, independent central banks, and inflation-targeting regimes. In addition, many countries have put in place a fiscal framework comprised by ten institutional components, among which an independent fiscal council and a fiscal rule are key.

Systematic empirical evidence shows that all the latter macroeconomic institutions have contributed significantly to higher economic growth and more macroeconomic stability. The world evidence also shows that countries which have not modernized and upgraded their macroeconomic institutions have sacrificed growth and have been subject more frequently to economic and financial crises.

Table 4. GCC countries: macroeconomic institutions and macroeconomic performance

	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	United Arab Emirates
Exchange-rate regime	Fixed Exchange Rate	Fixed Exchange Rate	Fixed Exchange Rate	Fixed Exchange Rate	Fixed Exchange Rate	Fixed Exchange Rate
Monetary policy anchor	Exchange Rate Anchor	Exchange Rate Anchor	Exchange Rate Anchor	Exchange Rate Anchor	Exchange Rate Anchor	Exchange Rate Anchor
Monetary policy rule	No	No	No	No	No	No
Fiscal Rule in place	No	No	No	No	No	No
Fiscal Council in place	No	No	No	No	No	No
GDP Growth (%, 10-year avge)	2.5	0.2	1.7	1.9	2.4	3.0
Inflation (%, 10-year avge)	1.3	2.5	0.9	1.5	1.7	1.7
Gross Debt (% of GDP, 10-year avge)	97.2	9.2	39.2	48.8	18.3	25.7
Fiscal Balance (% of GDP, 10-year avge)	-11.4	5.8	-6.2	7.0	-6.2	1.5
Sovereign Wealth Fund Assets (USD billion, Dec. 2022)	19	804	42	405	837	1,889

Note: the period for which the 10-year average (10-year avge) is calculated is between 2014 and 2023.
Source: the author, based on Exchange Arrangements and Exchange Restrictions IMF Database (2023) and WEO IMF Database (oct. 2023).

The current macroeconomic framework applied in GCC countries has served them rather well until now. However, their future energy and industrial transition toward a greener, sustainable economy will imply a more diversified production structure. In their transition toward a greener and diversified economy, GCC countries will face much more difficult policy challenges and more frequent, diverse, intensive, and prolonged shocks than those they have faced until now. Facing the latter shocks and policy challenges will require a very profound upgrade of GCC countries' institutions that govern their macroeconomic management.

The international evidence suggests that GCC countries, in order to manage successfully their green transition, will require more real-exchange flexibility and a more advanced framework of monetary and fiscal institutions and rules, in order to ensure macroeconomic stability and to deal more effectively with foreign and domestic shocks.

GCC countries should carefully evaluate their current combination of a fixed ER regime and lack of an independent monetary policy. In their transition to a more diversified production, they are likely to face larger and more significant international and domestic shocks than before. International experience suggests that nominal ER flexibility is an adequate buffer for such shocks, especially if it is complemented by an independent central bank conducting a monetary policy under IT. Hence particularly the larger GCC economies should implement adoption of such an ER and monetary regime mix.

Regarding their fiscal policy framework, all GCC countries would do well in considering and implementing different institutional components of a frontier fiscal framework. In particular, adoption of an independent fiscal council and a fiscal rule would contribute to their fiscal sustainability, transparency, and credibility.

References

Carrasco, M. and K. Schmidt-Hebbel (2024). "**Monetary Policy Decisions by the World's Central Banks using Real-Time Data**", Working Paper, Universidad del Desarrollo, Chile, January.

IMF (2023). **Annual Report on Exchange Arrangements and Exchange Restrictions 2022**. Washington, DC: International Monetary Fund, Washington, DC.

Schmidt-Hebbel, K. (2018): "The Role of Economic Institutions in Supporting Growth and Development", in D.W. Beuermann and M.J. Schwartz: **Nurturing Institutions for a Resilient Caribbean.** Washington, DC: Inter-American Development Bank.

ERF at a Glance: *The Economic Research Forum (ERF) is a regional network dedicated to promoting high-quality economic research for sustainable development in the Arab countries, Iran and Turkey. Established in 1993, ERF's core objectives are to build a strong research capacity in the region; to encourage the production of independent, high-quality research; and to disseminate research output to a wide and diverse audience. To achieve these objectives, ERF's portfolio of activities includes managing carefully selected regional research initiatives; providing training and mentoring to junior researchers; and disseminating the research findings through seminars, conferences and a variety of publications. The network is headquartered in Egypt but its affiliates come primarily from different countries in the region.*

Contact Information

ERF Office
Address: 21 Al-Sad Al-Aaly St. Dokki, Giza, Egypt
PO Box 12311
Tel: +202 333 18 600 - 603
Fax: +202 333 18 604
Email: erf@erf.org.eg
Website: http://www.erf.org.eg

Follow us

economic-research-forum *ERFlatest* *TheERFLatest* *www.erf.org.eg*