

Models of Economic Integration: the EU and the GCC countries

Paola Subacchi

Head, International Economics Programme

Chatham House

10 St James's Square, London SW1Y 4LE

psubacchi@chathamhouse.org.uk

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Introduction

The European Union (EU) is regarded as a model of how economic integration has helped a rather instable region to achieve peace and prosperity over more than two generations. Throughout the history of the EU there has always been broad consensus around the goal of deeper economic integration among Europe's economies. Even the so-called Eurosceptics have always been in favour of creating and expanding a common market in Europe even if they have objected to regulatory policy, competition policy and tax policy, and, more broadly, to the institutional and regulatory framework which facilitates such a market.

Europe's economic integration has been made possible by creating interdependent product and labour markets. Creating a common market has helped firms to exploit economies of scale and so increase their market share. The abolition of trade and non-trade barriers has considerably reduced incumbent firms' market power and expanded the number of firms in the market for particular products. This has not only increased consumers' welfare by giving them wider choice, but has also raised real wages and so encourage labour supply. A wider, more competitive market has also increased the returns to product and process innovation. This, in its turn, helps channel resources into research and development and into investment more generally, with positive longer run consequences for output, incomes and welfare.

The fact that the European single market is going through some 'growing pains' and has not delivered the results that national leaders had, somehow incautiously, promised, does not mean that the EU should not provide some valuable lessons to other regions that are now moving towards more integration. But the EU model should be taken with a pinch of salt as it cannot be replicated as a whole in other regions. There is certainly no "one size fits all" here.

In this paper I look in particular at the process of economic integration in the EU and among countries belonging to the Cooperation Council for the Arab States of the Gulf (GCC) and argue that there are some fundamental differences between the EU and the

GCC, mainly in terms of size and economic diversification, that makes difficult for the latter to follow step by step the EU path. Moreover, the EU highly-formal approach to integration and an inclination for supernational institutions and far-reaching regional economic policies, which has proved controversial in Europe, may be even more difficult to digest in other parts of the world. I conclude that the EU can offer examples that need to be rethought rather than models to be applied to other regions. If there is a lesson from Europe is its policy-makers's flexibility and willingness to accommodate differences across member states.

The paper is organised as follows. Part 1 looks at several decades of regional integration and focuses, in particular, on the pattern of regional integration in GCC countries. Part 2 compares integration in the GCC and EU and argue that there is scope for more intra-regional integration, as well as more diversification, in the GCC even if on a limited scale. Part 3 assesses the strengths and weaknesses of EU integration. Part 4 concludes that the EU cannot offer models that can be re-applied to the GCC, but examples that need to be re-adjusted.

Part 1: Towards more integrated regions

Several decades of regional integration

Some of the first initiatives to promote intra-regional trade and investment in the Arab world through regional agreements go back to the 1950s and 1960s. In 1957 several Arab countries¹ signed the Agreement in Arab Economic Unity which had the aim of liberalizing the movement of people, capital and goods among the Arab League States. The agreement was followed a year later by the conclusion of the Convention

¹ Iraq, Jordan Kuwait, Lebanon, Libya, Morocco, Saudi Arabia, Sudan, Syrian Arab Republic, Tunisia, United Arab Republic and the Arab Republic of Yemen. Mauritania, Palestine and Somalia joined later. The agreement was signed on 3 June 1957 and came into force on 30 April 1964.

Establishing the Inter-Arab Investment Guarantee Corporation further creating an enabling framework for investment flows in the region.²

In the same period, in Europe, six European countries – Germany, France, Italy, Belgium, the Netherlands and Luxembourg – signed the Treaty of Rome (1957) to establish the European Economic Community (ECC), while the European Free Trade Association was established in 1960³. By the time, in the 1980s, the ECC had unveiled plans for further enlargement and for the establishment of the single market by 1992, similar efforts were under way elsewhere. The Cooperation Council for the Arab States of the Gulf (GCC), created in 1981 by Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and United Arab Emirates, were moving toward deeper economic relations between the members with the signing of the Unified Economic Agreement.⁴ The US and Canada had concluded their FTA in 1988 while the Southern Common Market (MERCOSUR) was established in 1991.

This process of regional economic integration has been interwoven with the proliferation of FTAs. Since 1990 the number of FTAs has risen from 50 to almost 230 as of 2004, and over 50 are in various stages of formation. Many countries belong to several of these schemes. On average a country belongs to six arrangements, though there is a great deal of variation depending on the region and the level of development. The result is a ‘spaghetti bowl’ of overlapping arrangements with different provisions that strain trade policy and trade administration (Table 1, United Nations, 2005:63-64).

Table 1: Trade within selected trade blocs, 1970-2002

² The Convention was signed in May 1971 and entered into force in April 1974.

³ Seven countries joined EFTA in 1960: UK, Denmark, Norway, Sweden, Austria, Switzerland and Portugal. Now the only members are Iceland, Norway, Switzerland and Liechtenstein as all the other countries have joined the EU.

⁴ Provisions in investment and services, however, were marginal. The Article 21 of the Agreement dealt with establishing common investment rules and a joint investment policy, but no specific implementation was envisaged (El-Kady, 2005).

	Percentage of total bloc exports					Percentage of world exports	
	1970	1980	1990	1998	2002	1970	2002
High-income and low- and middle-income economies							
APEC	57.8	57.9	68.3	69.7	73.3	36.0	46.0
EU	59.5	60.8	65.9	56.8	60.6	45.6	37.9
NAFTA	36.0	33.6	41.4	51.7	56.7	21.7	17.2
Latin America and the Caribbean Andean group							
Andean Group	1.8	3.8	4.1	12.8	9.5	1.9	0.8
CACM	26.1	24.4	15.3	15.8	11.1	0.4	0.4
CARICOM	4.2	5.3	8.1	17.3	12.5	0.4	0.2
LAIA	9.9	13.7	10.8	16.7	11.1	4.5	5.0
MERCOSUR	9.4	11.6	8.9	25.0	11.6	1.7	1.4
Africa							
COMESA	8.7	6.0	6.3	7.7	6.4	1.6	0.4
ECOWAS	2.9	10.1	7.9	10.7	10.6	1.1	0.4
UDEAC	4.9	1.6	2.3	2.3	1.5	0.2	0.1
Asia							
Arab Common Market	2.2	2.4	2.7	4.8	4.8	1.6	0.6
ASEAN	22.9	18.7	19.8	21.9	23.7	2.0	6.3

Bangkok Agreement	2.7	3.7	3.7	5.0	5.6	1.6	5.1
EAEC	28.9	35.6	39.7	42.0	48.2	11.3	25.2

Source: United Nations, 2005, p.64

Regionalism and bilateralism in GCC countries

Like the EU the GCC countries provides an example of a region in which economic integration is proceeding through regionalism.⁵ Such a process has taken a rather quick turn in recent years with the establishment of the customs union in January 2003. The creation of a common market is scheduled for 2007 and the introduction of a common currency by 2010.

The institutional framework created by regional integration places member countries in a better bargaining position when negotiating trade and investment agreements either bilaterally or as a group. Growing shares of intra-regional trade and investment flows have been led by government initiatives in the form of free trade agreements (FTAs), bilateral investment treaties (BITs) and trade and investment framework agreements (TIFAs). Indeed, despite claims of being committed to collective rather than bilateral negotiations with trade partners, GCC countries have recently embarked on a number of bilateral trade and investment agreements with the objective of fostering their integration into the world economy. This was partly triggered by the US post-9/11 policy of creating a Middle East Free Trade Area by 2013. Also, bilateral deals are usually easier to negotiate than regional agreements which at times involve competing national interests and priorities among regional states, even if they move the centre of attention from the regional dimension (El-Kady, 2005).

⁵ Asia, on the other hand, is an example of regionalization, that is growing shares of intra-regional trade and investment flows that have been led by market actors. See Jones and Plummer (2004).

A FTA between the US and Bahrain was signed in September 2004⁶, the first between Washington and a Gulf Arab state, which angered Saudi Arabia (Janardhan and Rutledge, 2004).⁷ The deal was ratified by Bahrain's Parliament in July 2005. In late 2005, the US Congress voted overwhelmingly in favour of this FTA. On 11 January 2006, US President George W. Bush signed legislation to implement the agreement. At the time of writing, the document is one step closer to being brought into force.⁸

Similar deals are likely to follow. In September 2005 Saudi Arabia and the United States signed a bilateral trade agreement to develop trade and investment relations in energy, transport, distribution, commerce, the environment, restaurants, post services and agriculture. However, no FTA has been signed as yet (March 2006). In January 2006 US officials said that they hoped that 2006 would bring the beginning of a process to sign a FTA with Qatar, to build on the already existing TIFA, which was signed in 2004. A FTA between the UAE and the US is also expected by the middle of 2006. Free trade talks have been re-scheduled for the end of April 2006 after a delay stalled talks in March following the collapse of a deal that would have allowed Dubai Ports World to manage a total of six American port terminals⁹. The UAE and US had signed the TIFA in March 2004. Both sides have been working on a FTA since March 2005 and have already had four rounds of talks. The UAE is a member of the WTO and the government has begun to implement WTO rules relating to pharmaceuticals, textiles and financial services.

⁶ According to the deal both sides will receive immediate duty free access to 100% of bilateral trade in non-textiles industrial goods, 100% of Bahrain's agricultural exports and 98 % of US agricultural exports. Further, along with preferential access for US firms in Bahrain's service sectors including finance and tourism.

⁷ The US-Bahrain deal came in the wake of Saudi-American relations suffering a serious economic setback in 2003 when Saudi Arabia rejected two major proposals by US energy companies – ExxonMobil and Conoco/Phillips – to develop Saudi natural gas resources. Instead Saudi Arabia struck important deals with the EU and Russia on trade and energy issues respectively.

⁸ Around 60% of Bahrain's exports to US are in the apparel and garment sector. The number of textile firms fell from 22 in 2003 to 15 in 2004 due to high input costs such as high wage rates, scarce water and land costs. However, the sector is a vital actor in the economy employing 3,600 Bahraini women (98% of the female workforce in the manufacturing sector) and 11,000 expatriate workers. Although the sector contributes to 3% of the manufacturing's GDP, Bahrain only enjoys 0.177% of the US market share.

⁹ Officials, though, have denied a link between these two events.

Following the TIFA in 2004, US-Kuwaiti trade talks took place in February 2006. The main goal of the meeting was to bring the two sides into closer understanding on a number of issues related to the TIFA agreement and to prepare for the next round of negotiations of the TIFA. There are not expected to be any FTA talks however this year. The Kuwaiti government has shown a great deal of commitment in protecting intellectual property rights and is keen to build strong trade relations with the US. However, signing a FTA with the US may take some time due to still unresolved issues over protection of intellectual property rights, labour laws and technical barriers to trade.¹⁰

The end of 2004 also saw the launch of the Greater Arab Free Trade Zone. The UAE is projected to be its largest beneficiary, with a 53% increase predicted in the total trans-border trade between the UAE and the rest Arab world. Being the largest Arab re-export center, the UAE will be able to save more than Dh43 billion (almost US\$12 billion) per annum re-exporting huge quantities of goods to other Arab countries without paying taxes.

GCC-EU Free Trade Agreement

EU-GCC relations are channelled through a Co-operation Agreement signed in 1989 between the EU and the GCC. The objective of this agreement was to contribute to strengthening stability in the region and to facilitate political and economic relations. Working groups were established in the fields of energy and the economy. The Co-operation Agreement laid out in article 14 the establishment of an annual Joint Council/Ministerial Meeting between the EU and the GCC foreign ministers as well as

¹⁰ On 4 June 2005 Ambassador Richard LeBaron identified key areas in which Kuwait will need to make progress. These include better protection of intellectual property rights, which should be achieved through passage, implementation and enforcement of appropriate laws to protect copyrights, patents and trademarks, and to criminalize piracy as well through amendments to Kuwait's copyright, patent and trademark laws. Also Kuwait must eliminate its International Conformity Certification Program. The US considers this import testing and inspection program to be a technical barrier to trade that is inconsistent with Kuwait's WTO obligations. Labour laws need to be more consistent with ILO principles. Kuwait has not signed two of the eight fundamental ILO conventions, Convention #98, which allows for freedom of association and collective bargaining, and Convention #100, which covers equal remuneration. http://kuwait.usembassy.gov/june_4_2005.html.

between senior officials at a Joint Co-operation Committee. Such EU-GCC meetings have been held at alternating locations.

The aftermath of the Iraq war and EU efforts towards the establishment of an EU Strategic Partnership for the Mediterranean and the Middle East provoked a renewed interest in EU-GCC relations. Recently the Joint Council, in the meeting held in Bahrain in 2005, stressed its shared political will to further relations and co-operation in all areas besides trade and economic issues. On issues of common interest between the two regions, the GCC and the EU reiterated their determination to further develop their political dialogue in order to seek common solutions to common challenges. On specific areas such as counter-terrorism, there was a strong reaffirmation by both parties on their commitment to fight terrorism in all its forms and manifestations.

In contrast with the US, the EU has chosen to deepen integration with the Gulf countries at the regional level, rather than bilaterally, and to negotiate a FTA with the GCC. This goes back several years. The 1989 Co-operation Agreement contains a commitment from both sides to enter into negotiations on a Free Trade Agreement. Free Trade Agreement negotiations were initiated in 1990 but soon reached a standstill. Finally in 1999, the negotiations regained momentum after the GCC's declaration to create a GCC customs union. Negotiations continued at an accelerated pace throughout 2005. They are now well advanced and both parties have conveyed their commitment to close them as soon as possible.

Three rounds of talks between the GCC and EU were held between April 2005 and March 2006. In early March 2006, outstanding issues between the GCC and EU, including EU tariffs on exports of aluminium and petrochemicals were resolved. A few outstanding issues will be tackled in Riyadh in April 2006. This should be the last round of talks. One issue that should be finalised is that GCC exports of aluminium and petrochemicals will have zero tariffs from day one of the enforcement of the agreement. The other outstanding issues pertain to rules of origin, services, and disputes settlement.

The EU is also asking that all the services sectors in the GCC are opened up. If agreement cannot be reached on these issues, a ministerial level decision will be taken.¹¹

On the basis of the new EU negotiating directives, the proposed FTA would provide for a progressive and reciprocal liberalisation of trade in goods and services aiming at assuring a comparable level of market access opportunities, consistent with the relevant provisions of the WTO and taking into account the level of development of the GCC countries. For the GCC the FTA have to take into account the differences in economic advancement of the two sides and bring about a balance in trade, which currently is in favour of the EU, generate gains for the non-oil export sector, increase GCC exports to the EU and help consolidate the GCC's regional integration process. In this last area, significant progress has already been made. For example, the establishment of a GCC Customs Union in 2003 was a precondition set by the EU to the signing of the FTA.

The FTA ultimately aims at fostering economic integration between the parties, with a view to diversifying and increasing the mutual trade in a sustainable manner.

Negotiations cover market access on goods and services, common rules and disciplines on intellectual property rights, competition, dispute settlement or rules of origin. The agreement will also cover political issues such as human rights, illegal immigration and fight against terrorism.

The European Commission views GCC integration as a step toward greater regional stability and prosperity and seeks to enhance co-operation activities with the GCC within the framework of the *Strategic Partnership for the Mediterranean and the Middle East*, approved by the European Council in June 2004. Such co-operation would encompass the political, economic and social fields and will open up possibilities for the European

¹¹ As well as the EU, the GCC have been talking to Northern European countries. Representatives of the GCC and the European Free Trade Association (EFTA), which includes Iceland, Liechtenstein, Norway and Switzerland, met in Riyadh on 18 February 2006 in order to discuss their economic co-operation and trade relations. They discussed the possibility of an EFTA-GCC Free Trade Agreement. The first meeting of negotiations will be in Geneva on 20-22 June 2006.

Commission to support the region's domestic reform efforts including areas such as education or human rights.

Part 2: The EU and Arab countries in the global economy

Significant changes in the trade dynamics

<p>Box 1: The Cooperation Council for the Arab States of the Gulf (GCC)</p> <p>Member states: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates</p> <p>Secretary-general: Abdul-Rahman Bin Hamad Al-Attiyah</p> <p>Source: European Commission, www.europa.eu.int</p>	Population	33 million (2003)
	Surface	2,476 million km
	GDP	€70 billion (2004)
	GDP per capita	11,244 euro (2004)
	Real GDP growth (%)	5.7 (2004)

<p>Box 2: The European Union (EU)</p> <p>Member states: Austria, Belgium, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden, United Kingdom</p> <p>President of the European Commission: José Manuel Barroso</p> <p>Source: European Commission, www.europa.eu.int</p>	Population	457 million (2004)
	Surface	3,893 million km
	GDP	€7,755 billion (2003)
	GDP per capita	21,400 euro (2003)
	Real GDP growth (%)	2.4 (2004)

The world today is very different from the origin of integration in Europe and in the Arab countries. First, the contemporary marketplace is much more open. The GATT and then WTO rounds as well as unilateral liberalization have led to extensive reductions in trade barriers and to huge increases in international capital flows, including FDI. Thanks to its position at the crossroads of three continents the Middle East¹² can hugely benefit from the fast changing dynamics of the international trade by acting as a trading bridge between Europe and Asia as well as Africa and Asia. At the same time it can play a much bigger role than just being an energy source.

Despite the potential advantages for them within the global trade the GCC economies remain largely undiversified with the energy sector playing by far the most prominent role. They hold 45% of the world's oil reserves and supply 20% of global crude production¹³. Fuels and mining products represent over 80% of the exports of these countries¹⁴ while manufactured goods are more than 70% of imports¹⁵.

Over the last couple of decades, and in particular following a period of oil price consolidation in the 1990s, the GCC countries have moved towards more diversification in their economies in order to raise revenues other than oil. Efforts to encourage foreign investments, privatise state-owned companies and cut back on national subsidies have been made across the region, with some success stories such as Dubai that in four decades has changed from being a pearl fishing and trading outpost to a regional centre

¹² In this paper I follow the definition used by the World Trade Organisation (WTO) which includes in the Middle East the GCC countries, Iran, Iraq, Israel, Jordan, Lebanon, Syria, Yemen, the West Bank and the Gaza Strip (WTO, 2005). *Middle East* usually defines a cultural area, so it does not have precise borders. The most common and highly arbitrary definition includes: Bahrain, Cyprus, Egypt, Turkey, Iran, Iraq, Israel, Jordan, Kuwait, Lebanon, Oman, Qatar, Saudi Arabia, Syria, the United Arab Emirates, Yemen, the West Bank and the Gaza Strip. Iran is often the eastern border, but Afghanistan and western Pakistan are often included. North Africa - i.e., Algeria, Libya, Mauritania, Morocco, Sudan and Tunisia - although often placed outside the Middle East proper, does have strong cultural and linguistic links to the region.

¹³ Apart from Bahrain and Oman all GCC states are members of OPEC.

¹⁴ The exception being the United Arab Emirates with 46% of their exports in fuels and mining products. WTO, Country profiles, www.wto.org.

¹⁵ The exception here is Bahrain with 43% of its imports in manufactured goods. WTO, Country profiles, www.wto.org.

for commerce, transport, tourism and increasingly finance. The emirate has seen its economy double in size in real terms within the last ten years while its population of about 1.5 million is being boosted by immigration. More diversification is also evident in the emergence of UAE and Qatar in the Middle East trade. UAE's shares of Middle East total exports rose to over 20% in 2004 from just over 10% in 1980. Similarly, the share of exports from Qatar increase to 4% in 2004 from below 3% in 1980 (WTO, 2005).

The recent oil boom, while posing the problem of investing the current account surplus of about \$150 billion (or 32% of GDP) wisely and in a sustainable way – and to strike a balance between short-term welfare and job creation and long-term structural investment – has not removed the issue nor stopped the effort towards achieving a more diversified economy. The emergence of more dynamic and diversified economies in the Gulf region is evident from shares of the region's exports and imports held by each country (Table 2). Over more than twenty years from 1980 to 2004 the share of UAE exports over the total for the GCC countries more than double – from 13.4% to 30.2%.¹⁶ Similarly, Qatar's share of exports rose from 3.5% in 1980 to 5.6% in 2004. On the other hand, the share of Saudi exports over the total dropped from over 65% to just above 45%.

Table 2: Merchandise Exporters and Importers in GCC countries, 2004

	Value	Share			
	2004	1980	1990	2000	2004
Exporters					
GCC	274.1	100.0	100.0	100.0	100.0
Saudi Arabia	126.2	66.6	50.5	44.1	46.0
United Arab Emirates	82.8	13.4	26.7	28.3	30.2
Kuwait	28.7	12.0	7.9	11.1	10.6
Qatar	15.5	3.5	4.4	6.6	5.6
Oman	13.3	2.3	6.2	6.4	4.8
Bahrain	7.6	2.2	4.3	3.5	2.8
Importers					
GCC	119.4	100.0	100.0	100.0	100.0

¹⁶ The total exports of the GCC countries has risen to \$274 billion in 2004 compared to about \$160 billion in 1980.

United Arab Emirates	47.6	16.7	23.7	34.8	38.1
Saudi Arabia	44.6	58.1	51.0	39.3	35.8
Kuwait	12.0	12.5	8.2	9.2	9.6
Oman	8.9	3.3	5.7	6.5	7.1
Bahrain	6.3	6.7	7.8	6.0	5.1
Qatar	5.4	2.7	3.6	4.2	4.3

Source: WTO, *World Trade Statistics*, 2005, author's calculations

The extreme specialisation of the GCC economies, on the other hand, has kept them rather insulated from changes on the global trade dynamics. They have not been adversely affected by increased economic integration of their largest markets, the EU and the US, unlike other countries in the Middle East where, for example, the integration of Eastern Europe in the EU presents a problem for competitiveness in skill-intensive production. Turkey has been successful in managing this kind of problem through its trade agreements with the EU, and this should provide a benchmark for evaluating the appropriateness of similar policies with other countries. Similarly, the emergence of India and China as well as other Asian countries such as Vietnam and Indonesia in the global trade of labour-intensive goods provides another challenge to the integration of a large segment of the Arab's region working population in international trade, but leaves the GCC countries rather unaffected.

Intra- and extra-regional trade: the GCC and the EU

In this section I look at the share of intra and extra-regional trade for the GCC and EU, and compare the level of integration reached in both regions. As the breakdown for trade figures is not available for GCC I use WTO figures for the Middle East¹⁷ as a whole in order to draw a comparison with other regions of the world for illustrative purposes.

The EU accounts for about a fifth of global imports and exports and ranks first for exports in the world trade. It is second to the US for imports. In 2004 the value of its exports was just over \$4,000 billion. Intra-EU trade accounts for over half of all trade in each of the 25 countries, and in some of the smaller countries, such as Belgium,

¹⁷ For the definition see note 12.

Luxembourg, the Czech Republic, it amounts to around 80%. Intra-trade for the EU as a whole is almost three quarters of its exports.¹⁸ The US is the EU's biggest extra-regional export market, with about 10% of total exports, followed by Asia with about 8%.

Imports were over \$4,100 billion in 2004, almost three quarter of which are intra-EU. Asia's is an important source of extra-EU imports with a share of about 12%, followed by North America (5.9%). Of particular importance is the trade with China that between 1999 and 2003 has more than doubled in value resulting in China's being the second biggest supplier of EU imports (12.4%) after the US (16.1%).

Europe is the Middle East's main trade partner, especially on the import side with over 40% of imports coming from Europe. Exports to Europe represent 16.4% of the total exports from the region. For GCC countries, in particular, over 30% of imports for Kuwait, Saudi Arabia, Qatar and United Arab Emirates come from Europe and between 7% and 12% of their exports go to Europe. The EU exports to the GCC have been increasing since the 1980s. The GCC is currently the EU's sixth largest export market and the EU is GCC's first trading partner. In 2004 the EU exports to the GCC were around €40 billion whereas the EU imports from the GCC amounted to around €25 billion. The EU exports to GCC are diversified, but the main weight remains on machinery and transport materials (56%), such as power generation plants, railway locomotives and aircraft as well as electrical machinery and mechanical appliances. EU imports from the GCC consist mostly of fuels and derivatives (70% of total EU imports from the GCC countries). GCC countries currently benefit from preferential access to the EU market under the EU's Generalised System of Preferences (GSP).

Looking at intra-regional trade for the whole Middle East, it is striking how limited it is despite several bilateral, regional and association agreements. This can be attributed to several factors, including the fact that the Barcelona Process, initiated in 1995 as a comprehensive drive toward greater inter-regional cooperation, has stalled.¹⁹ The

¹⁸ Figures are for the year 2004. WTO (2005).

¹⁹ The aim of creating a Euro-Mediterranean Free Trade Area by 2010 would appear unfeasible.

incorporation of the Euro-Mediterranean partnership in the European Neighbourhood Policy also leaves many questions unanswered. A certain amount of cooperation has taken place in trade, labour services and production, mostly as a result of bilateral agreements. But the policy objectives and goals of regional integration have remained largely unimplemented. The level of economic integration currently in place in other regions, such as Latin America and South East Asia, are far more advanced than the Middle East. As can be seen from Table 3, intra-Middle East trade is about 6% of total trade, with just 5.5% of the total exports and 8.8% of the total imports going in the region. This is the lowest share of intra-regional trade and puts Middle East behind all other world's regions in terms of regional economic integration.²⁰

Table 3: Intra- and inter-regional merchandise trade, 2004 (% of total trade)

Origin	Destination							
	North America	South and Central America	Europe	Commonwealth of Independent States (CIS)	Africa	Middle East	Asia	World
Value								
North America	56.0	5.4	16.3	0.4	1.1	1.9	18.8	100.0
South and Central America	33.7	23.2	21.4	1.1	2.5	1.8	14.1	100.0
Europe	9.1	1.3	73.8	2.2	2.4	2.6	7.6	100.0
Commonwealth of Independent States (CIS)	6.8	2.3	48.5	20.7	1.5	3.8	13.2	100.0
Africa	18.5	3.0	42.7	0.4	9.9	1.3	16.8	100.0
Middle East	14.1	1.0	16.4	0.3	3.3	5.6	49.5	100.0
Asia	22.3	1.6	17.5	1.0	1.9	3.1	50.3	100.0
World	20.8	2.7	44.4	2.0	2.3	2.8	23.2	100.0

Source: WTO, *World Trade Statistics*, 2005

²⁰ Comparing the level of Europe's economic integration with that of the Middle East and, more specifically, of the GCC, is not entirely accurate as the former is the result by a series of policy-driven discriminatory initiative, but it is useful for illustrative purposes. On this point see Jones and Plummer, 2004:83.

As most economic-integration initiatives take place at the subregional level, we now compare three sub-regional trade blocs, EU, GCC and ASEAN (Table 4). At the sub-regional level the intra-GCC trade is over 6% of the total GCC trade, slightly similar of that of the Middle East as a whole (Table 3). The EU intra-trade is almost 70% of EU total trade, again not substantially different from the share of intra-regional trade for Europe as a whole. Looking at shares in intra- and extra-regional trade, all the three sub-regions have become more integrated. Table 4 notes that since 1990 the share of intra-GCC exports over the total GCC exports have steadily grown and in 2004 were almost 5% of total exports. A similar trend can be identified for intra-GCC imports, with the difference of a slightly bigger share of intra-regional imports over the total.

With regard to the services sector, integration here is far less advanced with key industries such as distribution, finance and telecommunications still relatively closed.

Table 4: Share of intra-regional trade, EU, GCC and ASEAN

	Value \$bn	Share %			
	2004	1990	1995	2000	2004
EU (25)					
Total exports*	3714	100.0	100.0	100.0	100.0
Intra-exports	2510	64.9	64.1	67.5	67.6
Extra-exports	1204	35.1	35.9	32.5	32.4
Total imports*	3791	100.0	100.0	100.0	100.0
Intra-imports	2511	63.1	65.2	64.1	66.2
Extra imports	1280	36.9	34.8	35.9	33.8
GCC					
Total exports	274	100.0	100.0	100.0	100.0
Intra-exports	13	3.6	4.0	4.1	4.8
Extra-exports	261	96.4	96.0	95.9	95.2
Total imports	119	100.0	100.0	100.0	100.0
Intra-imports	11	11.6	7.9	8.9	9.2
Extra imports	108	88.4	92.1	91.1	90.8
ASEAN					
Total exports	552	100.0	100.0	100.0	100.0
Intra-exports	128	20.1	25.5	24.1	23.2
Extra-exports	424	79.9	74.5	75.9	76.8
Total imports	500	100.0	100.0	100.0	100.0
Intra-imports	115	16.2	18.9	23.4	23.0
Extra imports	385	83.8	81.1	76.6	77.0

Note: * Figures for merchandise trade

Source: UN, Comtrade Database, <http://unstats.un.org/unsd/comtrade>, author's calculations

The role of foreign direct investment

Promoting foreign direct investment (FDI) is a means of attracting (non-debt creating) long-term capital flows, foreign exchange, access to foreign markets and technology transfer. It is also a way to foster integration between regions and areas. Unlike Europe – and Asia – direct investment and trade flows have so far played a very limited role in the Gulf region, and in the Middle East as a whole. UNCTAD includes the GCC member states in the group of countries with high FDI potential, but below potential in terms of performance.²¹

In the five years between 1998 and 2003 only Bahrain and UAE had a considerable increase in FDI inflows (Table 5). In most cases the inflow remained broadly unchanged while in the case of Saudi Arabia FDI fell dramatically from \$4,289 million in 1998 to \$208 million in 2003. This is despite it relaxed its regulations covering private investment in 2000, and now allows 100% foreign ownership of new ventures. Nonetheless, it has kept a 'negative list' of companies in which foreign investment remains forbidden. This illustrates the fact that, although there has been a significant improvement in Saudi Arabia, the dominant culture within the government is still hostile to foreign ownership [EIU, 2004].

²¹ UNCTAD (2004:17). The UNCTAD rank refers to the period 2000-2002. In 1993-1995 the outlook was rather different with Bahrain and Qatar be 'front-runners', ie countries with high FDI potential and performance.

Table 5: GCC Countries: Foreign Direct Investment Inflows, 1998-2003, \$m

Host economy	Annual Average 1992-1997	1998	1999	2000	2001	2002	2003
Bahrain	602	180	454	364	81	217	517
Kuwait	70	59	72	16	-147	7	67
Oman	79	101	39	16	83	23	138
Qatar	182	347	113	252	296	631	400
Saudi Arabia	280	4289	-780	-1184	20	-615	208
UAE	254	258	-985	-515	1184	834	480

Source: UNCTAD, 2004, Annex Table B.1.

The EU continues to be an important source of FDI. However, between 2001 and 2003, EU foreign direct investments decreased in the GCC countries, Yemen and Iraq²², from € 1.8 billion in 2001 to €0.6 billion in 2003. EU capital employed in the region has increased from 0.4% of total EU outward stock in 2001 to 0.9% in 2003. At the same time, investments in the EU increased from €0.1 billion in 2001 to €0.8 billion in 2003.

Attracting FDI has begun to assume importance even in the wealthier Gulf states. They are establishing national legal frameworks aimed at FDI and reducing obstacles for foreign investors. Such measures include the simplification of legal procedures, tax holidays, incentives and guarantees to the free transfer of capital and profit. These

²² Economist Intelligence Unit (2004). There is currently no data available for the GCC 6 on investment.

developments in domestic rules governing FDI mirror the growth of bilateral trade and investment agreements at the international levels.

However, many stumbling-blocks remain. Scarce diversification means that few countries in the region are able to attract substantial investment inflows outside the hydrocarbons sector. Equally, they have a limited skill base, relatively low per-capita income and not fully developed regulatory environments. Moreover the size of individual markets is still relatively small. All these problems will be difficult to resolve in the medium term.

Part 3: Strengths and weaknesses of European economic integration

Is the EU single market stalled?

It may not be entirely appropriate to look at the EU as a model for economic integration when it is experiencing “growing pains” as in the words of the European Commission President José Manuel Barroso. The single market increasingly looks like an “unfinished business”, especially now that member states seem keen to build up trade barriers and protect ‘strategic’ sectors such as banking and energy.

As can be seen from Table 4, Europe is a very integrated region compared to other areas, but it is certainly the case that in contrast with earlier trends economic integration has not become deeper in recent years. Over the 1990s intra-EU manufacturing trade approximately doubled in value terms and increased by nearly 50% in volume terms while it has been much more subdued since 2000. The ratio of intra-EU trade to EU exports to the rest of the world has remained strikingly constant since 2001.²³ This suggests that the internal market in goods has certainly not displayed signs of significant deepening in recent years. With regard to the services sector this is not fully integrated with the result that services trade is only about a fifth of the value of goods trade.

²³ The ratio in 2004 was 1.35, exactly the same as it was in 2001. <http://stat.wto.org/StatisticalProgram>

Cross-border investment between Member States in the EU has been “a significant driver of Internal Market integration and has grown substantially faster than domestic investment over the last decade” (European Commission, 2005:6). However, here, too, we observe a substantial slowdown in the relative importance of cross-border transactions. Indeed the ratio of cross-border investment to domestic investment reached nearly 35% in 2000, but had fallen back to under 10% by 2003. While much of the volatility in these data is due to the rise and then fall in merger and acquisition activity associated with the “dot com” boom, the overall pattern shows only modest growth in cross-border investment activity relative to the opportunities which should have been created by the internal market process.

The fact that the volume of cross-border transactions has not grown as rapidly as optimists predicted suggests that the costs of carrying out such transactions are greater than they might appear at first sight, given the absence of tariffs between EU member countries and the use, in a number of member countries, of a common currency. Empirical evidence (Verwaal and Cnossen, 2002) shows that, despite the abolition of border controls in 1993, the EU’s VAT rules and the requirement to collect statistical data for its Intrastat system impose substantial compliance costs on firms which engage in cross-border transactions. For the firms surveyed in the study these costs represent, on average, 5% of the value of intra-EU trade. For more than one-third of the firms in their sample compliance costs were in excess of 12% of intra-EU trade and, in the authors’ view, were likely to have exhausted the profit from these transactions.

Another way to measure the success of the internal market project is to look at price dispersion. According to the European Commission (2005) after narrowing between 1995 and 1999, price dispersion has widened over the last four years in EU15 countries. Price dispersion in new member states has narrowed substantially and continues to do so, but

the situation in EU15 countries suggests that the internal market process in these countries has stalled.²⁴

Most of all, has internal market raised the rate of growth of total factor productivity (TFP) and improved labour market conditions? Such a question is at the hearth of the current debate in Europe. In theory, the development of the internal market should create the conditions for a more efficient use of resources that would be evident in the growth of total factor productivity as well as boosting job creation.²⁵ In practice unemployment remains high, even if cyclical conditions have improved in the last couple of years, while TFP growth has slowed in Europe, both absolutely and relative to TFP growth in the US, as Table 6 shows.

Table 6: Productivity Growth in the Euro Area and the US, 1970-2003

	Euro area annual rates, %			United States annual rates, %		
	Labour Productivity	Capital Deepening	TFP	Labour Productivity	Capital Deepening	TFP
1970-80	3.9	1.2	2.7	1.6	0.4	1.2
1980-90	2.2	0.6	1.6	1.4	0.2	1.2
1990-95	2.6	1.0	1.6	1.3	0.3	1.0

²⁴ Additional evidence on price dispersion based on different data sets is provided by Engel and Rogers (2004).

²⁵ Note that TFP is the appropriate productivity measure here. Many comparisons between the EU and the US focus on labour productivity differences but, since there has been more capital deepening in Europe than in the US, labour productivity should have grown faster, even without the effects of the single market. To isolate the single market effect it is appropriate to strip out the effect of capital deepening by comparing TFP.

1995-2000	1.6	0.4	1.2	2.1	0.4	1.7
2000-2003	1.2	0.4	0.8	2.1	0.6	1.4

Source: Estevão (2004), Table 2.

The slowdown in productivity growth in Europe relative to that in the US is key to the current economic policy debate and many empirical studies have focused on the role of different factors – including information and communications technology – to explain the gap between the two economies. For the purpose of this paper, however, one conclusion is relevant, that the expected effects of a broader and deeper market in Europe have not (yet) found their way into the productivity data. Indeed European productivity performance has certainly not accelerated in the recent period in the way many commentators hoped that it would.

The fact that the Europe's single market has been slower than expected in delivering results should not doom the entire project – a fear than more than ever is now evident. Clearly it is difficult to maintain the political consensus that was created around the internal market project when the benefits are not immediately evident. But, we believe, retreating from the project is not an option, especially in view of the trend towards more regional integration elsewhere. Instead, building the single market should continue in existing areas and be extended to new areas, such as, for example, services, intellectual property, harmonisation of VAT. More work needs to be done to create a truly integrated services sector.²⁶ According to a report produced for the Commission by Copenhagen Economics (Copenhagen Economics: 2005), the benefits would include an increase in

²⁶ The Directive on Services in the Internal Market (the Bolkestein Directive) was approved the European Parliament on 16 February 2006. This was a largely diluted version of the draft directive to ease cross-border provision of services. When it was first presented in spring 2005 the Bolkestein Directive provoked mass protests in a number of countries that persuaded EU heads of government to revise it to meet French objections and also those of Germany, Sweden and Belgium.

total consumption in the EU of 0.6% or €37 billion and the creation of 600,000 jobs. These estimates, however, need to be taken with a pinch of salt as they involve a large degree of uncertainty on how the pattern and extent of trade flows follow liberalisation.

Part 4: Lessons from the EU?

The EU’s “growing pains” should not deter other regions, and in particular the Gulf area, to carry on their own economic integration. There is clearly scope for expanding economic integration among GCC countries, especially on the back of their increasing diversification from oil and gas. However, there are limits to it. The region is just too small and dependent on the rest of the world to be able to reach a level of integration similar to that of the EU. The total population is less than one tenth of that of the EU, and the size of the economy is about 3% that of the EU.

As can be seen from Table 7, Saudi Arabia, GCC’s biggest economy, is similar to Poland and Spain in population size, but it is in between them in economic size. GDP per head – just over \$11,000 – is close to that of Poland, which is one of the poorest members of the EU, but is almost half of that of Spain. GDP per capita in Qatar and UAE is closer to the EU average, reflecting these countries’ successful development path.

Table 7 : Distribution of GCC and EU countries by population and economic size, 2004

Population, m	Gross national income, \$bn					
	Up to 25	Over 25 to 50	Over 50 to 100	Over 100 to 250	Over 250 to 500	Over 500
Over 50						France Germany Italy United Kingdom
Over 20 to				Poland	Saudi Arabia	Spain

50						
Over 10 to 20			Hungary	Czech Republic Greece		Netherlands
Over 5 to 10				Ireland	Sweden	
Over 1 to 5	Oman	Kuwait		UAE		
Less than 1	Bahrain	Qatar				

Source: AMECO Database, author's calculations

Another difficulty that might seriously undermine the process of regional integration is the lack of complementarity among GCC economies. They produce similar and competitive products, with the oil and gas sector representing a disproportionate portion of GDP – about 40% on average – compared with manufacturing – about 10% – and the services sector – about 12%. This is in marked contrast with Europe's experience in the 1960s, where trade in goods was the main source of integration.

A successful economic integration strategy, therefore, would have to focus on two pillars. First, each country needs to continue developing strategic non-oil industries in order to diversify their exports. In particular, the development of services in banking, finance, tourism and personal care sector that could be traded on a regional basis could result in more integration.

Second, the development of a single market should not focus only on eliminating barriers to trade in goods, but also on the liberalization of the services sectors and the encouragement of intra-Arab investment flows. At present, no robust framework agreement for the liberalization of services and investment exists in the region (El-Kady, 2005). The successful economic integration of ASEAN and MERCOSUR for example was consolidated by a network of regional agreements with substantive provisions on services and investment. In the case of ASEAN, for instance, the Framework Agreement on Services, the Agreement on the Promotion and Protection of Investment (amended in

the 1996 Protocol), the Framework Agreement on the ASEAN Investment Area²⁷ have not only encouraged intra-regional trade and investment, but have also made it easier for foreign companies to access the markets of the whole region once they are established in any one member countries.

The creation of the GCC currency union – currently scheduled in 2010 – could also boost the region’s financial and banking sector, attract significant investment flows and increase intra-regional trade. Most of all, successful economic integration needs to take into account contextual factors such as the history and institutions of each country. In Europe, economic integration was triggered, at least at the beginning, from the political determination to end the threat of war. Such goal was pursued even if the economic benefits were disputable. This also explains why today, in an age of relative peace for Europe, tangible economic benefits are necessary to keep the consensus around the ‘European project’. There are no models or policies from the European integration that can be applied to other regions. If there is a lesson from Europe is its policy-makers’s flexibility and willingness to accommodate differences across member states, but also their inability of recognising the need for reforms, and acting accordingly (Jones and Plummer, 2004:841).

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