



## GCC ECONOMIC INTEGRATION: FICTION OR REALITY?

### 1. INTRODUCTION:

The recent impressive economic transformation of the GCC region has come against the backdrop of a strong official desire to achieve greater regional integration. While significant strides have been made with the removal of nominal barriers to trade and investment, which have paved the way for the establishment of a customs union and a common market, achievements have, nevertheless, been limited. Real regional integration has proven largely illusory in the presence of important structural obstacles and an absence of robust economic policy coordination.

The region's recent record of development has been impressive by all accounts as a period of favourable oil prices has witnessed rapid population and economic growth. The GCC population grew by 50 percent between 2004 and 2014 to reach almost 50 million, while GDP doubled to \$1.6 trillion in the same period. Although such trends were positively influenced by the strong performance of the energy sector, diversification efforts into financial services, tourism and manufacturing have been real and substantial. Dubai has emerged as a cosmopolitan regional financial centre and trading hub, Qatar has won the bid to host the 2022 FIFA World Cup, and Saudi Arabia is now a member of the G20.

Despite these achievements, oil continues to dominate the GCC economies: it accounts for 50 percent of their GDP, 80 percent of fiscal revenues and an even higher proportion of their exports earnings (reaching 85-90 percent for Saudi Arabia, Kuwait and Qatar). This undoubtedly leaves the GCC states vulnerable to swings in international energy markets as witnessed by the recent slide in international oil prices to below \$80 for the first time in four years.

In this context, interest in economic integration is likely to be revived given its potential to reduce the region's dependence on its natural resource endowment:

- Increasing non-oil intra-GCC trade and investment can enhance export diversification and reduce volatility in export earnings and contribute to overall economic activity.
- Developing alternative sectors and economic diversification can improve productivity growth, generate technological spill-overs, create new jobs and boost tax income and state revenues.

Overall, broader and deeper economic integration can synergise economies by facilitating the movement of goods, capital and labour. In the GCC region, however, despite

favourable official proclamations, this potential is still largely unexploited.

The European Union common market created the largest global economic entity as both firms and consumers benefitted from economies of scale and competition, which has led to higher quality goods and services at lower prices in a much larger market. It is estimated that over a 15-year period, European integration generated 2.75 million additional jobs and contributed to an extra 2.2 percent of GDP growth.

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THE ECONOMIC ENVIRONMENT PREVAILING EMBODIES KEY CHALLENGES THAT HINDER THE IMPROVEMENT OF THE INDUSTRIAL SECTOR.

## 2. THE LONG ROAD TO INTEGRATION:

Since its inception in 1981, the GCC charter has emphasised the role of “coordination, integration and inter-connection between member states in all fields.” In practice, however, this has been translated into greater political cooperation in the face of emerging security threats and social initiatives in culture and education. The oil price slump and financial slowdown of the 1990s brought economic integration back on the agenda as leaders realised the potential of regional markets for exploiting growth opportunities.

The Economic Agreement of 2001 set more specific goals and targets for achieving a common market and monetary union. Coordination in agriculture, industry, environmental sustainability and scientific research were also mentioned. By 2003, a customs union was announced but implementation lagged behind as conflicts in revenue sharing emerged with disagreements on whether the member state of first entry or the product’s final destination of consumption should retain tax revenues. Bahrain and Oman delivered a further blow to the project by signing bilateral free-trade agreements with the United States in 2004 and 2006, respectively.

A crucial step was taken when the GCC common market was launched in 2008, granting economic equality for firms and citizens across the regions’ borders. This essentially removed barriers to the movement of goods as well as capital and labour. The pinnacle was perhaps the announcement that a single currency would be adopted by 2010. This was, however, stymied by the emergent Eurozone crisis, doubts from Oman on its ability to meet the convergence criteria and disagreements by the UAE about the location of a future central bank.

The future of the project remains in doubt as the commitment of the four remaining states is fading away.



### 3. IMPEDIMENTS TO ACHIEVING GREATER INTEGRATION

#### GOODS AND SERVICES:

Intra-GCC trade in goods and services stands at \$85 billion, growing by an impressive 23 percent annually on average since 2003, yet this remains a low fraction of less than 10 percent of the total GCC trade volumes. In comparison, intra-EU trade represents 57 percent, intra-NAFTA at 41 percent and intra-ASEAN at 23 percent of their respective total trade volumes. The fact remains that the GCC economies have very similar economic structures and trade patterns:

- exports are dominated by oil and gas,
- Imports consist of consumables and capital goods, and
- Europe is still the largest single trading partner with Asia catching up.

As stated above, tariffs on regional trade have been removed but non-tariff barriers (NTBs) still remain and act as impediments to free market integration. Subsidies on energy vary from country to country and affect the cost structure of producers. Competition laws and the regulatory environment are convoluted in certain states which makes it difficult for regional and international players to enter their markets. Privatisation of state-owned enterprises (SOEs) has picked up in recent years but remains largely a work in progress.

#### RECOMMENDATIONS

Several steps need to be taken to harmonise and facilitate real economic integration between the GCC economies. Easing licensing restrictions and market entry for domestic, regional and foreign firms is necessary to promote competition and increase efficiency. The UAE ranks 22, Qatar ranks 50, and Kuwait 86 out of 189 countries on the World Bank's Doing Business report. This reflects the disparity and difficulty in setting up and running enterprises across the GCC states. For example, border controls need to be relaxed as it takes numerous days for trucks carrying goods to cross them.

The GCC states also have to coordinate industrial policy to complement rather than compete with each other to collectively fit into the global supply chain. Similar large-

scale downstream projects have appeared throughout the region such as refineries, aluminium smelters and petrochemical facilities. They capitalise on the cost of energy and labour in the GCC and compete to export to similar regions, as they engage in a race to the bottom to capture market share. There needs to be a common agenda in forming new industries to avoid overlaps and maximise the regional benefits of specialisation. This in turn requires a comprehensive and coordinated approach to industrial and diversification policy across member states.

#### 4. MOVEMENT OF CAPITAL:

The oil boom flooded the region with liquidity, which has no doubt raised its profile and role in the global economy significantly. As the GCC economies cannot absorb such high inflows, oil revenues are sterilised through foreign direct investment and sovereign wealth funds. The majority of such investments are directed towards more developed economies but increasingly in emerging markets and neighbouring countries.

At its peak in 2008, intra-GCC FDI was estimated to be around \$74 billion, or one-quarter of overall FDI inflow into the region. Kuwait and the UAE were the largest investors while Saudi Arabia and the UAE captured the lion's share of receiving destinations. A significant portion of such investments though were concentrated in the finance and real-estate boom. Taking Bahrain as an example, FDI increased ten-fold between 2002 and 2006 with the GCC states constituting 70 percent of these investments. Moreover, a stark 85 percent of inflows were directed into finance and real-estate, while manufacturing, education, healthcare and other productivity enhancing sectors received little attention.

The growth of equity and bond markets was a significant target for FDI as GCC financial markets were transformed in terms of size, openness and maturity. This, however, led to hoarding, speculation and arbitrage opportunities, which contributed to the market crash following the global financial crisis in 2008.

#### RECOMMENDATIONS

To avoid such adverse results in the future, foreign capital needs to be regulated more closely and redirected into strategic sectors such as technology and tourism which could contribute to greater productivity and jobs, particularly for nationals.



## 5. LABOUR MARKETS:

These markets in the GCC remain heavily segmented and imbalanced as the national population is concentrated in the public sector while foreign workers dominate the private sector. While the GCC economies generated a high number of jobs in the past decade, locals lack the skills for these jobs and so cheaper and more skilled expatriates are preferred. Lucrative wages and comfortable working conditions attract locals to government jobs, but the persistent national youth bulge means that there is greater supply than demand of labour, resulting in youth unemployment.

The formation of the common market agreement has allowed for the free movement of labour for nationals but foreign workers are still tied down by their employers through the 'kafala' system (an administrative system that binds unskilled imported workers to their private firm sponsors). Some young GCC workers are beginning to look for opportunities regionally, especially in fast growing cities such as Dubai and Doha. However, evidence suggests that a mere one percent of Dubai's working population is from the region. Structural impediments such as national quotas, social ties and skills gaps are preventing a free movement of labour across borders.

## RECOMMENDATIONS

Governments have reacted to local unemployment by enforcing administrative measures to nationalise the workforce through quotas on foreign labour, visa restrictions and taxes. Such policies have only contributed to cementing duality in this market rather than promoting a more cohesive labour market strategy. Long-term challenges such as education and citizenship rights need to be addressed by the GCC collectively to give their youth the skills and create a more inclusive national identity and society. Only then can labour markets become vibrant and flexible and turn the population challenges into a demographic dividend.

## 6. MONETARY AND FISCAL POLICY:

An aligned monetary and fiscal policy could take the GCC ahead of other trading blocs. GCC currencies, with the exception of Kuwait, are pegged to the U.S. dollar at more or less the same parity, which de facto ties up the member states' monetary policy to the U.S. Federal Reserve. This encourages foreign investment and insures stability as the region's major exports are denominated in U.S. dollars. However, it restricts the ability of central banks to spur growth during times of recession, or restrain inflation during economic booms.



Hence, fiscal policy becomes a powerful tool for GCC governments to influence their macroeconomic variables. However, this is predominantly attached to the volatile oil and gas sectors, as government revenues from alternative sources are miniscule. As fiscal expenditure commitments increase to sustain the growing population and expanding economy, the incentive to diversify government revenues is pressing.

## RECOMMENDATIONS

Introducing a single currency could have major benefits in terms of facilitating trade, investment and job creation as the EU experience has shown. This would be a crucial step in achieving the fiscal union which Saudi Arabia proposed in 2011. A more attainable idea of a value-added tax on goods and services across the GCC was raised, and could act as a stepping stone for cooperation and coordination in raising and collecting taxes across the six nations.

## OVERALL

Given the GCC's shared language, culture and history; political and economic integration holds a great potential to tackling country specific issues. For instance:

- Diversification efforts by Bahrain and the UAE lead the way but to move up a gear they need the scale and scope only achieved through larger markets.
- Rising unemployment in Oman and Saudi Arabia could fill in labour shortages in smaller neighbouring states.
- Development ambitions and abundant capital in Kuwait and Qatar can draw lessons from the experiences of other successful GCC firms and sectors.

The GCC states remain one of the more stable regions in the Arab world in the face of events sparked by popular movements in 2011. The recent sliding trend in oil prices presents the region with another economically testing period on the horizon. The political turbulence of the past few years combined with uncertainty over the economic future of oil economies should act as catalysts to the integration process of the GCC region as a way of addressing their unresolved political and economic challenges.

Only through eliminating nominal and structural barriers in the movement of goods, capital and labour – along with institutional efforts at unifying fiscal and monetary policies – can the GCC nations benefit from real and effective regional economic integration and chart their future as sustainable high growth economies.

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## ABSTRACT:

*The GCC states boast high per capita incomes and a voracious appetite for showcase construction projects, which symbolise their drive to transform finite oil resources into modern economies. During the past decade, significant strides were made in integrating their economies through establishing a customs union, common market and monetary council to study prospects for a shared currency.*

*Underlying fundamentals, however, point at a different direction as the movement of goods, capital and labour has not been as fluid as anticipated. This policy brief evaluates the challenges, successes and future opportunities of economic integration in the GCC. Only through eliminating nominal and structural barriers in the movement of goods, capital and labour – along with institutional efforts at unifying fiscal and monetary policy – can the region benefit from integration.*

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