GCC Economic Integration in Focus
With Special Reference to the UAE

Dr. Belaid Rettab
Dr. Abdulaziz Istaitieh

Data Management and Business Research Department

2007

Published by:

DCCI – Data Management & Business Research Department

P.O. Box 1457 Tel: + 971 4 2028410

Fax: + 971 4 2028478

Email: dm&r@dcci.ae

Website: www.dcci.ae

Dubai, United Arab Emirates

ISBN ……

TABLE OF CONTENTS

ملخص تنفيذي

يحتوي هذا الكتاب على خمسة فصول تتفحص اقتصاديات دول الخليج من محاور مختلفة. في ما يلي نقوم بعرض ملخص سريع لأهم ما ورد في هذه المحاور.

الفصل الأول:

- تبدأ هذه الدراسة بتقديم نظرة عامة سريعة حول عملية التكامل الاقتصادي بين دول مجلس التعاون الخليجي. حتى تاريخ إعداد هذه الدراسة، قامت الدول أعضاء المجلس بتطبيق مرحلتين من التكامل الاقتصادي: منطقة التجـارة الحرة (1983) والاتحاد الجمركي (2003). طبقا للاتفاقية الاقتصادية الموحدة التي وقعت بـين دول المجلـس، يتوجب على الأعضاء تعديل أوضاع اقتصادياتهم قبل الانتقال إلى الخطوة التالية من التكامل الاقتـصادي (نعنـي بذلك السوق الموحدة والاتحاد النقدي). وقد تم الاتفاق على خمسة معايير للتقارب بين اقتصاديات هذه الدول هـي الميزانية الموزونة، والاحتياطيات الأجنبية، والدين العام، ومعدلات الفائدة على الودائع، والتضخم. واستوفت كـل الدول الأعضاء معيارا واحدا حتى الآن (الميزانية الموزونة).
- كما سنرى لاحقا من خلال الدراسة، لقد استوفت كافة الدول أعضاء المجلس معيار الاحتياطيات الأجنبية لواردات أربعة أشهر عدا الإمارات، ونجد أنه عند تطبيق نفس المعيار لمدة ستة أشهر نجد أن البحرين قد فشلت أيضا في استيفائه. لذلك على البلدين زيادة مستوى الاحتياطيات الأجنبية لديهما لاستيفاء هذا المعيار مثلمـا فعلـت الـدول الأربعة الأخرى.
- تتفاوت معدلات الدين العام بصورة كبيرة بين 10.5% من إجمالي الناتج المحلي في سلطنة عمان إلـى 75.9% في السعودية، لذلك قد يكون من غير المنطقي تطبيق نفس معيار الدين العام بصورة آنية على كل دولة. يتوجـب على أعضاء المجلس معرفة أن المعايير لا تناسب كل الدول في كل الأوقات. من المهم وجود ميثاق للاسـتقرار يمكن أن يكون مجموعة قوانين لكل لجنة وطنية للسياسة المالية، لحماية أوامرها الملزمة، واستقلاليتها وحقها فـي وضع ميزانية موزونة. على سبيل المثال، يمكن لكل دولة اقتراح فترة زمنية لتقليل الدين العـام، لنقـل خمـسة

سنوات. وسوف يوضع في الحسبان خلال هذه الفترة الزمنية وضع الدولة ويجب أن يتم الاتفاق عليها مع دول المجلس الأخرى. سوف يكون متوقعا من بعض الدول (كالسعودية مثلا) أن تقلل من دينها العام، لكن دول أخرى قد تعارض بحكم حاجتها القيام باستثمارات عامة هامة (عمان مثلا).

- بالنسبة لمعدلات الفائدة على الودائع، يتوجب على أعضاء مجلس التعاون الخليجي البدء في تقليل الاختلاف في معدلاتها وذلك لأجل تمهيد الطريق أمام الخطوة التالية من التكامل الاقتصادي: تطبيق الاتحاد النقدي. سوف يتضمن الاتحاد النقدي إصدار عملة موحدة، الأمر الذي يعني أن تكون معدلات الفائدة على الودائع واحدة في كل الدول الأعضاء. لذلك، يجب على الأعضاء مقاربة معدلات الفوائد على الودائع لديها لتجنب أن تتمتع بعض الدول بربحية أكبر من غيرها.
- أخيرا، نجد أن معيار معدل التضخم قد أستوفي من قبل دولتين فقط (وهما عمان 0.2% والسعودية 0.7%). لذلك، يجب على الدول الأربعة الأخرى أن تكيف سياساتها حتى تتمكن من الحد الذي وضعه المسئولون عن المصارف المركزية الخليجية. ونجد أن أعلى معدلات التضخم بين الدول الأعضاء هي في قطر والإمارات (3.9% و 3.2% على التوالي) تأتي بعدهما الكويت والبحرين (2.3% و2.2% على التوالي). وهذه الدول الأربعة لديها معدلات تضخم أعلى من الحد الذي حدده مسئولو المصارف المركزية (وهو المعدل الموزون للستة دول زائدا 2% والذي يساوي حوالي 1.5%).

الفصل الثاني:

- تقوم الدراسة بتحليل إحصائيات التجارة الخارجية للإمارات بهدف تحديد مؤشرات خلق التجارة وتنوعها بين الإمارات ودول مجلس التعاون الخليجي الأخرى نتيجة لقيام الاتحاد الجمركي في يناير 2003.
- تشير بيانات الفترة من 2001 إلى 2004 إلى أن تسارع خطى تجارة الإمارات يعود بشكل رئيسي إلى تجارتها مع دول خارج مجلس التعاون حيث كانت الحصة النسبية لتجارتها مع دول المجلس منخفضة. في الواقع سجلت تجارة الإمارات مع دول من خارج المجلس ارتفاعا واضحا خلال الفترة التي تلت قيام الاتحاد الجمركي في حين لوحظ العكس في نمو تجارة الإمارات مع دول المجلس الأخرى.

- باستخدام نظام احتساب الأداء بناء على النمو في القيمة والتغيرات في مكونات التجارة، توضح نتائج الأداء تحسن التجارة مع دول مجلس التعاون، الأمر الذي يشير إلى خلق التجارة. ومع ذلك، فإن التحليل المفصل لأسباب هذه التغيرات يبين أنها أقرب لأن تكون استجابة لفرص التجارة العالمية وليست رد فعل لقيام الاتحاد الجمركي.
- تنفي النتيجة الإيجابية للأداء التجاري مع دول خارج مجلس التعاون الافتراض بشأن حدوث تحول في التجارة بين الإمارات ودول المجلس من جهة وبين الإمارات وباقي دول العالم من جهة أخرى. عوضا عن ذلك، تلقي بيانات دبي لعام 2005 الضوء على تنامي ميل الإمارات نحو شراء وارداتها الرئيسية مباشرة من مصادرها الأساسية.

الفصل الثالث:

- يركز هذا التقرير على ميزان المدفوعات لكل دولة من أعضاء مجلس التعاون الخليجي. كـذلك وضـع ميـزان مدفوعات مجمع لدول المجلس استنادا على ميزان مدفوعات كل دولة على حدة.
- شهدت جميع الدول الأعضاء في مجلس التعاون فوائض في موازين مدفوعاتها في عام 2004: البحـرين (158 مليون دولار أمريكي)، الكويت (668.5 مليون دولار)، عمان (515 مليـون دولار)، قطـر (3,926.9 مليـون دولار)، الإمارات (3,490.3 مليون دولار)، السعودية (4,671 مليون دولار).
- بتجميع كل موازين مدفوعات دول المجلس، يوضح ميزان المدفوعات المجمع حدوث فـائض قـدره 13,429.7 مليون دولار في عام 2004. الجدير بالذكر، أنه على الرغم من ارتفاع حساب رأس المـال والحـساب المـالي السلبي لدول المجلس، إلا أن ميزان المدفوعات المجمع يعتبر إيجابيا إجمالا وذلك نتيجة لإيجابية الحساب الجاري المجمع لدول المجلس وتفوقه على حساب رأس المال والحساب المالي السلبي.
- على نقيض ميزان المدفوعات في دول مجلس التعاون، سجل الاتحاد الأوروبي عجزا قدره 15.4 مليار دولار في ميزان مدفوعاته. منذ عام 2000، ظلت دول مجلس التعاون تسجل فائضا في ميزان المدفوعات، في حين أظهـر الاتحاد الأوروبي عجزا (ما عدا في عام 2002 عندما سجل فائضا بلغ 2.6 مليار دولار).

- أخيرا، يبدو أن جميع دول مجلس التعاون ليس لديها فقط فوائض في ميزان المدفوعات، بل لديها كـذلك هياكـل متشابهة ضمن ميزان المدفوعات. وقد أدى كل ذلك إلى أن ينسجم ميزان المدفوعات المجمـع للـدول أعـضاء المجلس وأن يمكن مقارنته بميزان مدفوعات كل دولة عضو في المجلس على حدة.

الفصل الرابع:

- تحاول الدراسة إلقاء الضوء على مميزات معينة تتصف بها القطاعات المصرفية في دول مجلس التعاون الخليجي والولايات المتحدة مع وضع التحرير المتوقع للقطاعات المالية لدول المجلس في الاعتبار. تكـشف نتـائج هـذه الدراسة على أن غالبية دول المجلس وكذلك الولايات المتحدة تتمتع بقاعدة نقدية قوية. تعكس هذه الحقيقة درجـة عالية من الثقة في بنوك هذه الدول وقدرتها على توفير خدمات متقدمة للعملاء.
- في غالبية دول المجلس يلعب القطاع الخاص دورا بارزا في الأنشطة الاقتصادية حيث يشكل نـسبة مهمـة مـن إجمالي مطالبات البنوك: عمان (93%)، الإمارات (85%)، السعودية (56%)، الكويـت (50.3%) والبحـرين (47%). ينطبق الأمر بشكل مشابه على الولايات المتحدة حيث بلغ المعدل 79% في عام 2003. على النقـيض من ذلك انعكس الدور المهيمن للقطاع العام بشكل واضح على معدل مطالبات البنوك على القطاع في قطر حيـث بلغت 53%.
- مع الأخذ بعين الاعتبار أن التحرير المالي سيؤدي إلى فتح قطاعات المصارف المحلية أمام البنوك الأجنبية، فـإن وجود بنوك تتمتع بعائدات مرتفعة لكن مع ارتفاع في معدل القروض غير المنفذة في العديد مـن دول المجلـس (مثل الكويت، قطر، السعودية والإمارات) سوف يجذب انتباه البنوك الأمريكية ويبدأ التفكير في اختراق قطاعـات مصارف دول المجلس حتى تجني الفوائد من خلال تقديم إدارة أفضل وكفاءة عالية. لذلك فإن تخفيض البنوك في دول المجلس لمستوى القروض غير المنفذة سيكون خطوة إستراتيجية ذكية. بالإضافة إلى ذلك، يمثل الاندماج بين البنوك في دول المجلس واحد من أدوات مواجهة التحرير لأنه يزيد من كفاءة عملها. قد يكون من الأفضل أيـضا تحرير القطاع المالي بين دول المجلس أولاً لتقوية التكامل الاقتصادي بينها ومن ثـم الانطـلاق نحـو التحريـر العالمي.

- أخيرا، على الرغم من أن القطاع المصرفي في الولايات المتحدة يتمتع بسيولة نقدية أكبر من جميع القطاعات المصرفية في دول المجلس - بناء على معايير السيولة التي ذكرت في هذه الدراسة، إلا أن معدلات السيولة في القطاعات المصرفية بدول المجلس تعتبر مرتفعة أيضاً. لذلك، فإن القطاعات المصرفية بدول المجلس فعالة ومرنة. ومع ذلك، قد تحتاج معدلات السيولة ببنوك البحرين إلى بعض التعزيز.

الفصل الخامس:

- تستعرض الدراسة الأدبيات الاقتصادية المنشورة بشأن اتفاقية التجارة الحرة المقترح توقيعها بين الاتحاد الأوروبي ودول مجلس التعاون الخليجي. صنفت الأبحاث إلى فئتين: دراسات الاقتصاد السياسي وتلك الخاصة بالتحليل الاقتصادي.
- حتى وقت إعداد هذه الدراسة أجري فقط اثنين من الأبحاث لقياس التأثير الاقتصادي لاتفاقية التجارة الحرة بين الاتحاد الأوروبي ودول المجلس: PWC (2004) وBaier & Bergstrand (2004). بشكل عام، أوضحت كلا الدراستان أن اتفاقية التجارة الحرة المقترحة سوف تؤثر على الرفاهية الاقتصادية لطرفيها. من جهة، أوضحت دراسة PWC (2004) أن الزيادة في الرفاهية الاقتصادية لدول مجلس التعاون سوف تقدر بـ 2.7% من الناتج المحلي الإجمالي، بينما يتوقع أن لا تكون للزيادة في الرفاهية الاقتصادية الكلية للاتحاد الأوروبي قيمة تذكر (0.6 % من الناتج المحلي الإجمالي). من جهة أخرى، أظهرت النتائج التي توصل إليها Baier & Bergstrand (2004) توقع أن يستفيد الاتحاد الأوروبي من خلق صافي تجارة بقيمة 2.8 مليار دولار بناء على نتائج نموذج مقصور (وبقيمة 28 مليار دولار بناء على نتائج نموذج غير مقصور) في حين سوف تعاني دول مجلس التعاون من تحول لصافي تجارة بقيمة 4.3 مليار دولار بناء على نتائج نموذج مقصور (لكن مع خلق لصافي تجارة بقيمة 27 مليار دولار بناء على نتائج نموذج غير مقصور).
- تعود البيانات التي استخدمت في دراستي PWC و Baier & Bergstrand إلى العام 2001 الأمر الذي يفرض شكوكا على مصداقية النتائج وذلك لأنه وابتداء من يناير 2003 وحدت دول مجلس التعاون رسومها الجمركية الخارجية عند نسبة 5% وذلك مع تطبيق الاتحاد الجمركي للمنظومة. للأسف، لم تظهر هذه التغيرات في

الدراستين المذكورتين سواء كانت التي أعدها PWC أو Baier & Bergstrand. لذلك، هناك حاجة لتقييم مشابه للتأثيرات الاقتصادية باستخدام بيانات حديثة.

Executive Summary

This book includes five major chapters examining the economies of the GCC countries from different perspectives. Presented below is a brief overview and the major findings.

CHAPTER 1:

- This chapter starts by presenting a quick overview of the economic integration process between GCC countries. Hitherto, GCC members have implemented two stages of economic integration: a Free Trade Area (1983) and a Customs Union (2003). According to the Unified Economic Agreement signed between GCC countries, members should align their economies before moving to the next step of economic integration (i.e., a Single Market and Monetary Union). Five criteria of convergence have been agreed on: budget balance, foreign reserves, public debt, interest rates on deposits and inflation. Only one criterion is met by all GCC countries so far (budget balance).
- All GCC countries meet the foreign reserves / 4 months imports criterion, except the UAE. When applying the foreign reserves / 6 months imports criterion Bahrain also fails. Thus, these two countries should increase their level of foreign reserves to meet the criteria and be in line with the other four countries.
- Indebtedness varies enormously from 10.5% of GDP in Oman to 75.9% in Saudi Arabia, thus it maybe unreasonable to immediately apply the same public debt criterion to each country. GCC countries should recognize that the same rules will not suit all countries at all times. The important thing is to have a stability pact; a common set of rules for every national fiscal policy committee, protecting its mandates, independence and right to set the budget balance. For instance, each country would propose a debt target over, say five years. The target would take into account the country's initial position and would have to be agreed upon by the other members of GCC. Some members (e.g. Saudi Arabia) would be expected to bring down their public debts, but some could argue that they needed to make important public investment (e.g. Oman).
- For interest rates on deposits, GCC countries should start reducing differences in their rates in order to pave the way for the next step of economic integration: the implementation of the monetary union (MU). MU will include the issue of a single currency which means that

interest rates on deposits should be the same in all GCC countries. Therefore, members should align their interest rates on deposits to avoid some countries being more profitable than others.

- Finally, the inflation rate criterion is only met by two countries (i.e. Oman 0.2% and Saudi Arabia 0.7%). Therefore, the other four countries should adopt their policies so they complete the limit set by Gulf Arab central bankers. Highest inflation rates between the six members are those of Qatar and UAE (3.9% and 3.2% respectively) followed by those of Kuwait and Bahrain (2.3% and 2.2% respectively). These four countries have inflation rates above the limit set by central bankers (i.e. weighted average of the six countries plus 2% which is about 1.5%).

CHAPTER 2:

- The second chapter analyzes foreign trade statistics of the UAE with the GCC from the point of view of identifying trade creation and trade diversion resulting from the implementation of the Customs Union (CU) in January 2003.
- Data from 2001 to 2004 indicate that the accelerating pace of UAE trade has been primarily due to trade with non-GCC countries; the relative share of trade with GCC countries had been low. In fact, growth of trade with non-GCC countries has been significantly higher in the ex-post CU period compared with the ex-ante CU period, while the reverse has been the case in the growth of UAE trade with other GCC countries.
- Using a performance scoring system, based on growth in value and changes in the composition of trade, performance scores showed improvements in trade with GCC countries, suggesting trade creation. However, detailed analysis of the causes behind these changes showed that they were more likely to be responses to global trading opportunities rather than as a reaction to the CU.
- The positive trade performance scores for non-GCC countries negated the hypothesis on trade diversion. Instead, Dubai data for 2005 highlighted the growing tendency for the UAE to source its major imports from the world's major producers/exporters of these products.

CHAPTER 3:

- This chapter focuses on the GCC countries individual balances of payments (BOPs). It also constructs an aggregated GCC BOP out of the individual BOPs of all GCC countries.
- All GCC countries witnessed a surplus in their BOPs in 2004: Bahrain (US$ 158 million), Kuwait (US$ 668.5 million), Oman (US$ 515 million), Qatar (US$ 3,926.9 million), UAE (US$ 3,490.3 million), Saudi Arabia (US$ 4,671 million).
- By gathering all GCC countries' individual BOPs, an aggregated GCC BOP was created which showed a surplus of US$ 13,429.7 million in 2004. Interestingly, although the aggregated GCC capital and financial accounts were highly negative, the aggregated GCC BOP was positive due to the positive aggregated GCC current account.
- Unlike the aggregated GCC BOP, the EU registered a deficit of US$ 15.4 billion in its BOP. Since 2000, the GCC has recorded a BOP surplus while the EU has been showing a deficit (except for the year 2002 were a surplus of US$ 2.6 billion was registered).
- Finally, all GCC countries seem not only to have surpluses in their BOPs but they also seem, in general, to be similarly structured. Factors constituting the aggregated GCC BOP are consistent and comparable between each BOP of the individual GCC countries.

CHAPTER 4:

- This chapter attempts to shed light on the soundness of specific characteristics related to the GCC and USA's banking sectors, in light of potential liberalization between their financial sectors. The results of this paper reveal that almost all GCC countries, as well as USA, are well monetized. This fact reflects a high degree of confidence in the banks and their ability to provide advanced customer services.
- In the majority of GCC countries the role of the private sector is remarkable; they constitute a significant proportion of the banks' total claims: Oman (93%), UAE (85%), Saudi Arabia (56%), Kuwait (50.3%) and Bahrain (47%). A similar facet applies to the USA, where 79% of total claims were made by the private sector in 2003. In contrast, the public sector is dominant in Qatar where the ratio of claims on the public sector to total claims was 53% in 2003.
- Financial liberalization would result in opening local banking sectors to foreign banks. Many of the GCC banks (i.e. Kuwait, Qatar, Saudi Arabia and UAE) have relatively high ROAs

and ROEs although beset by high ratios of NPLs. These performance indicators may attract the attention of US banks to the GCC banking sector in order to reap benefits by offering better management and efficiency. Therefore, in order to protect themselves, a wise, strategic move for GCC banks would be to reduce the level of NPLs besetting them. Mergers, between GCC banks, offer an alternative tool to face liberalization with resulting in increased efficiency. An alternative strategy would be to liberalize the financial sector between GCC countries initially to strengthen their economic integration and opting for international liberalization once this is stable.

- Finally, although the USA banking sector is considered more liquid than those of all GCC countries – based on the liquidity criteria presented in this paper - the liquidity ratios of GCC banking sectors are still quite high and their banking sectors are viable and flexible. Nonetheless, the liquidity ratios of Bahrain's banks may need some reinforcement.

CHAPTER 5:

- This chapter reviews the existing literature regarding the proposed FTA between the EU and GCC countries. The literature is classified into two categories: political economy literature and economic analysis literature. The latter is our main focus in this study.
- Hitherto, there are only two studies measuring the economic impact of the EU-GCC FTA; PWC (2004) and Baier and Bergstrand (2004). In general, both studies showed that the proposed FTA will impact economic welfare for both parties involved. On the one hand, PWC (2004) showed that increases in economic welfare for the GCC will be around 2.7% of GDP, while it will have a negligible overall welfare effect on the EU (0.6% of GDP). On the other hand, Baier and Bergstrand (2004) results show that the proposed FTA is expected to benefit the EU with a net trade creation of $ 2.8 billion based on restricted model results ($ 28 billion based on unrestricted model results) while the GCC will undergo a net trade diversion of $ 4.3 billion based on the restricted model's results (but net trade creation of $ 27 billion based on unrestricted model results).
- Data used in both PWC and Baier and Bergstrand is up to 2001 which imposes a relevant caveat on the results credibility because, starting from January 2003, the GCC unified all of its external tariffs at 5% as their Customs Union. Therefore, trade patterns after that date have changed given the alteration in tariffs rates. Unfortunately, these changes are neither

captured in PWC nor in Baier and Bergstrand studies. Therefore, similar economic impact estimations are required with more up-to-date data.

PREAMBLE

This book sheds light on the economies of the six Gulf Cooperation Council countries (GCC). Special reference has been given to the UAE. The book contains five chapters.

The first chapter analyzes the current economic situation of the GCC countries to see how compatible they are to progress in their economic integration. We focus on the set of five monetary criteria agreed on by Gulf Arab central bankers in order to move towards the next step of the process of economic integration (i.e. Single Market and Gulf Monetary Union). The chapter shows how GCC countries can reinforce their economic integration process regarding their present economic features.

The second chapter studies more in depth one of the major steps that has been taken in the GCC economic integration process, i.e. the effect of the formation of Customs Union (CU) on their intra-trade. More specifically, the UAE with Dubai in the lead had been serving as a major entry point of goods destined to the GCC. This is primarily due to the modern port facilities, simplified procedures implemented, and efficient support services. Customs Union theory revolves around trade creation and trade diversion reactions of the participating countries. This chapter focuses on generating some indicators of these reactions of the UAE to the CU.

The third chapter constructs an aggregated GCC balance of payments out of the individual balances of payments of all GCC countries. The reasoning behind this is to analyze in depth the resulting GCC balance of payments in order to identify countries that are responsible for balance surplus/deficit, among others, and focus on underlying factors resulting into surpluses and deficits. The resulting aggregated GCC balance of payments is also compared to the EU balance of payments.

The fourth chapter analyzes specific characteristics of both GCC and USA banking sectors taking into account the potential benefits to possibly emerge from liberalization. Financial deepening and sophistication together with liquidity and profitability are amongst main factor to be examined in the banking sectors of both parties. This chapter aims at identifying GCC

banking sectors that will be more targeted by USA banks for penetration or acquisition in case of liberalizing banking sectors.

The fifth chapter presents an overview of existing literature regarding the proposed EU-GCC Free Trade Agreement (FTA). It aims mainly at interpreting the proposed FTA from the GCC viewpoint in the light of the present impact analysis. Comments on empirical methodologies applied in these studies are also provided.

Finally, the data on GCC economies is provided by many local and international sources, however, available figures from different sources are sometimes inconsistent. This might be due to different definitions, calculation methods, or access to accurate data. As a result we choose to rely on a single source of data for each of the sort of the data required in order to obtain the best possible fit. In this book, data is mainly extracted from the following sources:

- National Central Banks of GCC countries.
- UAE Ministry of Economy.
- Arab Monetary Fund (AMF)
  - Balance of Payment and External Public Debt Statistics.
- Economist Intelligence Unit (EIU) – country data database.
- International Monetary Fund (IMF):
  - Balance of Payments Statistics Yearbook (BOPs).
  - International Financial Statistics (IFS).
- US Federal Reserve Board.

CHAPTER 1. THE PATH TOWARDS GCC ECONOMIC INTEGRATION

1.1. Introduction

Many economic blocs have been established around the world despite significant social and economic disparities. Examples include European Union (EU), North American Free Trade Agreement (NAFTA), Asian Free Trade Area (AFTA), among others.

Economic blocs are usually established with a major focus on either political or economical considerations. The rising of high political differences and/or inadequate harmonization of economic policies might cause the demise of the economic integration process. Therefore, involved countries should find the best combination to ensure the success of moving from an economic integration stage to the consecutive one.

Following the desire for broadly integrated market, GCC countries have taken the first step in their long journey of economic integration by establishing a Free Trade Area in 1983. In January 2003, they implemented a Customs Union (CU) as a second stage towards a deeper economic integration. Table 1.1 includes the planned stages of economic integration between GCC countries.

GCC countries recognize that rules will not suit all countries at all times. Crutial is to have a stability pact which could be a common set of rules for every national fiscal policy committee, protecting its mandates, independence and right to set the budget balance. Therefore, they decided to increase convergence in their economies by meeting five criteria before implementing the Single Market and the Monetary Union. These are maximum level of the budget deficit, foreign reserves, public debt, interest rates and inflation. However, do the present features of GCC economies meet these five criteria? This chapter attempts to answer this question.

1.2. Quick Overview of Economic Integration Process between GCC Countries

In order to achieve economic integration, concerned countries should go through a gradual process of discrimination removal between members, and the application of coordinated and common policies on a sufficient scale to ensure that major economic and welfare objectives are met. Integration has been said to progress through eliminating trade barriers, the liberalization of factor movements, the harmonization of national economic policies, and the complete unification of these policies (Balassa, 1976). Whatever the definition used to describe economic integration, it can be taken to denote a state of affairs or a process involving attempts to combine separate national economies into larger economic regions (e.g., Bende-Nabende, 2002).

Gulf Cooperation Council countries (GCC) have decided to strengthen their economic power and increase welfare by taking advantage of commonalities in their economies and attempt to harmonize their economic policies. To do so, GCC countries have started a process of convergence to align economic integration. This process has started with the establishment of a Free Trade Area in 1983 which was followed by a Customs Union in 2003. Procedures of implementing a Single Market are now being executed to prepare the region for the Monetary Union commencement no later than 2010. Below, we present a quick overview of some main features of these stages.

1.2.1. Free Trade Area

When GCC was established in 1981, member countries agreed on two main issues: first, they set up the objectives, rules, and functions of the GCC and its structure; second, they decided on implementing gradually a unified economic agreement towards establishing an economic union. Although the path to achieve this goal is quite long and needs huge efforts by each country, members decided to take the first step: i.e., the establishment of a Free Trade Area (FTA).

The Gulf FTA was established in 1983, under which tariffs on goods of national origins are eliminated entirely, while each country will keep having its own external tariffs. However, rules of origin have to be agreed upon among members so as to determine which products can be exported duty-free. Article Three of the First Chapter in the Unified Economic Agreement

between GCC countries specifies that every item in order to enjoy exemption shall be accompanied by a certificate of origin duly authenticated by the appropriate government agency concerned. Moreover, for products of national origin to be qualified as national manufactured products, the value added ensuing from their production in member states shall not be less than 40% of their final value as at the termination of the production phase. In addition, member states citizens' share in the ownership of the producing plant shall not be less than 51%.

FTA represents a modest integration by means of an agreement to apply symmetric preferential treatment of imports and assign supporting functions and instruments to jointly operated institutions. All this should facilitate trade and investment among GCC members. The fact that FTAs only include the abolition of tariffs and quotas among members, and demand little or no economic harmonization makes them attractive. Their attractiveness is generated by the members' benefits of free trade without giving up immediately their economic independence. Indeed, most processes of economic integration around the world in the past have been limited to the FTA stage. This is the case, for instance, of the European Free Trade Association (EFTA), and many of the current multinational regional economic associations such as the North America Free Trade Area (NAFTA), the Australia and New Zealand Closer Economic Relations and Trade Agreement (ANZCERTA), or the Latin America Integration Association (LAIA).

One of the disadvantages of the FTA is that since members maintain their own tariffs and quotas vis-à-vis third parties, countries outside the area may redirect their trade and target the country with the lowest tariffs or the highest quotas in order to access the markets within the area. This problem is exacerbated as the FTA lasts for long periods without applying any further protective procedures. In order to prevent this as well as other related problems, which might lead to tensions among the members of the FTA and demise the agreement, most FTAs go beyond the simple elimination of tariffs and adopt some timid form of policy integration. However, as we mentioned earlier, GCC countries knew at the beginning that FTA was just the first step (transition period) among others to be taken later on in order to achieve the economic integration. This fact has induced GCC countries to channel their efforts since early 80's to early 90's towards reaching unified external tariffs in order to constitute the Custom Union (CU).

1.2.2. Customs Union

Ten years after the establishment of the FTA in 1983, the first fruit of the efforts of the GCC countries was obtained as they finally achieved an agreement to set Common External Tariffs (CET). In January 2003, the Customs Union (CU) was actually implemented and CET were decided to be 5% on all foreign goods imported from outside, except for the exempted commodities.[1]

The Gulf CU is a more advanced stage of economic integration. Here, the elimination of internal tariffs –under FTA– is accompanied by some common external trade restrictions and the harmonization of external tariffs. The establishment of CET implies a much greater level of institutional coordination than in the FTA. Under CU, members do not only give up their capacity to set up external tariffs, but also harmonize and make compatible other aspects of their respective national trade policies. Consequently, CU results in the creation of common regulatory bodies and institutions which control trade within the union and even implement policies that foster and regulate trade within members.

Under CU, there is no need for rules of origins given that the existence of CET makes imports into the CU face the same tariff in each member country. Hence, there is no incentive for transship of imports between members.

The Gulf CU is based on the following principles:

a. A Common External Tariffs (CET) charging a 5% duty rate on all foreign imports.[2]
b. A common customs law.
c. Unified customs regulations and rules applicable in all member countries.
d. Unification of the internal customs, financial and administrative regulations and procedures relating to importation, exportation and re-exportation in the GCC countries.

[1] The list incorporates 417 commodities to be exempted from all customs duties "taxes", in addition to the exemptions provided for in the Unified Customs Regulation of the GCC countries. Moreover, specific customs duties "taxes" imposed on tobacco and products thereof in the member countries of the Customs Union shall be 100%.

[2] However, there are some exceptions to be applied to specific categories. For more details please see Implementation Procedures for the GCC Customs Union (www.gcc-sg.org).

e. The free movement of goods among the GCC countries without customs or non-customs restrictions, while taking into consideration the implementation of the veterinary and agricultural quarantine regulations and the prohibited and restricted goods.
f. Treatment of the goods produced in any of the GCC members as national products.

The establishment of Gulf CU has many objectives. These include: 1) minimizing the difficulties and restrictions hindering the movement of the foreign and national goods in the GCC countries; 2) increasing intra-GCC trade between members; 3) increased competition, high production rates, and optimal utilization of the available resources due to the facilitation of the flow of the intra-GCC trade leading to reduced consumer prices; 4) enhancement of the collective negotiating position of the GCC members, which would bring in better conditions with their trading partners in the field of trade and investment; 5) and finally, an essential step which paves the way towards implementing the Single Market [SM].

1.2.3. Single Market

The Single Market (SM) can be considered the first stage of thorough economic integration. The main characteristic of the SM is the free movement of the key participants in the production process. In general, benefits of the SM are mainly expressed by the comparative advantage generated by changes in relative prices when barriers are removed, benefits due to reduction in monopoly rents, x-inefficiency and reaping of economies of scale.

The establishment of SM in the Gulf is dated back to 1983 when GCC countries agreed on implementing gradually a unified economic agreement towards establishing an economic union. At that time, GCC countries have determined four main areas of economic activity to be freed in order to pave the way for the establishment of the SM:

- Freedom of residence, movement and work.
- Right of ownership, inheritance and bequest.
- Freedom of exercising economic activity.
- Free movement of capital.

GCC countries agreed on executive principles to ensure that each member shall grant the citizens of all other member countries the same treatment as is granted to its own citizens without any discrimination of differentiation in the above mentioned fields. However, the agreement on these four areas was initially on general principles only, as this list will be enlarged later on. In 2002, Article Three in the New Economic Agreement contains the new extended list of economic activity areas where equality should be applied. The new list comprises of the following areas:

1. Residence and movement of GCC nationals.
2. Work in private and government sectors.
3. Social insurance and pension schemes.
4. Education, health and social services.
5. Exercise of all professions and crafts.
6. Exercise of all economic, investment and services activities.
7. Real estate ownership.
8. Movement of capital.
9. Tax treatment.
10. Incorporation and purchase and sale of shares.

The achievement of equality in all these areas is necessary in order to successfully implement the SM. Up to now, many gradual steps have been taken to apply these equalities and further steps will be taken till the Gulf SM is fully implemented no later than 2007. In fact, actual implementation differs from one area of economic activity to another. Building a SM is very fruitful especially when a Monetary Union (MU) accompanies it at a certain stage.

1.2.4. Monetary Union

According to the Unified Economic Agreement signed between the GCC countries in 2002, members shall seek to coordinate their financial, monetary and banking policies and enhance cooperation between monetary agencies and central banks, including the endeavor to establish a joint currency in order to further their desired economic integration. This statement is considered as a reference to start establishing their Monetary Union (MU).

The formation of the MU itself has both benefits and costs. On the one hand, benefits are mainly presented by the attractive characteristics of the new unified GCC market. The MU would result in a reduction in foreign exchange transaction costs, eliminate exchange rate risk, promote pricing transparency and, consequently, increase competition, thus fostering trade, investment and growth. Fiscal discipline would lead to a lower inflation and interest rate in the Gulf region. At micro level, the single currency would have a long-term impact on major regional banks by encouraging more efficient use of financial resources. The costs of hedging against exchange rate volatility would be reduced. The Gulf MU would lead to the formation of the largest and most liquid capital market in the Middle East. Portfolio managers and private investors would be able to invest in the region without any fear of additional currency risk.

On the other hand, costs of the Gulf MU are expressed by the loss of national sovereignty due to relinquishing of independent control over domestic monetary, fiscal and exchange rate policies. There also might be possible net loss in income due to lack of ability to pursue expansionary monetary and fiscal policy during periods of falling oil prices. Furthermore, the Gulf MU would involve arbitrary restrictions on national budgetary policies which could be interpreted as a breach on member countries' control over their individual taxation and public spending programs. Nevertheless, such costs are not of much significance when considering the benefits generated by the formation of the MU.

GCC countries are now in the process of setting up convergence criteria for the MU. Indeed, the adoption of the single currency is conceived as a way to enhance the MU. An important issue is addressing to which currency is the Gulf MU going to peg its new currency given that all GCC currencies are pegged to the dollar? The Gulf single currency is argued to either be pegged to the dollar or to a basket of world's leading currencies including dollar and euro. Another possibility could be not pegging the currency to any other currencies at all, thus making it float. This last option might be the best choice to reflect market values, be independent in policy making and to avoid being highly affected by the negative performance of other currencies.

1.3. How ready are GCC Countries for the Next Level of Economic Integration?

Before the joining of the Single Market and the Common Currency, and according to the previously mentioned Initial Economic Agreement, GCC members are supposed to achieve a high degree of sustainable economic convergence in order to increase their probability for success. This entailed meeting five criteria, as agreed on by Gulf Arab central bankers on March 2005 in Riyadh (Saudi Arabia): maximum level of the budget deficit, foreign reserves, public debt, interest rates and inflation. In this section, we will make a comparison between economic figures of GCC countries concerning these five criteria.

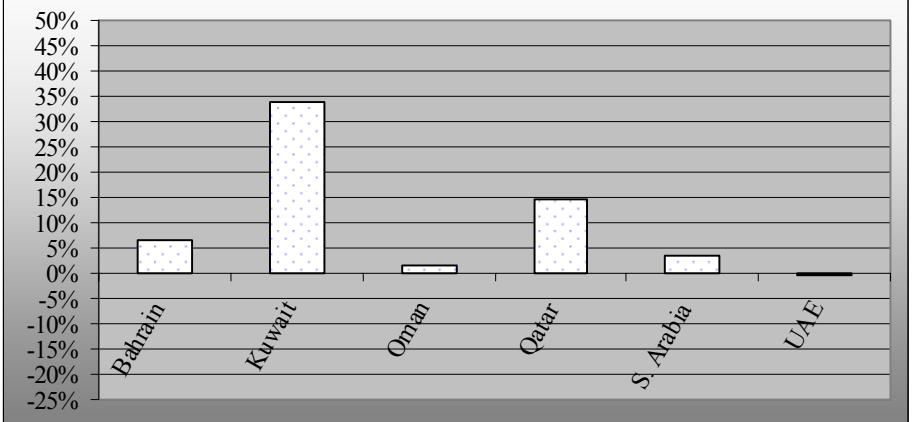
1.3.1. Budget Balance

Budget balance is the net state of the government's finances. When government spending equals revenue, the budget is said to be balanced. When spending is greater /lower than revenue, the government's budget is in deficit /surplus. Countries usually avoid excessive budget deficits given that they generally lead to more public debt and inflation.

From the arguments above, an interesting question rises: At what levels should the deficit be considered as on acceptable state? The central bankers of GCC members have limited the budget deficit to 3% of GDP in each member; the same ratio is used in the European Union. Figure 1 shows budget balance as a percentage of GDP for GCC countries in 2004.

In 2004, all GCC countries recorded a budget surplus except for the UAE. Kuwait has the highest level of budget surplus between all six countries (about 34% of GDP) while Oman was the lowest country in terms of budget surplus with about 1.5% of GDP. Surpluses of Qatar, Bahrain and Saudi Arabia were 15%, 6.6% and 3.6% of GDP, respectively. However, the UAE's budget deficit was not very excessive (about -0.4% of GDP).

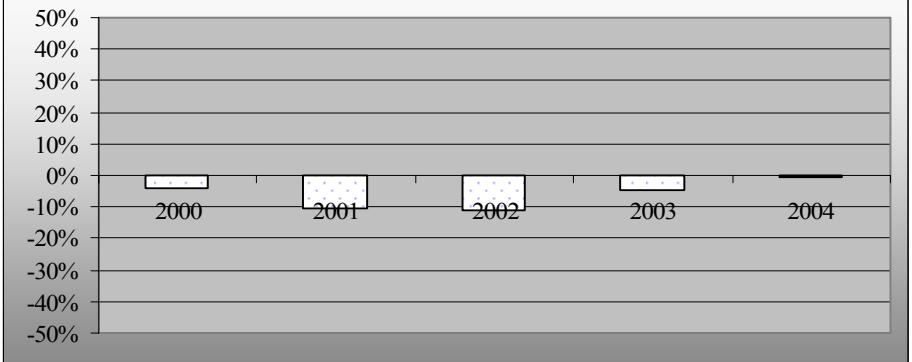
Figure 1. GCC Budget Balance (%GDP) in 2004



Source: Economist Intelligence Unit (EIU) Country Data Database

By looking at the past record of UAE's budget balance we notice that it had always recorded budget deficits during recent years (see Figure 2). Its budget deficit was declining between 2001 and 2004. Specifically, in 2001 UAE recorded a budget deficit of -11.5% (as % of GDP) and -11.2% in 2002 and -4.6% in 2003. Again, these deficits levels are not excessive especially when compared to its moderate levels of public debt in these same years as we will see later in section 1.1.3 when discussing the ratio of public debt to GDP for GCC countries.

Figure 2. UAE's Budget Balance (%GDP)



* Data of 2003 and 2004 are estimates

Source: Economist Intelligence Unit (EIU) Country Data Database

1.3.2. Foreign Reserves

Foreign reserves are the stock of foreign assets held by a government as investments, and used, where necessary in financial transactions to support the exchange rate of the domestic currency. Foreign reserves are also used for making payments in foreign currencies without the need to sell the domestic currency in the market. In general, the larger the foreign reserve, the better the country is able to engage in transactions with foreign countries.

After their last meeting in Riyadh (Saudi Arabia), Gulf Arab central bankers have decided to include foreign reserves as a criterion to go on with their economic integration process. Although the agreement on foreign reserves is not final yet, foreign reserves criterion was initially set to cover at least 4-6 months of total imports.

As we can see from Table 1.1., all GCC countries meet the foreign reserves / 4 months imports criterion except the UAE. Furthermore, when we apply the foreign reserves / 6 months criterion Bahrain also fails to meet the criterion.

Table 1: GCC Foreign Reserves and Total Imports in 2004 (billion $)

	Bahrain	**Kuwait**	**Oman**	**Qatar**	**S. Arabia**	**UAE**
Foreign Reserves	2	8	4	3	27	17
4 Months Imports	2	4	3	2	13	20
Criterion Check	YES	YES	YES	YES	YES	NO
6 Months Imports	4	7	4	3	19	31
Criterion Check	NO	YES	YES	YES	YES	NO

Source: Economist Intelligence Unit (EIU) Country Data Database

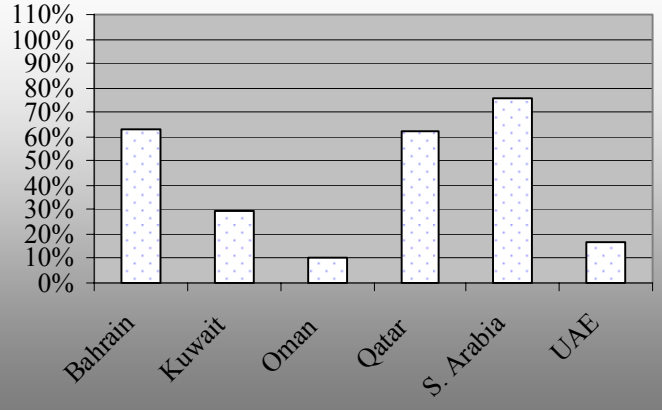
1.3.3. Public Debt

Public debt is the total of the nation's debts: debts of local, state and national governments (including public enterprises). It is an indicator of how much public spending is financed by borrowing instead of taxation. In a broader macroeconomic context for public policy, governments should seek to insure that the level of their public debt is fundamentally sustained and can be serviced under a wide range of circumstances while meeting cost and risk objectives.

Public debt managers share fiscal and monetary policy advisors' concerns that public sector indebtedness remains on a sustainable path and that a credible strategy is in place to reduce excessive levels of debt that might result in higher interest rates which could have adverse effects on real output (e.g., Alesina et al., 1992).

GCC countries have agreed to set the percentage of public debt to GDP as a criterion for entrance in Monetary Union and continuity in the economic integration process. They adopted the debt ratio enforced in the European Union (EU) as a common standard in their fiscal adjustment for the monetary union, which stipulates that the public debt must not exceed 60% of the GDP[3] while the budget deficit should be kept under control to avoid monetary intervention and subsequently, pressure on the currency. Although over the past years GCC members have sought to align their economic policies under the umbrella of the FTA, a large gap still exists among members in terms of public debt (see Figure 3).

Figure 3. GCC Public Debt (%GDP) in 2004



Source: Economist Intelligence Unit (EIU) Country Data Database

According to the above graph, we can divide GCC countries into two groups: those with high percentage of public debt to GDP and those with a moderate percentage. On the one hand, Saudi Arabia is at the top of the former group with a public debt of about 75.9% of its GDP followed by Bahrain (62.9%) and Qatar (61.8%). Considering 60% as a benchmark similar to the EU, then

[3] Although a higher ratio may be permissible in the EU if it is sufficiently diminishing.

these three countries should adapt their economic policies so they can reduce the percentage of their public debt to GDP. By looking back at past record of each country, we can see how the percentages of public debt to GDP of both Saudi Arabia and Qatar were declining (see Figures 4 and 5). Nevertheless, despite the decline from 103.8% in 2002 to 87.9% in 2003 and to 75.9% in 2004, Saudi Arabia's percentage of public debt to GDP is still considered high. Qatar also has presented a decline in its percentage of public debt to GDP from 79.8% in 2001 to 74.5% in 2002 and to 72.7% in 2003.

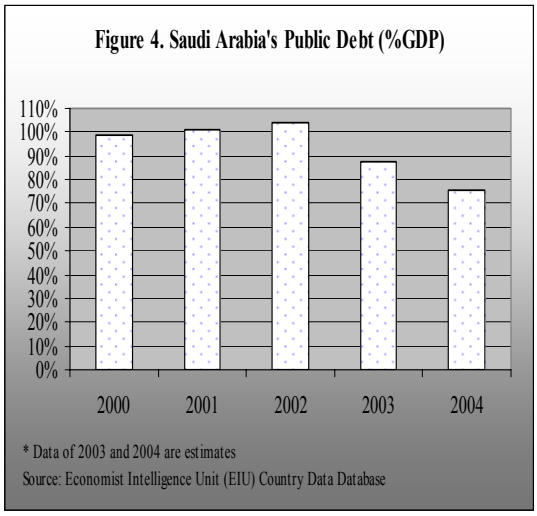


Figure 4. Saudi Arabia's Public Debt (%GDP)

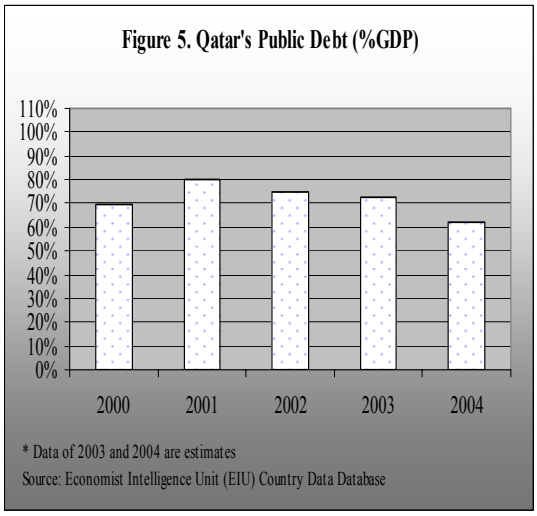
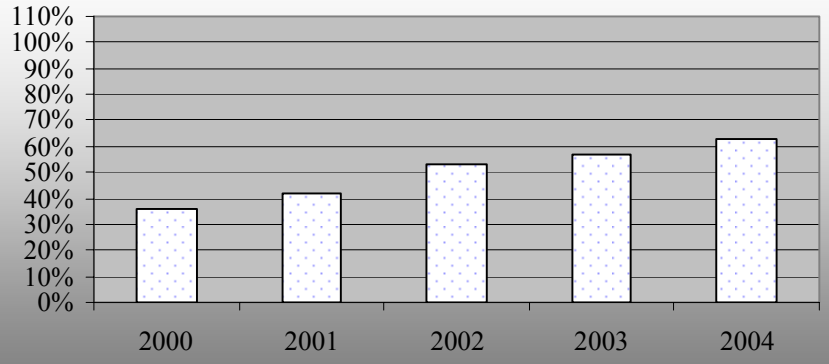


Figure 5. Qatar's Public Debt (%GDP)

Unlike Saudi Arabia and Qatar, the percentage of Bahrain's public debt to GDP was increasing and it rose above 60% recently (about 62.9% in 2004) while for the four years prior to 2004 its percentage was between 35.7% in 2000 and 56.5% in 2003 (see Figure 6). The increasing trend of Bahrain's percentage –if it continues– will not be favorable to the country if it wants to pursue its journey towards the economic integration with the other GCC members.

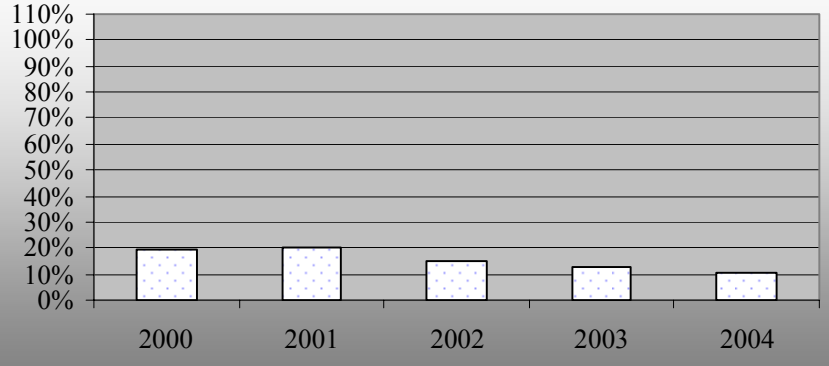
Figure 6. Bahrain's Public Debt (%GDP)



* Data of 2003 and 2004 are estimates
Source: Economist Intelligence Unit (EIU) Country Data Database

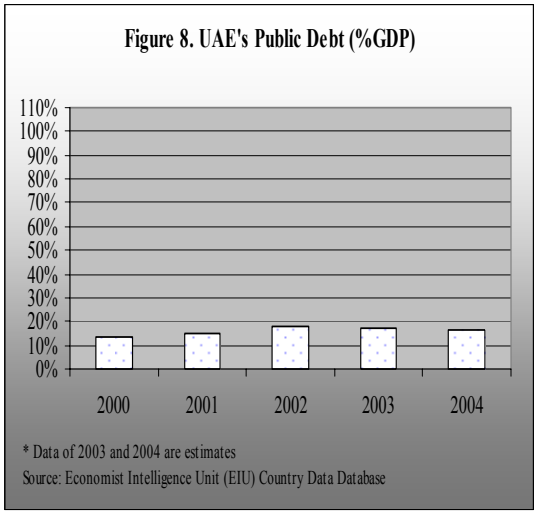
On the other hand, the second group of countries with moderate percentages of public debt to GDP comprises of Oman, UAE and Kuwait. Oman has the lowest percentage of public debt to GDP in comparison to the other two countries. In 2001, it recorded about 20.1% and this percentage has fallen to 14.6% in 2002 and to 12.7% in 2003 to end up with 10.5% in 2004, which is the lowest percentage in last recent years (see Figure 7).

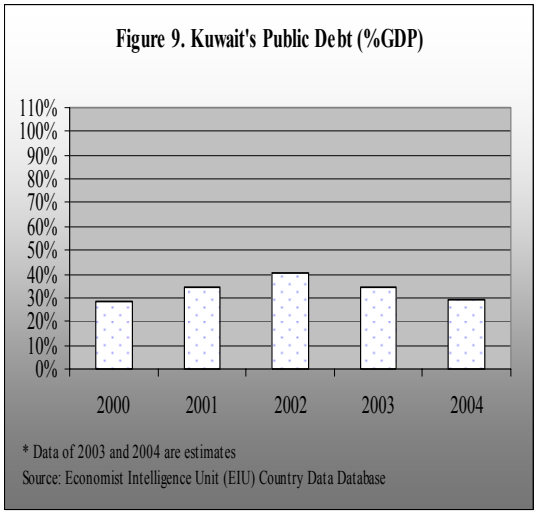
Figure 7. Oman's Public Debt (%GDP)



* Data of 2003 and 2004 are estimates
Source: Economist Intelligence Unit (EIU) Country Data Database

If Oman maintains these percentages of public debt to GDP, then it will easily be able to meet GCC criterion of having a maximum of 60% of public debt to GDP. Similarly UAE and Kuwait have low percentages of public debt to GDP 16.8% and 29.4% in 2004, respectively. The percentages of public debt to GDP of both countries were decreasing in last years. UAE had a percentage of 17.7% in 2002 and 17.5% in 2003 while Kuwait had 40.4% in 2002 and 34.4% in 2003 (see Figures 8 and 9).





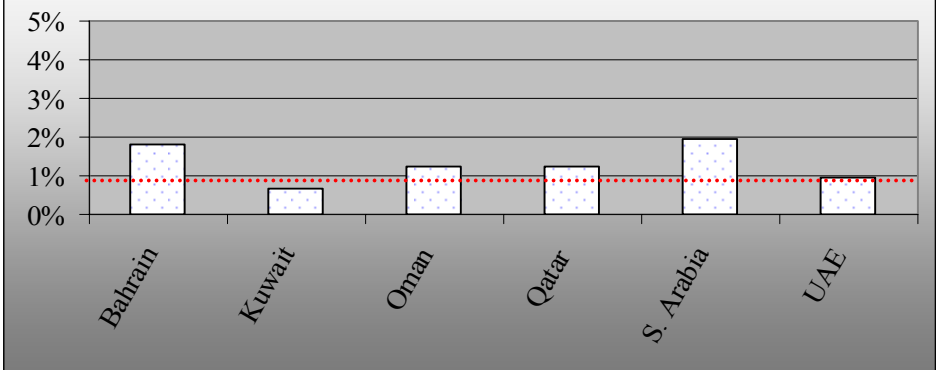
1.3.4. Interest Rates on Deposits

GCC countries are trying now to align their economic and fiscal policies in order to prepare themselves for the next level of economic integration process of Monetary Union (MU). MU will include the issue of a single currency which means that interest rates on deposits should be the same in all GCC member countries. The reason is simply that some countries will be more profitable –in terms of interest rates on deposits– than others. Given the free mobility of capital according to the GCC economic integration rules, this will make capital to be transferred from those countries with low interest rates on deposits to those with high interest rates on deposits. If for example interest rates on deposits in Saudi Arabia were higher than those in UAE, then depositors would switch from UAE to Saudi Arabia. As a consequence, either UAE rates will be forced up because of a shortage of money to lend or Saudi Arabia rates will fall down due to excess amounts to lend.

The Gulf Central Bank (GCB) must then set interest rates that suit the average of all six countries. This means that the two main ways in which a country's government or central bank controls the behavior of its own economy by varying interest rates and the value of its currency. Loss of monetary policy control causes problems of economic management which have to be dealt with somehow.

From the arguments above, we can infer that GCC countries should start reducing the differences in their interest rates on deposits. To do so, Gulf Arab central bankers stated that interest rates on deposits should not be more than the interest rates average of the lowest three countries. In 2003, the average of interest rates on deposits of the lowest three GCC countries was about 0.94%, represented by the red horizontal line in Figure 10. Note how the majority of GCC countries surpass the limit: Saudi Arabia (1.94%), Bahrain (1.81%), Oman (1.26%) and Qatar (1.23%). On the other hand, UAE equals the average while Kuwait is the sole country below it with interest rates on deposits of about 0.66%. If this situation remains as it is now, then after the implementation of the Gulf MU and the issuance of a Single Currency, we would expect some capital to be transferred from the latter two countries to the former two countries in search for higher profits.[4] This shift is quite plausible given that the difference between interest rates on deposits of 1.94% offered by Saudi Arabia and those of 0.66% offered by Kuwait is about 1.28%, which is high. This difference is almost similar to the total interest rates on deposits offered by countries like Qatar (1.23%) and Oman (1.26%).

Figure 10. GCC Interest Rates on Deposits in 2003 (annual average)



Source: National Central Banks

[4] Our assumption here is merely based on economic factors regardless of political and other factors.

1.3.5. Inflation

When economists speak of inflation as an economic problem, they generally mean a persistent upward movement in the general price level over a period of time, resulting in a decline of the purchasing power of a nation. Countries usually strive to reduce inflation due to its distorting effects because it makes planning more difficult. Inflation also changes the income distribution in society in favor of those with much capital against people with relatively fixed nominal wages. There is also a psychological cost. People simply do not like inflation and price increases. So, given that inflation is costly, countries attempt to reduce it.

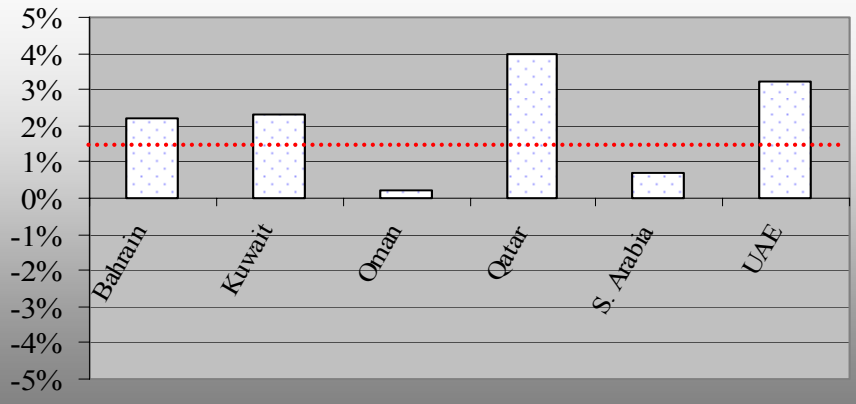
In order to reinforce their economic integration fundamentals, GCC countries agreed that there should be a criterion for inflation. According to this criterion, the inflation rate should be capped at the weighted average of the six countries plus 2%. Having similar inflation rates in GCC countries is important as it signals similarity in their structure and in the conduct of economic policies. This would be desirable for countries that would like to coordinate more their policies to strengthen their position and increase their possibilities of success in the economic integration process. In what follows, we will present recent inflation rates of the six GCC countries.

Figure 11 shows inflation rates in GCC countries in 2004. Highest inflation rates between the six members are those of Qatar and UAE (3.9% and 3.2%) followed by those of Kuwait (2.3%) and Bahrain (2.2%). The lowest inflation rates are those of Saudi Arabia (0.7%) and Oman (0.2%).[5] The weighted average of the six countries plus 2% is about 1.5%, which is represented by the red line in the figure below.[6] Thus, those countries who meet this criterion are Saudi Arabia and Oman while others do not.

[5] Countries with high inflation rates (i.e. Qatar and UAE) have more liberalized economies than those of low inflation rates (i.e. Saudi Arabia and Oman). Thus, the difference in inflation rates may be explained by difference in economic structures.

[6] Weights are calculated based on GDP of each country.

Figure 11. GCC Inflation in 2004



* Figures of 2004 are estimates
Source: Economist Intelligence Unit (EIU) Country Data Database

Finally, we notice from the previously presented sections that only one criterion is met by all GCC countries so far (i.e. budget balance).

1.4. Conclusions and Recommendations

Concerning the five criteria set by GCC countries to achieve a high degree of sustainable economic convergence in order to pursue their economic integration process, the sole criterion met by all members is budget balance while efforts should be channeled towards reinforcing the other four (i.e. foreign reserves, public debt, interest rates on deposits and inflation rate). Table A shows the criteria already met by GCC countries.

As we can see from the table, all GCC countries meet the foreign reserves / 4 months imports criterion except the UAE, while, when we apply the foreign reserves / 6 months imports criterion, Bahrain also fails to meet the criterion. Thus, these two countries should increase their level of foreign reserves to meet the criterion as the other four countries do.

Table A. Check List of GCC Countries and Five Monetary Targets

	Bahrain	Kuwait	Oman	Qatar	S. Arabia	UAE
Budget Balance	+	+	+	+	+	+
Foreign Reserves:						
- 4 months imports	+	+	+	+	+	-
- 6 months imports	-	+	+	+	+	-
Public Debt	-	+	+	-	-	+
Interest rates	-	+	-	-	-	+
Inflation	-	-	+	-	+	-

+ : Countries that meet the set criteria.

- : Countries that do not meet the set criteria.

Since indebtedness varies enormously from 10.5% of GDP in Oman to 75.9% in Saudi Arabia, it might be quite unreasonable to apply immediately the same public debt criterion to each country. GCC countries should recognize that rules will not suit all countries at all times. The important thing is to have a stability pact which could be a common set of rules for every national fiscal policy committee, protecting its mandates, independence and right to set the budget balance. For instance, each country would propose a debt target over say five years. The target would take into account the country's initial position and would have to be agreed upon by the other members of GCC. Some members (e.g. Saudi Arabia) would be expected to bring down their public debts, but some could argue that they needed to make important public investment (e.g. Oman).

For interest rates on deposits, GCC countries should start reducing differences in their rates in order to pave the way to the next step of economic integration: the implementation of the monetary union (MU). MU will include the issue of a single currency which means that interest

rates on deposits should be the same in all GCC countries. Therefore, members should align their interest rates on deposits to avoid that some countries be more profitable than others.

The inflation rate criterion is only met by two countries (i.e. Oman and Saudi Arabia). Therefore, the other four countries should adopt their policies so they complete the limit set by Gulf Arab central bankers. Highest inflation rates between the six members are those of Qatar and UAE (3.9% and 3.2%). These two countries have inflation rates above the double limit set by central bankers (i.e. weighted average of the six countries plus 2% which is about 1.5%). These relatively high inflation rates might be explained by the more liberalized economies of these countries compared to less liberalized economies with lower inflation rates of countries such as Saudi Arabia and Oman.

CHAPTER 2. IMPLICATIONS OF CUSTOMS UNION ON UAE TRADE WITH GCC

2.1. Introduction

Market integration is seen as the road to free movement of capital, labor, goods and services, as exemplified by the European Union experience.

GCC member countries laid down a comprehensive framework for economic cooperation, as manifested in the Unified Economic Agreement ratified in 1981. This paved the way for setting up a free trade zone in 1983, granting tariff exemptions to goods of national origin.

The Riyadh summit in 1999 approved the second stage of economic integration by setting up a Customs Union (CU) effective January 2003. The main features of CU are the unification of customs laws and procedures, single point-of-entry with internally free movement of goods, and treatment of goods as national origin within the GCC.

The December 2001 Summit formally adopted an across-the-board external tariff of five percent for most products to start in January 2003. As early as 2002, GCC Countries had moved towards a general 5% tariff, with their respective lists of exemptions. However, agreements on exemptions, standards and revenue distribution have not been finalized.

The UAE, with Dubai in the lead, had been serving as a major entry point of goods destined to the GCC. This is primarily due to the modern port facilities, the implemented simplified procedures, and the efficient support services.

2.2 Related studies

Researchers on customs union attributes the origin of the development of customs union theory to the pioneering works of Jacob Viner in his 1950[7] work showing that benefits of participating countries depend on whether it would lead to trade creation or trade diversion (See also LIoyd and Maclaren, 2004, Baghwati and Panagariya, 1996, Siu-Hung Yu et al., 1975, Cooper and

[7] Viner, Jacob, *The Customs Union Issue.* 1950.

Massel, 1969,). Criticisms posed by Lipsey and Gehrels (Kraus, 1972) which became the foundation for much of subsequent work, were based on the argument that Viner's formulation ignored inter-commodity substitution (or consumption effects) and terms-of-trade effects. Siu Hung Yu went to the extent of showing that mathematically in the presence of domestic distortion; trade diversion could still lead to welfare improvement.

Loehr (1975), however, pointed out that Lipsey's formulation had been limited in terms of the assumptions on distribution of pre-tariff revenues. Extending the formulation to a more generalized case, Loehr showed that, in the short run, countries using tariff proceeds for investment purposes had increased possibilities of trade-diverting welfare-improving customs union. However, he pointed out that declining tariff proceeds would eventually lead to drying up of a source of domestic investment.

Frankel, et. al. (1996) evaluated the trade-off between trade creation and trade diversion in the context of a geographic variable – transportation costs between regions. Simulations showed that moderate improvement in economic welfare from regional trading arrangements could be attainable at external liberalization of 25 percent of internal level.

GCC Customs Union has been in effect only since January 2003, and it is, to a certain extent, premature to measure its full impact on intra-trade in the region. Nonetheless, some comparative analysis between levels and patterns between the periods before and after the CU could show some changes that could be linked to its implementation.

Apart from the features of the agreement and the implementing guidelines, literatures on the impact of the Customs Unification of the GCC on the intra-trade in the region are still very few and inconclusive. Although the study conducted by Rettab and Istaitieh (2005) noted an increase in total trade between Dubai and the other GCC Member States, a worsening of Dubai trade balance was also noted. While the former could be interpreted as an indication of market expansion, the latter could indicate increasing tendency of the other GCC member countries to import directly; thus, declining reliance on Dubai.

A succeeding study conducted by Rettab and Morada (2005) on UAE data for 2003 likewise indicated improvements in trade performance of UAE in the GCC market during the ex-post CU

period. This study extends analysis to 2005 taking into consideration recorded impact of GCC customs union on trade levels, structure and trade performance.

2.3. Trade levels, structure and performance, 2000 - 2004

2.3.1. UAE's trade patterns

In 2004, UAE total imports reached AED 203 billions, recording an increase of 37.3 percent from 2003 and an annual average growth of 19.9 percent during the period 2000 – 2004 (Table 1). Imports from GCC countries and Non-GCC countries both grew at an annual average rate of 19.9 percent.

Imports from GCC countries accounted for about 4.5 percent of UAE's imports, growing from AED 4.5 billion in 2000 to AED 9.4 billion in 2004. However, a slowing down may be noted in 2003, when growth rate dropped to only 11.4 percent, before accelerating again by 25.8 percent in 2004 to reach a total value of AED 9.4 billion. On the other hand, imports from Non-GCC countries slowed down in 2002 to 8.6 percent, before accelerating by 21.1 percent in 2003 and by 37.9 percent in 2004 to reach a value of AED 193.5 billion.

UAE's exports to the world had been on increasing rate, from only 5.5 percent in 2001 to 37.9 percent in 2004, for an annual average of 20.2 percent. This observation could be noted for Non-GCC countries, but at higher rates. Exports to Non-GCC countries grew from AED 6.2 billion to AED 12.4 billion, or at an average rate of 20.3 percent per annum. On the other hand, exports to GCC countries had been accelerating until 2002 when annual growth was posted at 55.8 percent. Slowing down was noted in 2003 when annual rate of increase fell to 29.0 percent. In 2004, however, a very slight decline in the value was recorded for an annual rate of decline of 2.7 percent to reach AED 2.3 billion in 2004.

Annual value of re-exports of UAE to the world nearly tripled in a period of five years, from AED 26.1 billion in 2000 to AED 69.5 billion in 2004, or for an annual average growth of 27.9 percent. However, a slight slowing down could be noted in 2003, when the recorded growth rate of 23.3 percent was about 7.55 percentage points lower than the growth of 30.8 percent in the previous year, but in 2004 it increased to 37.1 percent.

The GCC countries had been the major market for UAE's re-exports absorbing 24 percent of total re-exports in 2000. However, a declining share could be noted annually, so that by 2004, the share has dropped considerably to only 9.4 percent. In fact, the value recorded for 2004 represented a decline of 11 percent from the value posted in 2003.

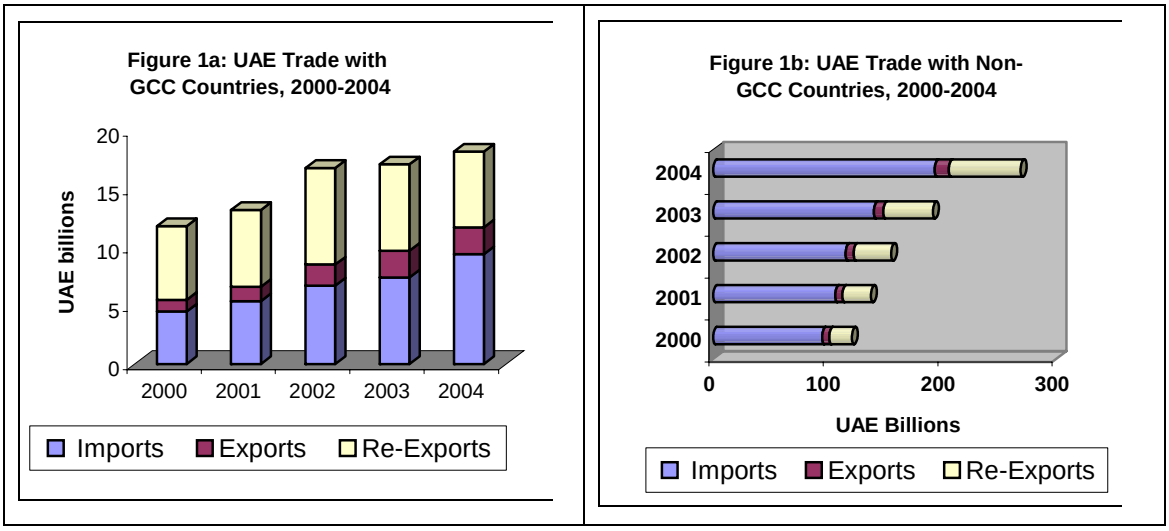
Table 1. UAE's non-oil foreign trade, 2000 - 2004

Trade Flow	Partner	Value (AED billion)					Ave. Annual Growth* (%)
		2000	2001	2002	2003	2004	
Import	World	99.9	112.2	122.6	147.8	202.9	19.9
	GCC - Value	4.5	5.4	6.7	7.4	9.4	19.9
	%	4.5	4.8	5.4	5.0	4.6	
	Non-GCC	95.3	106.7	115.9	140.3	193.5	19.9
Export	World	7.1	7.5	8.6	10.6	14.6	20.2
	GCC - Value	1.0	1.2	1.8	2.3	2.3	24.7
	%	13.9	15.3	20.8	21.9	15.5	
	Non-GCC	6.2	6.4	6.9	8.3	12.4	20.3
Re-export	World	26.1	31.4	41.1	50.7	69.5	27.9
	GCC - Value	6.3	6.6	8.3	7.4	6.5	2.1
	%	24.1	21.0	20.1	14.5	9.4	
	Non-GCC	19.8	24.8	32.9	43.3	63.0	33.7
Total	World	133.1	151.2	172.4	209.1	287.0	21.5
	GCC - Value	11.8	13.2	16.7	17.1	18.2	11.7
	%	8.9	8.7	9.7	8.2	6.3	
	Non-GCC	121.3	138.0	155.6	192.0	268.9	22.5

Source of data for the calculations: Ministry of Economy

** - Computed as simple average of annual rates of change, using the actual values*

Figures 1a and 1b show the differentials in the structure of UAE's trade with GCC and with non-GCC countries. Trade with non-GCC countries had been dominated by imports, while exports had been very small. Although re-exports had not been very substantial compared to imports, the value had been increasing. On the other hand, re-exports accounted for more than half of UAE's total trade with GCC in 2000 and 2001, while imports had a share of less than 40 percent; and exports, about 10 percent, in 2003, however, the share of exports had fallen to about 16 percent. With share of imports relatively stable at less than 40 percent, the share of re-exports had gone down to a little less than half by 2004.



Source: Ministry of Economy, UAE

UAE's total trade with the world had been increasing from 2000 to 2004, at an accelerating rate. From 2000 to 2002, average annual growth was 10.8 percent, while the corresponding rate for the period 2002 to 2004 was 28.9 percent. Meanwhile, export was growing at respective period rates of 10.2 and 29 percent; and re-exports, 25.6 and 30.2 percent.

By region, however, the accelerating pace of imports, exports and re-exports had been primarily due to trade with non-GCC countries, since the relative share of intra-GCC trade had been very small. Annual growth rates of all trade flows with non-GCC countries were higher during the ex-post period.

As shown in the table, all trade flows with GCC countries were increasing faster during the earlier period. Imports from GCC countries posted an annual increase of 22.0 percent during the ex-ante period, while in the ex-post period, annual growth declined to 18.7 percent. Growth of exports were 35.0 and 13.9 percent in respective periods; while re-export's grew by 15.3 percent during the ex-ante period, but registered a decline of 11.5 percent in actual value during the ex-post period.

Tests of significance showed that the differences in the levels during the two periods were significant; i.e., there had been slowing down of trade between the UAE and GCC Member States.

Table 2. UAE's trade with GCC and Non-GCC countries, 2000 - 2004

Trade Flow	Partner	Value (AED billion)					Average Annual Growth (%)	
		2000	2001	2002	2003	2004	2000-2002	2003-2004
Import	World	99.9	112.2	122.6	147.8	202.9	10.8	28.9
	GCC	4.5	5.4	6.7	7.4	9.4	22.0	18.7
	Non-GCC	95.4	105.8	115.9	140.4	193.5	10.2	29.5
Export	World	7.1	7.5	8.7	10.6	14.6	10.8	29.8
	GCC	1	1.2	1.8	2.3	2.3	35.0	13.9
	Non-GCC	6.1	6.3	6.9	8.3	12.3	6.4	34.2
Re-export	World	26.1	31.4	41.1	50.7	69.5	25.6	30.2
	GCC	6.3	6.6	8.3	7.4	6.5	15.3	-11.5
	Non-GCC	19.8	24.8	32.8	43.3	63	28.8	38.8
Total	World	133.1	151.1	172.4	209.1	287	13.8	29.3
	GCC	11.8	13.2	16.7	17.1	18.2	19.2	4.4
	Non-GCC	121.3	137.9	155.7	192	268.8	13.3	31.7

Source of data for the calculations: UAE Ministry of Economy

2.3.2. UAE's trade performance

One important dimension to market expansion is diversification. Thus, despite slower growth, performance may actually improve due to expansion of product coverage; i.e., more diversified trade. This is an aspect of trade that is generally ignored when movement of the aggregate value is the sole basis for evaluating performance.

Performance scores computed using the proposed methodology (see Appendix I) appears to negate the declining pattern gleaned from trends in the value of UAE's trade with GCC. Performance score of UAE's trade with GCC were all positive (Table 3). In addition, they were higher during the ex-post period, except for imports, which posted a very high performance score during the ex-ante period owing to a surge in imports of cereals in 2001 to AED 198 million, from only AED 183 thousand in 2000. The value continued to increase to AED 872 million in 2002, before dropping to AED 559 thousand in 2003 and remaining at the same level in 2004. Removing the products from the basket led to a much lower performance score of 50.5 for the ex-ante period, comparable to the ex-post performance score of 54.8.

Table 3. Performance score of UAE's trade by partner, Ex-Ante/Ex-Post CU periods

Flow	Partner	2001	2002	2003	2004	Ex-Ante	Ex-Post
Import	GCC	4,000.1	71.0	52.1	57.6	2,035.5	54.8
	Non-GCC	26.9	11.0	25.9	51.4	19.0	38.7
Export	GCC	138.4	354.6	428.3	1,394.7	246.5	911.5
	Non-GCC	94.8	59.2	286.0	27,497.2	77.0	13,891.6
Re-export	GCC	140.3	48.9	371.8	48.7	94.6	210.3
	Non-GCC	51.3	344.2	45.4	63.0	197.7	54.2

Non-GCC countries supplied much of UAE's imports. Table 3 shows that UAE's import performance in non-GCC countries continued to improve. By product, major contributions to the import performance were from improvements in imports of construction materials (cement and non-metallic mineral products and metal products) and of products that comprise of UAE's major re-exports. Specifically, import performance scores in non-GCC countries for machinery, electrical and electronic equipment, vehicles and aircrafts during the ex-post period were higher by about 2 points than their corresponding performance scores during the ex-ante period.

The significant increase in the total performance score for exports to GCC for the ex-post period to 911.5 from 246.5 a year earlier was a product of diversification of product composition of UAE's exports to GCC. Significant expansion was recorded during the ex-post period in the exports of meat; fish and other marine products; plants and cut flowers; vegetables and root crops; coffee, tea, mate and spices; cereals and cocoa and cocoa preparations.

Re-exports during the ex-post period suffered a set-back as price of gold soared in the world market. A shift in market from GCC to India for semi-precious/precious stones and metals and jewelry led to a drop in performance score of the product group from 55.3 during the ex-ante period to only 0.7 during the ex-post period. However, diversification of product composition of re-exports pulled the overall performance score from 94.6 to 210.3. Products that performed well during the ex-post period were cereals; meat and fish preparations; petroleum products; cork and articles of cork; knitted/crocheted garments and clothing

accessories; articles of iron and steel; tin and articles of tin; vehicles; and ship, boats and floating structures. Although machinery and electrical and electronic equipment remained to be the major re-exports of UAE to GCC, there was no significant change in the level and pattern of trade; thus, leading to low performance score for the product group.

Improvements in import performance in Non-GCC countries and declining re-export performance were not considerable. However, it was export performance which had increased substantially. Looking at the product composition of exports, however, this phenomenal increase could be attributed mostly to export of vegetables, roots and tubers, which increased from just more than AED half a million to almost AED 1.5 billion in 2004, for an annual increase of 216,674 percent. Other products with significant contribution to the higher export performance score of UAE in Non-GCC markets were semi-precious/precious stones and metal and jewelry; oil seeds and oleaginous fruits, seeds and fruits, medicinal plants and straw fodder; and foodstuffs.

The significant jumps in trade performances are indicative of the sensitivity of the nature of the UAE's trade structure and composition. The UAE is characterized as an open market, highly sensitive for emerging opportunities in the world market and highly flexible and coherent with ups and downs.

2.3.3. Measuring performance score at Dubai level[8]

The long trading tradition of Dubai coupled with its modern and efficient ports and airports and trading support services, made Dubai the trading hub in the region. Dubai's non-oil foreign trade makes up more than 70 percent of UAE's non-oil trade with the rest of the world. Specifically, more than 80 percent of UAE's re-exports are from Dubai. Availability of data on Dubai trade for 2005 allowed for detailed analysis at product and trading partner levels. Thus, Dubai's 2005 foreign trade statistics are used here to extend the analysis of trade performance, shedding further light into the trade synergies between the UAE and the other GCC members.

[8] At the time the paper is being prepared, data for UAE for 2005 were not yet available.

Has implementation of the CU affected the trading pattern of Dubai with the GCC and with the rest of the world?

Table 4a shows that performance score of Dubai's imports from GCC increased from 5.93 percent in 2004 to 11.15 percent in 2005, or a 5.22 percentage point increase. By country, imports from Saudi Arabia showed the highest score of 13.03 percent, followed by Bahrain at 6.31 percent. Imports from Kuwait, Oman and Qatar were performing poorly as they were negative. In 2005, imports from Bahrain improved, for the largest score of 8.87 percent, followed by Saudi Arabia, at 4.33 percent. Imports from the other three countries remained negative, though improving. The scores showed that the GCC was not a very attractive import market for Dubai.

Table 4a. Dubai's import performance score in the GCC by country, 2004 & 2005

CTRY	2004		2005	
	Growth	Score	Growth	Import
BAHRAIN	22.25	6.31	27.31	8.87
KUWAIT	-41.26	-4.87	-5.41	-0.54
OMAN	-52.82	-0.53	-23.84	-0.16
QATAR	-11.06	-0.56	-3.16	-0.14
SAUDI ARABIA	24.21	13.03	8.26	4.33
GCC		**5.93**		**11.15**

By product, Table 4b shows that Dubai's primary imports from the GCC are precious/semi-precious stones and metal and jewelry items, with a score of 8.99, followed by iron and steel (7.80), miscellaneous articles of base metals (1.32), miscellaneous chemical products (1.02) and plastics and plastic articles (0.96).

Table 4b. Highest product-level import performance scores, 2004 & 2005

Product Code	Product - Description	2004	2005
71	Natural or cultured pearls, precious or semi-precious stones, precious metals, metals clad with precious metal and articles thereof; imitation jewellery; coin.	0.22	8.99
72	Iron and steel.	-0.03	7.80
83	Miscellaneous articles of base metal.	-0.04	1.32
38	Miscellaneous chemical products.	0.04	1.02
39	Plastics and articles thereof.	1.98	0.96
Sum (Highest performance scores)		**2.16**	**20.09**
Total Import Performance Score		**5.93**	**11.15**

In contrast, the GCC is a primary market as far as Dubai's total exports[9] are concerned. Table 5a shows that marked improvements were seen in 2005, when exports of Dubai to all the GCC countries improved significantly leading to positive performance scores. Export performance score was highest in Saudi Arabia at 21.07, from only 3.41 a year earlier. Performance score also improved to 12.93 in Kuwait, from a negative score of 2.74; and 9.39 in Qatar from only 1.21. Performance scores in Bahrain and Oman were lowest at 4.76 and 1.40, respectively. However, respective performance scores in these two countries a year earlier were much lower at 0.93 and -1.06.

Table 5a. Dubai's export performance score in the GCC by country, 2004 & 2005

CTRY	2004		2005	
	Growth	Score	Growth	Score
BAHRAIN	7.67	0.93	41.37	4.76
KUWAIT	-11.91	-2.74	54.22	12.93
OMAN	-15.81	-1.06	24.91	1.40
QATAR	9.98	1.21	68.31	9.39
SAUDI ARABIA	7.40	3.41	46.53	21.07
GCC		**0.77**		**48.87**

Table 5b shows a diversified product composition of Dubai's exports. The export products with the highest performance score were precious/semi-precious stones and metal and

[9] Data for Dubai includes trade of Dubai and its free zones. Since data for the free zones do not differentiate between exports and re-exports, 'exports' in this section refers to both exports and re-exports, with re-exports constituting more than 80 percent of the total.

jewelry items with 21.78; followed by electrical and electronic machinery and parts, with a score of 13.09; printed products, 7.99; articles of iron and steel, 5.20; machinery and mechanical appliances and parts, 5.14; vehicles, 4.63; ships, boats and floating structures, 3.01.

Total performance score for products with performance scores higher than 0.5 was 74.13.

Table 5b. Highest product-level export performance scores, 2004 & 2005

Product Code - Description		2004	2005
71	Natural or cultured pearls, precious or semi-precious stones, precious metals, metals clad with precious metal and articles thereof; imitation jewellery; coin.	-0.84	21.78
85	Electrical machinery and equipment and parts thereof; sound recorders and reproducers, television image and sound recorders and reproducers, and parts and accessories of such articles.	2.25	13.09
49	Printed books, newspapers, pictures and other products of the printing industry; manuscripts, typescripts and plans.	0.12	7.99
73	Articles of iron or steel.	1.52	5.20
84	Nuclear reactors, boilers, machinery and mechanical appliances; parts thereof.	1.42	5.14
87	Vehicles other than railway or tramway rolling-stock, and parts and accessories thereof.	1.66	4.63
89	Ships, boats and floating structures.	-0.03	3.01
61	Articles of apparel and clothing accessories, knitted or crocheted.	-0.40	1.94
72	Iron and steel.	0.31	1.79
37	Photographic or cinematographic goods.	0.20	1.75
44	Wood and articles of wood; wood charcoal.	-0.04	1.37
12	Oil seeds and oleaginous fruits; miscellaneous grains, seeds and fruit; industrial or medicinal plants; straw and fodder.	0.01	0.91
26	Ores, slag and ash.	0.14	0.73
39	Plastics and articles thereof.	0.05	0.70
33	Essential oils and resinoids; perfumery, cosmetic or toilet preparations.	-0.08	0.69
94	Furniture; bedding, mattresses, mattress supports, cushions and similar stuffed furnishings; lamps and lighting fittings, not elsewhere specified or included; illuminated signs, illuminated name-plates and the like; prefabricated buildings.	0.01	0.61
21	Miscellaneous edible preparations.	0.03	0.60
15	Animal or vegetable fats and oils and their cleavage products; prepared edible fats; animal or vegetable waxes.	-0.06	0.60
91	Clocks and watches and parts thereof.	0.10	0.57
20	Preparations of vegetables, fruit, nuts or other parts of plants.	-0.08	0.53
32	Tanning or dyeing extracts; tannins and their derivatives; dyes, pigments and other colouring matter; paints and varnishes; putty and other mastics; inks.	-0.23	0.52
Sum (Highest performance scores)		**6.07**	**74.13**
Total Export Performance Score		**0.77**	**48.87**

The increasing tendency of Dubai to maximize its re-export advantage by sourcing its imports directly from producing countries could be gleaned in Table 6a. Dubai's leading re-exports are electronic equipments. The table shows that highest performance score was noted for Finland, the leading manufacturer of mobile phones and other similar electronic gadgets. In second place was Jamaica with a score of 11.70 owing to a large volume of aluminum oxide imports in 2005. Jamaica is one of the world's leading producers of alumina.

The remaining countries in the top 15 list are producers of major imports and re-exports of Dubai. Total performance score for these countries in 2005 reached 57.51. Total performance score for non-GCC countries during the year was 62.81, a marked improvement from 50.14 posted in 2004.

Table 6a. Highest country-level import performance scores, 2005

PARTNER	2004	2005
Finland	2.90	22.61
Jamaica	0.00	11.70
UK	2.82	3.96
China	4.90	3.71
India	7.74	3.31
USA	2.36	3.20
Germany	1.65	2.31
Belgium	1.07	1.83
Japan	2.16	0.94
Hungary	2.02	0.90
Turley	0.95	0.78
Singapore	0.20	0.66
South Korea	1.13	0.56
Malaysia	1.04	0.52
Russia	1.53	0.50
Sum (Top scores)	**32.48**	**57.51**
Total Import Performance Score	**50.14**	**62.81**

Expansion of Dubai's exports is not limited to the GCC countries. In fact, the performance score for Dubai's exports to non-GCC countries in 2005 was higher at 75.60 in 2004 and 77.78 in 2005. Topping the list of countries where export performance scores with Dubai were high was the Netherlands, primarily due to large shipments of mobile phones and other cordless telephone sets for line telephony. The majority of the shipments were from the free zones. The same products were also the main exports to the following European countries in the list – Luxembourg, Sweden, Denmark, Germany, and Hungary.

Exports to Switzerland and Belgium were unset (or loose) diamonds. The same products topped exports to USA and India. Top exports to Iraq were cigarettes, and to Pakistan, gold ingots. The Middle East and neighboring countries are Dubai's markets for electronics and vehicles.

Winning import products in Dubai's import market that originated from non-GCC countries are presented in Table 6a. Topping the list, with a score of 14.61 was the group of electrical and electronic machinery and equipments and parts and accessories. A slump in trade of gold as gold prices soared in the international market led to a decline in the performance of gold from the top position in 2004 to the second, with a score of 7.77. Other products with a score of at least 1.0 were machinery and mechanical appliances and parts, with a score of 3.63; vehicles, 1.98; iron and steel, 1.45; and articles of iron and steel, 1.37.

Table 8 presents the exports winners of Dubai. As expected, Dubai's top imports are also Dubai's top exports, with performance scores of 26.27. Even assuming a mark-up of 10 percent on the price of re-exports, export-import ratios still exceeded AED 59 of exports to AED 100 of imports; thus, implying that domestic demand was secondary to re-exports as basis for imports.

Precious/semi-precious stones and metals and jewelry managed to remain in second place despite the slump in the trade of gold, on the basis of the strength in the trade of diamonds. Export-import ratios for the other products in the list were likewise relatively high, suggesting that the products had been imported for re-exports or as raw materials for manufacturing of products, a large part of which are for export markets.

Table 6b. Highest product-level import performance scores, 2004 & 2005

Product		2004	2005
Code	Description		
85	Electrical machinery and equipment and parts thereof; sound recorders and reproducers, television image and sound recorders and reproducers, and parts and accessories of such articles.	8.35	14.61
71	Natural or cultured pearls, precious or semi-precious stones, precious metals, metals clad with precious metal and articles thereof; imitation jewellery; coin.	14.69	7.77
84	Nuclear reactors, boilers, machinery and mechanical appliances; parts thereof.	3.92	3.63
87	Vehicles other than railway or tramway rolling-stock, and parts and accessories thereof.	2.44	1.98
72	Iron and steel.	2.45	1.45
73	Articles of iron or steel.	1.30	1.37
97	Works of art, collectors' pieces and antiques.	0.01	0.51
88	Aircraft, spacecraft, and parts thereof.	-0.47	0.39
40	Rubber and articles thereof.	0.48	0.38
90	Optical, photographic, cinematographic, measuring, checking, precision, medical or surgical instruments and apparatus; parts and accessories thereof.	0.32	0.35
33	Essential oils and resinoids; perfumery, cosmetic or toilet preparations.	0.32	0.34
39	Plastics and articles thereof.	0.53	0.31
89	Ships, boats and floating structures.	0.05	0.29
29	Organic chemicals.	0.40	0.24
61	Articles of apparel and clothing accessories, knitted or crocheted.	0.37	0.24
27	Mineral fuels, mineral oils and products of their distillation; bituminous substances; mineral waxes.	0.00	0.23
94	Furniture; bedding, mattresses, mattress supports, cushions and similar stuffed furnishings; lamps and lighting fittings, not elsewhere specified or included; illuminated signs, illuminated name-plates and the like; prefabricated buildings.	0.50	0.22
70	Glass and glassware.	0.28	0.20
Sum (Highest performance scores)		**35.93**	**34.49**
Total Import Performance Score		**50.14**	**62.81**

Table 8. Highest product-level export performance scores, 2004 & 2005

Product		2004	2005
Code	Description		
85	Electrical machinery and equipment and parts thereof; sound recorders and reproducers, television image and sound recorders and reproducers, and parts and accessories of such articles.	10.89	26.27
71	Natural or cultured pearls, precious or semi-precious stones, precious metals, metals clad with precious metal and articles thereof; imitation jewellery; coin.	35.41	8.85
97	Works of art, collectors' pieces and antiques.	0.01	4.29
84	Nuclear reactors, boilers, machinery and mechanical appliances; parts thereof.	4.06	2.26
87	Vehicles other than railway or tramway rolling-stock, and parts and accessories thereof.	2.06	2.16
17	Sugars and sugar confectionery.	0.12	1.05
79	Zinc and articles thereof.	0.13	0.58
49	Printed books, newspapers, pictures and other products of the printing industry; manuscripts, typescripts and plans.	0.12	0.57
27	Mineral fuels, mineral oils and products of their distillation; bituminous substances; mineral waxes.	0.16	0.54
73	Articles of iron or steel.	0.18	0.52
90	Optical, photographic, cinematographic, measuring, checking, precision, medical or surgical instruments and apparatus; parts and accessories thereof.	0.74	0.43
24	Tobacco and manufactured tobacco substitutes.	0.08	0.41
39	Plastics and articles thereof.	0.61	0.32
40	Rubber and articles thereof.	0.62	0.30
70	Glass and glassware.	0.75	0.28
29	Organic chemicals.	0.59	0.28
32	Tanning or dyeing extracts; tannins and their derivatives; dyes, pigments and other colouring matter; paints and varnishes; putty and other mastics; inks.	0.11	0.27
74	Copper and articles thereof.	-0.12	0.21
Sum (Highest performance scores)		**56.51**	**49.60**
Total Export Performance Score		**75.60**	**77.78**

2.4. Summary

The value of trade of the UAE and of Dubai with other GCC countries appears not to have responded positively with the implementation of the Customs Union. However, performance scores were positive, indicating improvements in the trade of minor products and the expansion of trade with other member countries that had not been very active before (as is the case of Oman and Qatar). This implies trade creation, which in customs union theory was espoused by Viner, leads to increasing welfare from the customs union. Detailed analysis of the sources of the changes, however, indicated that they resulted from sudden changes that were temporal; in sum, reflecting more the UAE's response to global market opportunities than as response to CU.

It is important to note the lack of evidence of trade diversion. In contrast, there has been a growing tendency for Dubai to import products for re-exports and raw materials for large scale production directly from major producers; thus, taking advantage of lower prices which could improve the competitiveness of Dubai's exports and re-exports in their destination markets.

It must be noted that the non-oil manufacturing sectors of the Middle Eastern countries are small, owing to a lack of strong agricultural and mining sectors to support the industries' requirements for raw materials. Thus, it is not surprising to find no evidence of significant trade diversion from the major producing countries to customs union member countries. Instead, the UAE appears to move towards trade efficiency in conjuncture and consistency with theory on comparative advantage.

CHAPTER 3. GCC COUNTRIES BALANCES OF PAYMENTS: COMPARATIVE STUDY

3.1. Introduction

The balance of payments (BOP) can be used as an indicator of economic and political stability. It measures the payments that flow between any individual country and all other countries. The BOP is used to summarize all international economic transactions for that country during a specific time period, usually a year. The BOP is determined by the country's exports and imports of goods, services, and financial capital, as well as financial transfers. It reflects all payments and liabilities to foreigners (debits) and all payments and obligations received from foreigners (credits). A negative balance of payments means that more money is flowing out of the country than coming in, and vice versa.

The Gulf Cooperation Council (GCC) members have already concluded the free trade area (FTA) and the Customs Union (CU) steps as part of their economic integration process. They are approaching the single market and common currency stages. All this stresses the importance of having a closer look at the BOPs of the GCC countries.

3.2 Individual GCC Balances of Payments

In this section, we will discuss the BOP of each GCC country in order to highlight their main characteristics as well as identify major factors behind existing surplus/deficit.

3.2.1. Bahrain

Bahrain’s BOP recorded a surplus of US$ 158 million in 2004, which is more than triple the modest surplus of 2003 (US$ 43.9 million). As shown in the table below, the BOP surplus of 2004 is the highest surplus over the last four years. In years 2002-2003, the BOP surplus was the nearest to its equilibrium point during 2000-2004.

Table 1: Bahrain Balance of Payments during 2000-2004 (US$ Millions)

		2000	2001	2002	2003	2004
A. Current Account		**830.1**	**226.9**	**-50.5**	**201.1**	**415.4**
Goods:	Exports f.o.b.	6,242.6	5,657.2	5,887.2	6,721.0	7,620.7
	Imports f.o.b.	-4,393.6	-4,047.3	-4,697.3	-5,319.1	-6,135.4
Balance on Goods		1,848.9	1,609.8	1,189.9	1,401.9	1,485.9
Balance on Services & Income		-28.7	-118.9	-383.5	-118.6	50.0
Balance on Goods, Services & Income		1,820.2	1,491.0	806.4	1,283.2	1,535.4
Current Transfers (Net)		-990.2	-1,264.1	-856.9	-1,082.2	-1,119.9
B. Capital & Financial Account		**20.2**	**-317.0**	**-1,132.4**	**543.1**	**-340.7**
C. Net Errors & omissions		**-650.3**	**213.6**	**1,217.8**	**-700.3**	**83.2**
Balance of Payments		**200.0**	**123.4**	**34.8**	**43.9**	**158.0**

*Source: **IMF and AMF***

The observed surplus in Bahrain's BOP is driven by the remarkable growth in the current account that almost doubled in 2004. This growth is spurred by the jump recorded in services and income balance from US$ -118.6 million in 2003 to US$ 50 million in 2004. Current transfers have always been in negative during the last five years recording US$ -1,119.9 million in 2004. In contrast, the increase in both portfolio investment assets and direct investment abroad in conjunction with a decrease in portfolio investment liabilities, all contributed to the high drop registered in the capital and financial account in 2004, estimated at US$ -340.7 million in 2004 against US$ 543.1 million in the preceding year.

3.2.2. Kuwait

After recording a BOP deficit over two consecutive years, Kuwait showed a surplus in its BOP of US$ 668.5 million in 2004 (see Table 2). The BOP surplus was driven by a notable increase in the current account from US$ 9,414.7 million in 2003 to US$ 18,883.6 million in 2004, which outweighed the drop in the capital and financial account of US$ -8,874 million in the same year.

The increase in the current account is essentially caused by a significant increase in the balance of goods, services, and income which almost doubled its value from 2003 to 2004, while the drop in current transfers was marginal (around 7.1%). Current transfers have always been negative over the last five years.

Table 2: Kuwait Balance of Payments during 2000-2004 (US$ Millions)

		2000	2001	2002	2003	2004
A. Current Account		**14,671.3**	**8,328.5**	**4,250.4**	**9,414.7**	**18,883.6**
Goods:	Exports f.o.b.	19,476.0	16,245.9	15,363.4	21,791.9	30,220.3
	Imports f.o.b.	-6,450.7	-7,049.7	-8,122.5	-9,881.0	-10,919.6
Balance on Goods		13,025.3	9,196.2	7,240.9	11,910.9	19,301.0
Balance on Services & Income		3,601.8	1,210.3	-845.5	-117.4	2,131.0
Balance on Goods, Services & Income		16,627.1	10,406.5	6,395.4	11,793.5	21,432.0
Current Transfers (Net)		-1,955.8	-2,078.0	-2,145.0	-2,378.8	-2,548.4
B. Capital & Financial Account		**-11,555.2**	**-3,382.9**	**-3,490.5**	**-10,511.8**	**-19,385.8**
C. Net Errors & Omissions		**-850.7**	**-2,071.5**	**-1,717.2**	**-660.3**	**1,170.7**
Total Balance of Payments		**2,265.4**	**2,874.1**	**-957.3**	**-1,757.4**	**668.5**

*Source: **IMF and AMF***

It is worth mentioning that the deficit during 2002-2003 was driven by the same factors which caused the surplus later on in 2004 (i.e. balance on services and income). More specifically, unlike the years 2000 and 2001, the negative values recorded in the balance on services and income of US$ -845.5 million in 2002 have resulted in a BOP deficit especially when given the additional drop in trade balance in the same year. Furthermore, although the trade balance increased in 2003, the negative value in the balance of services and income of US$ -117.4 million more than offset the increase. This resulted in a deficit that is higher than that registered in year 2002. In contrast, this scenario was reversed in 2003 when the balance on services and income started to record a surplus again. Note that during 2000-2004, current transfers as well as the capital and financial accounts have always been negative dragging down the BOP of Kuwait.

3.2.3. Oman

Oman BOP showed a surplus in 2004 estimated at US$ 515 million. The surplus scenario persisted over the preceding four years; with the highest levels in the years 2000-2001, whilst more modest levels later on (see Table 3).

Table 3: Oman Balance of Payments during 2000-2004 (US$ Millions)

		2000	2001	2002	2003	2004
A. Current Account		**3,131.3**	**1,883.0**	**1,365.4**	**881.7**	**442.1**
Goods:	Exports f.o.b.	11,318.6	11,074.1	11.170.4	11,669.7	13,344.6
	Imports f.o.b.	-4,593.0	-5,310.8	-5,633.3	-6,085.8	-7,872.6
Balance on Goods		6,725.6	5,763.3	5,537.1	5,583.9	5,472.0
Balance on Services & Income		-2,143.0	-2,348.5	-2,569.6	-3,029.9	-3,204.2
Balance on Goods, Services & Income		4,582.6	3,414.8	2,967.5	2,554.0	2,267.9
Current Transfers (Net)		-1,451.2	-1,531.9	-1,602.1	-1,672.3	-1,825.7
B. Capital & Financial Account		**-361.5**	**-228.9**	**-1,074.1**	**-270.5**	**1,006.5**
C. Net Errors & Omissions		**-509.8**	**-642.4**	**23.4**	**57.2**	**-933.7**
Total Balance of Payments		**2,260.1**	**1,011.7**	**314.7**	**668.4**	**515.0**

*Source: **IMF and AMF***

The BOP surplus in 2004 is the result of the significant increase in the capital and financial account that started to register positive values having been negative since 2000. The balance on goods, services, and income in 2004 presented a notable decrease compared with 2000, while the current transfers recorded continuously negative values that grew slowly. Consequently, the current account declined remarkably between 2000 and 2004. Despite all that, Oman constantly recorded a surplus in its BOP (although diminishing) during the focused period.

3.2.4. Qatar

In 2004, Qatar's BOP was in surplus of US$ 3,926.9 million against US$ 4,230.5 million in 2003. The high current account compared to its capital and financial accounts was the main driver behind the relatively high BOP surplus witnessed between 2000 and 2004 (see Table 4).

The considerable increase in the trade balance between 2002 and 2004 led to a spur in the balance on goods, services and income (in parallel with the moderate increase in current transfers) which helped Qatar to record the notable jump observed in its current account in 2004. Given that the latter exceeds the capital and financial account remarkably, a surplus in the country's BOP was registered. Interestingly, both current transfers and capital and financial account were continuously negative over 2000-2004.

Table 4: Qatar Balance of Payments during 2000-2004 (US$ Millions)

		2000	2001	2002	2003	2004
A. Current Account		**4,575.5**	**4,151.9**	**3,823.9**	**5,753.6**	**7,417.6**
Goods:	Exports f.o.b.	11,594.0	10,871.2	10,978.0	13,382.1	17,900.8
	Imports f.o.b.	-2,929.7	-3,385.7	-3,650.3	-4,358.5	-4,824.5
Balance on Goods		8,664.3	7,485.4	7,327.7	9,023.6	13,076.4
Balance on Services & Income		-2,675.8	-1,732.1	-1,986.8	-1,619.8	-3,404.7
Balance on Goods, Services & Income		5,988.5	5,753.3	5,340.9	7,403.8	9,671.7
Current Transfers (Net)		-1,412.9	-1,601.4	-1,517.0	-1,650.3	-2,254.1
B. Capital & Financial Account		**-19.0**	**-1,054.7**	**-1,712.4**	**-756.6**	**-1,335.4**
C. Net Errors & Omissions		**-1,865.1**	**-472.3**	**-322.8**	**-766.5**	**-2,155.2**
Total Balance of Payments		**2,691.5**	**2,625.0**	**1,788.7**	**4,230.5**	**3,926.9**

*Source: **IMF and AMF***

3.2.5. United Arab Emirates

The UAE BOP stood at US$ 3,490.3 million in 2004 against US$ 1,289.3 million in 2003. Since 2000, the UAE recorded surpluses in its BOP except in the year 2002 where a deficit was recorded at US$ 410.1 million (see Table 5). This deficit was a natural result of the high decline in the current account caused mainly by a high negative balance on services and income. Despite the fact that the balance on services and income kept falling in later years, the UAE BOP recorded a surplus due to the substantial increase in the current account.

Table 5: UAE Balance of Payments during 2000-2004 (US$ Millions)

		2000	2001	2002	2003	2004
A. Current Account		**13,751.7**	**9,950.3**	**3,406.4**	**7,550.7**	**12,934.0**
Goods:	Exports f.o.b.	49,834.2	48,774.0	52,163.4	67,134.1	82,750.2
	Imports f.o.b.	-30,807.8	-32,817.2	-37,533.0	-45,824.4	-54,197.4
Balance on Goods		19,026.4	15,956.8	14,630.4	21,309.7	28,552.8
Balance on Services & Income		-1,312.9	-1,796.9	-6,799.2	-9,097.3	-10,562.3
Balance on Goods, Services & Income		17,713.6	14,160.0	7,831.2	12,212.4	17,990.5
Current Transfers (Net)		-3,961.8	-4,209.6	-4,424.8	-4,661.7	-5,056.5
B. Capital & Financial Account		**-10,916.6**	**-9,464.8**	**-2,872.4**	**-5,331.0**	**-5,775.4**
C. Net Errors & Omissions		**0.0**	**0.0**	**-944.0**	**-930.4**	**-3,668.3**
Total Balance of Payments		**2,835.1**	**485.5**	**-410.1**	**1,289.3**	**3,490.3**

*Source: **IMF and AMF***

The trade balance was the main driver behind the jump witnessed in the current account between 2003 and 2004. However, the trade balance also contributed to the drop in the current account from 2000 to 2002 that resulted in a BOP deficit in 2002. During the whole period (2000-2004), current transfers and capital and financial account had continuously negative values.

3.2.6. Saudi Arabia

The BOP in Saudi Arabia has recorded a surplus of US$ 4,671 million in 2004 against US$ 2,009 million in 2003 (see Table 6). The surplus of 2004 was caused by the high increase in current account that outweighed the negative value recorded by the balance on services and income. Current transfers helped as well in increasing the current account as it registered lower negative values in 2004 compared to 2003.

Table 6: Saudi Arabia Balance of Payments during 2000-2004 (US$ Millions)

		2000	2001	2002	2003	2004
A. Current Account		**14,318.0**	**9,354.0**	**11,873.0**	**28,047.0**	**51,488.0**
Goods:	Exports f.o.b.	77,269.0	67,794.0	72,273.0	92,997.0	125,728.0
	Imports f.o.b.	-27,704.0	-28,607.0	-29,624.0	-33,868.0	-40,841.0
Balance on Goods		49,565.0	39,187.0	42,649.0	59,129.0	84,887.0
Balance on Services & Income		-19,857.0	-14,713.0	-14,922.0	-16,299.0	-19,844.0
Balance on Goods, Services & Income		29,708.0	24,474.0	27,727.0	42,830.0	65,043.0
Current Transfers (Net)		-15,390.0	-15,120.0	-15,854.0	-14,783.0	-13,555.0
B. Capital & Financial Account		**-11,729.0**	**-11,344.0**	**-8,858.0**	**-26,038.0**	**-46,817.0**
C. Net Errors & Omissions		**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Total Balance of Payments		**2,589.0**	**-1,990.0**	**3,015.0**	**2,009.0**	**4,671.0**

Source: ***IMF and AMF***

The trade balance in Saudi Arabia rose considerably between 2002 and 2004 after the drop it encountered in 2001, which was reflected directly in the current account as it appears in the table above. The current transfers and capital and financial account showed consistent negative values between 2000 and 2004.

Saudi Arabia's BOP has recorded a surplus during 2000-2004, except in year 2001 due to the drop in the current account caused by, among other things, a fall in exports. Although the

negative value in the capital and financial account also dropped slightly in the same period, its negative value was still higher than that of the current account which resulted in BOP deficit.

3.3. Aggregated GCC Balance of Payments

After reviewing the BOP of each member of the GCC countries separately in the previous section, next, we present an aggregated GCC BOP for year 2004. The reasoning behind that is to highlight the effect of each GCC country on the aggregated BOP as well as to see how the latter will look like given that GCC countries are approaching a single market and common currency as a further step in their on-going economic integration process.

As shown in Table 7 below, the aggregated GCC BOP in 2004 stood at US$ 13,429.7 million. Each GCC country has a positive BOP which results in a positive aggregated GCC BOP. The highest BOPs are those of Saudi Arabia, Qatar, and UAE representing 34.8%, 29.2%, and 26% of aggregated GCC BOP respectively. Bahrain, Kuwait, and Oman represent only 10% of aggregated GCC BOP.

Table 7: Aggregated GCC Balance of Payments in 2004 (US$ Millions)

	Bahrain	Kuwait	Oman	Qatar	UAE	KSA	Aggregated
A. Current Account	415.4	18,883.6	442.1	7,417.6	12,934.0	51,488.0	**91,580.7**
-Balance on Goods	1,485.9	19,301.0	5,472.0	13,076.4	28,552.8	84,887.0	**152,775.1**
-Balance on Services & Income	50.0	2,131.0	-3,204.2	-3,404.7	-10,562.3	-19,844.0	**-34,834.2**
-Current Transfers (Net)	-1,119.9	-2,548.4	-1,825.7	-2,254.1	-5,056.5	-13,555.0	**-26,359.6**
B. Capital & Financial Account	-340.7	-19,385.8	1,006.5	-1,335.4	-5,775.4	-46,817.0	**-72,647.8**
C. Net Errors & Omissions	83.2	1,170.7	-933.7	-2,155.2	-3,668.3	0.0	**-5,503.3**
Total Balance of Payments	**158.0**	**668.5**	**515.0**	**3,926.9**	**3,490.3**	**4,671.0**	**13,429.7**
% to total aggregated BOP	**1.2%**	**5%**	**3.8%**	**29.2%**	**26%**	**34.8%**	**100%**

*Source: Calculations based on **IMF and AMF***

With regards to the current account, all GCC countries have positive current accounts leading to an aggregated GCC current account of US$ 91,580.7 million in 2004. The highest current accounts are those of Saudi Arabia and Kuwait representing 56.2% and 20.6% of the aggregated GCC current account, followed by the UAE and Qatar with 14.1% and 8.1% respectively.

Bahrain and Oman have the smallest current account relative to the rest of GCC countries as their percentages of the aggregated GCC current account were 0.5% each.

Trade balance for each GCC country was also positive which resulted in an aggregated GCC trade balance of US$ 152,775.1 million. Saudi Arabia and the UAE are the major contributors to the aggregated GCC trade balance as their shares of the total were 55.6% and 18.7%, followed by Kuwait and Qatar (12.6% and 8.6%, respectively). Bahrain and Oman represented only 0.9% and 3.6% of the aggregated GCC trade balance.

The trade balances –that are mainly spurred by oil exports– are the major drivers of the observed positive current accounts for each GCC country. In contrast, balances on services and income are not positive for all GCC countries. Specifically, only Bahrain and Kuwait showed positive balances on services and income (although that of the former is limited), while the rest of GCC countries presented negative balances on services and income. Saudi Arabia and the UAE had the highest negative balance on services and income followed by Qatar and Oman. In sum, the aggregated GCC balance on services and income resulted in negative value of US$ -34,834.2 million in 2004.

The aggregated GCC current transfers stood at US$ -26,359.6 million in 2004. Current transfers in each GCC country were negative in the same year. The most negative current transfers are those of Saudi Arabia and the UAE as they represent 51.4% and 19.2% of the aggregated GCC current transfers. Kuwait and Qatar represented 9.7% and 8.6% of the total, respectively, while Bahrain and Oman represented 4.2% and 6.9%, respectively.

Despite the negative values of balances on services and income and current transfers for the majority of GCC countries, the high positive trade balances in all GCC countries outweighed the negative values resulting in positive current accounts for each GCC country, which resulted in a positive aggregated GCC current account.

For capital and financial accounts, all GCC countries had negative values in 2004 except for Oman. However, it is worth mentioning that Oman had negative capital and financial account in

the earlier years between 2000 and 2003 (see Table 4.3). The most negative capital and financial accounts are those of Saudi Arabia and Kuwait. Much less negative was the capital and financial account of the UAE followed by Qatar and Oman. Lastly, Bahrain had the smallest negative capital and financial account among the GCC countries. The aggregated GCC capital and financial account stood at US$ -72,647.8 million in 2004. In spite of the large negative aggregated GCC capital and financial account, the aggregated GCC BOP was positive given the positive aggregated GCC current account that prevailed over the negative aggregated GCC capital and financial account.

3.4. Comparing Balances of Payments: GCC & EU

In terms of economic integration, the European Union (EU) –which now comprises of 25 members – is far more developed than the GCC –which encompasses 6 members–. For instance, the common currency (i.e. Euro) has already been put into circulation. Below, we will compare the balances of payments of both economic blocs.

Table 8: Balance of Payments of GCC and EU in 2004 (US$ billions)

	GCC*	EU**
A. Current Account	91.5	58.6
-Balance on Goods	152.7	127.1
-Balance on Services & Income	-34.8	0.4
-Current Transfers (Net)	-26.3	-68.9
B. Capital & Financial Account	-72.6	-2.3
C. Net Errors & Omissions	-5.5	-71.7
Total Balance of Payments	**13.4**	**-15.4**

**GCC includes Bahrain, Kuwait, Oman, Qatar, UAE, and Saudi Arabia.*
***European Union includes Austria, Belgium, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden, United Kingdom, and Netherlands.*
Source: IMF and AMF

Table 8 shows the balances of payments of both GCC and EU in 2004. The GCC recorded a BOP surplus of US$ 13.4 billion while the EU registered a deficit of US$ 15.4 billion.

Since 2000, the GCC has been recording BOP surplus while the EU has been showing deficit (except for year 2002 were a surplus of US$ 2.6 billion was registered).

In 2004, both the GCC and EU showed positive current accounts caused mainly by high positive trade balances. Furthermore, the GCC had negative balance on services and income given that it is a net importer of services, whereas the EU had a positive balance on services and income as it is considered one of the major exporters of services worldwide. Current transfers were negative for both the GCC and EU and a similar case applies to their capital and financial accounts as they are both negative.

3.5. Summary

The GCC countries' BOPs have been analyzed in this report. The analyzed data shows that all GCC countries recorded a surplus in their BOPs in 2004.

Bahrain's BOP recorded a surplus of US$ 158 million in 2004, which is more than triple the modest surplus of 2003 (US$ 43.9 million). This surplus was the highest surplus during 2000-2004. Kuwait showed a surplus in its BOP of US$ 668.5 million in 2004, after recording a BOP deficit over two consecutive years. The BOP surplus was driven by notable increases in the current account from US$ 9,414.7 million in 2003 to US$ 18,883.6 million in 2004, which outweighed the drop in the capital and financial account of US$ -8,874 million in the same year. Oman's BOP showed a surplus in 2004 estimated at US$ 515 million. The surplus scenario has persisted during the preceding four years as well, with highest levels in years 2000-2001 while more modest levels later on. Qatar's BOP in 2004 recorded a surplus of US$ 3,926.9 million against US$ 4,230.5 million in 2003. The high current account compared to capital and financial account was the main driver behind the relatively elevated BOP surplus witnessed between 2000 and 2004. The UAE's BOP stood at US$ 3,490.3 million in 2004 against US$ 1,289.3 million in 2003. Since 2000, the UAE recorded surpluses in its BOP apart from in the year 2002 given that a deficit was witnessed of US$ 410.1 million. This deficit is a natural result of the high decline in current account caused mainly by elevated negative balance on services and income. Despite the fact that the balance on services and income kept falling in the later years, the UAE BOP

recorded a surplus given that the increase in current account was higher. The BOP in Saudi Arabia recorded a surplus of US$ 4,671 million in 2004 against US$ 2,009 million in 2003. The surplus of 2004 was caused by the high increase in current account that outweighed the higher negative value recorded by the balance on services and income. Current transfers helped as well in increasing the current account as it registered lower negative value in 2004 compared to 2003.

Furthermore, GCC countries were treated as a bloc and all individual BOPs have been gathered in order to build one aggregated GCC BOP. Results show that the aggregated GCC BOP in 2004 stood at US$ 13,429.7 million. The highest BOPs are those of Saudi Arabia, Qatar, and the UAE representing 34.8%, 29.2%, and 26% of aggregated GCC BOP respectively. Bahrain, Kuwait, and Oman represent only 10% of aggregated GCC BOP. Interestingly, in spite of the high negative aggregated GCC capital and financial account, the aggregated GCC BOP resulted to be positive given the positive aggregated GCC current account that prevailed over the negative aggregated GCC capital and financial account. Unlike the aggregated GCC BOP, the EU registered a deficit of US$ 15.4 billion. Since 2000, the GCC has been recording a BOP surplus while the EU has been showing deficit (except for year 2002 were a surplus of US$ 2.6 billion was registered).

Finally, all GCC countries seem not only to have surplus in their BOPs but also they have in general similar structures of BOP. All that had led to an aggregated GCC BOP that is consistent and comparable to each individual BOP of GCC countries.

CHAPTER 4. COMPETITIVENESS OF GCC BANKS IN LIGHT OF FORTHCOMING USA FTA

4.1. Introduction

Bahrain has signed an agreement with the USA that opens up the banking and financial sectors to each other. On May second 2005, Saudi Arabia reached an agreement with the USA on insurance and financial services sectors for which the Office of the U.S. Trade Representative (USTR) had asked for greater foreign access. The UAE is expected to achieve an agreement similar to Bahrain's. Oman has also initiated FTA negotiations with the USA. The rest of the GCC countries (i.e. Kuwait and Qatar) might also follow the same path.

The GCC countries and the USA are very different in terms of size and in their stage of economic development. These differences are also demonstrated in the financial sectors of these countries. Hence, FTA negotiations must provide a special and unique treatment mechanism to compensate for these differences and ensure mutual benefit and guarantee that the process is sustainable over time. The liberalization of their respective banking sectors must be organized carefully given that foreign and domestic financial institutions differ in their performance, interest and operational focus. Gradually opening up will help local banks to adapt themselves to the new environment and survive. Otherwise, the liberalization process might be harmful to local banks.

In order to reap the potential benefits from the liberalization of the banking sectors, each country involved in the liberalization process should protect the interests of its banking sector. Well-regulated financial systems are essential for macroeconomic and financial stability in a world of liberalized financial sectors. GCC countries must endeavor to increase the effectiveness of their financial systems. They should identify the strengths and weaknesses of their financial systems; determine how key sources are being managed; ascertain the sectors' developmental and technical assistance needs; and help prioritize policy responses. The present paper attempts to focus on the characteristics and performance of the GCC and USA banking sectors in the light of the financial liberalization.

The remainder of this paper is organized as follows. Sections 2 and 3, respectively, include the objectives of the study, data and methodology. A literature review of liberalization of the banking sectors is presented in section 4. The general characteristics of GCC and USA banking sectors are discussed in section 5. Section 6 tests the relative healthiness of GCC and USA banking sectors with regards to the following attributes: financial deepening, growth in loans and deposits, claims on banking sectors, profitability, performance and liquidity. Finally, section 7 concludes and makes some relevant recommendations.

4.2. Liberalization of Banking Sector: A Literature Review

In general, liberalization refers to a process where previous government restrictions are relaxed, usually in areas of social or economic policy. In the case of financial liberalization, it refers to the removal of barriers on movement of capital. These major policy changes usually have impact on banks structure, conduct and performance. Supporters of financial liberalization argue that liberalization enhances credit, jobs and growth, and reduces poverty. King and Levine (1993) and Levine (1996 and 1997) show that both developed and developing countries with open financial sectors have typically grown faster than those with closed ones. Jayaratne and Strahan (1996) found out that deregulation of interstate branching in USA stimulated growth by 0.3-0.9% of GDP for the 10 year period following deregulation and 0.2-0.3% thereafter.

On the one hand, internationalization of financial services is an important issue for strengthening and liberalizing financial systems in developing countries. The elimination of discriminatory measures and the removal of entry barriers open doors to foreign investors. There has been considerable support for the view that liberalization adds more efficiency of financial systems, introduces international practices and standards, improves quality of services, and stabilizes financial markets. In Indonesia, for example, open financial markets are often credited with a beneficial effect on macroeconomic stability in the past decades (World Bank, 1997). It is reported that in Hong Kong, China and Singapore, a rapidly developing, well-regulated financial

services sector, in tandem with macroeconomic stability, have together strengthened the economy and promoted growth.

Empirical evidence shows that increased competitiveness enhanced through financial sector openness spurs economic growth (e.g. Sachs and Warner, 1995). Evidence also suggests that it is the number of foreign entrants in the market rather than their market share that has a positive effect on the functioning of national financial markets. Increased competition may imply a reduction in domestic bank profits, but banking customers gain through reduced net interest margins, lower costs of fee-based services and the availability of a greater variety of services.

On the other hand, there have been concerns about the risks that liberalization brings about for some countries, particularly in the absence of adequate regulatory structures. Although supporters of financial liberalization state that opening domestic banking sector to foreign ownership will result in much needed capital and know-how, opponents shed the light more on the dark side of liberalization. They argue that liberalization often results in the multinational banks coming in, who then work with multinational companies. In other words, domestic firms (especially small ones) do not prosper but instead slowly get squeezed out of markets.[10] Moreover, financial liberalization causes instability and volatility. Capital flows without controls and regulation are largely unpredictable and highly volatile. Investment comes in bubbles, which burst with greater consequences as a result of greater investment. Furthermore, some researchers show that financial liberalization causes banking system fragility (e.g. Adebiyi, 2002). Similarly, Fischer and Chénard (1997) provide empirical evidence that financial liberalization increases instability of banking systems in countries such as Greece, Malaysia, Mexico, Taiwan and Thailand. Their results show that liberalization was followed by increase in banks' risk, drop in profitability and fall in supply of funds. All this would obviously result in increasing probability of failure occurring.

[10] Examples include Ghana, where the National Bank of Ghana was taken over by Barclays. Barclays eventually closed the rural, unprofitable branches. Now Ghana is a largely rural country. The impacts of this were multiple. Less access to credit for rural farmers and companies, less domestic savings available for national firms and governments.

Financial liberalization should be therefore carefully studied and prepared for , and supervision and monitoring bodies should be appointed to reduce risks of failure and propose strategic changes.

4.3. A Closer Look at GCC and USA Banking Sectors

As shown in Table 1, Bahrain has 110 banks while UAE is comprised of 46 banks (21 local banks and 25 foreign banks). These two countries are considered highly over-banked. They serve a population of around 720 thousands in Bahrain and 4 million in the UAE. The fact that UAE population is almost six times more than that of Bahrain is reflected in the total assets of both countries. Total assets of UAE banks account for almost $100 billion which is almost 6 times the total assets of Bahraini banks ($17 billion). In terms of total assets, the UAE is ranked second after Saudi Arabia.

Table 1: Banks and Population in GCC and USA (2003)

	Bahrain	Kuwait	Oman	Qatar	S. Arabia	UAE	USA
No. of Banks	110[1]	10	14	14	10	46	1,367[2]
- Local	-	9	5	7	3	21	1,320
- Foreign	-	1	9	7	7[3]	25	50[4]
Total Assets (US$ bln.)	17	63	12	21	146	100	7,602
Population (thousands)	720	2,520	2,850	610	24,220	4,041	294,040

[1] This number represents 24 commercial banks, 36 investment banks and 50 offshore banking units.
[2] This number comprises of large commercial banks only.
[3] These are joint ventures between Saudi and foreign banks while the other three banks are 100% Saudi owned.
[4] Foreign banks are defined as those with foreign ownership over 50%.
Source: GCC National Central Banks, US Federal Reserve Board, International Financial Statistics (IMF)

The banking system with the largest total assets of all GCC countries is that of Saudi Arabia ($146 billion). Its banking system is comprised of 10 banks out of which 3 banks are fully Saudi owned. The absence of foreign fully owned banks in Saudi Arabia is obvious as the remaining 7 banks are all joint ventures with Saudi nationals.

Similar to Saudi Arabia, Kuwait also has 10 banks. The only foreign bank operating in the country is 50% Kuwaiti and 50% Bahraini. The total assets of Kuwaiti banks are about $63 billion for a population of around 2.5 million.

The Omani banking system consists of 9 foreign banks and 5 national banks while Qatar hosts 7 foreign banks out of 14 banks. Although the Qatari population is too small compared to Oman (610 thousands and 2.8 million, respectively), the Qatari banks have total assets amounting to $21 billion outweighing Oman ($12 billion).

Let us now consider the GCC as one bloc compared to the USA. The GCC total population is around 35 million compared to 294 million in the USA. The number of banks in GCC is about 204 banks while there are 1,367 large commercial banks in USA (of which 50 are foreign banks). Furthermore, the total assets of USA banks ($7,602 billion) are about 21 times those of all GCC countries ($359 billion).

4.4. Soundness of GCC and USA Banking Sectors

This section starts by presenting a general overview of the financial deepening of GCC and USA financial sectors. Later on, it highlights the structure of loans and deposits in addition to identifying whether GCC and USA banking systems are more oriented towards private or public sector. Moreover, the performance of GCC banks is compared to that of the USA banks. Finally, liquidity criteria are presented in order to compare the banking sectors' flexibility of the countries involved.

4.4.1. Financial Deepening

Some economists argue that financial liberalization and deepening are growth-enhancing economic policies (Shaw, 1973).[11] Similarly, King and Levine (1993), Demetriades and Luintel (1996) and Fry (1997) provide empirical evidence that there is a positive relationship between

[11] Financial deepening is a term used to describe the development and expansion of financial institutions (such as banks, stock markets and insurance companies) relative to the size of a country's economy.

financial deepening and growth. In contrast, other researchers show that financial deepening increases the macroeconomic instability and affects growth negatively (Singh, 1997).

In order to measure the financial deepening of GCC and USA, two traditional measures are used: "M2 to GDP" and "M1 to M2". The first ratio intends to show the depth of the market while the second ratio indicates the importance of long term banking and the degree of sophistication in the financial market.[12]

As shown in Table 2, the ratio "M2 to GDP" for GCC is ranging between 31% and 90% while the ratio of USA is ranging between 50% and 55%. These ratios were somewhat stable over the period 1999-2003. GCC countries with deepening ratio higher than USA in 2003 were Bahrain, Kuwait and UAE (85%, 84% and 68%, respectively). The lowest "M2 to GDP" ratio amongst all GCC countries in 2003 was that of Oman (34%).

Table2: M2 to GDP Ratio for GCC and USA (1999-2003)

	1999	2000	2001	2002	2003
Bahrain	79%	72%	79%	90%	85%
Kuwait	84%	72%	88%	90%	84%
Oman	38%	31%	34%	35%	34%
Qatar	58%	44%	45%	44%	50%
S. Arabia	40%	40%	43%	49%	49%
UAE	72%	70%	62%	66%	68%
USA	50%	50%	54%	55%	55%

Source: GCC National Central Banks, US Federal Reserve Board

Generally speaking, all GCC countries (except Oman) as well as USA have high ratios of "M2 to GDP" ranging between 50% and 90% showing that these countries are well monetized. This

[12] Both M1 and M1 are measures of the money supply. M1 designates the sum of all currency in circulation plus all checking account deposits (short-term deposits). M2 designates the sum of M1 plus all savings account deposits (short-term time deposits).

reflects the success of their financial sectors in attracting deposits. The high degree of monetization demonstrates the high degree of confidence in the banks of these countries and their ability in providing advanced customer services.

For the second ratio measuring the financial deepening (i.e. "M1 to M2" ratio), results are presented in Table 3. It is obvious from the table below that the majority of GCC countries have relatively low "M1 to M2" ratio expect for Saudi Arabia which had high ratio in 2003 (66%). The lower this ratio, the more successful the country is in mobilizing long term financial assets.

Table 3: M1 to M2 Ratio for GCC and USA (1999-2003)

	1999	2000	2001	2002	2003
Bahrain	22%	21%	23%	25%	30%
Kuwait	18%	18%	18%	21%	25%
Oman	22%	22%	26%	29%	28%
Qatar	16%	15%	18%	26%	30%
S. Arabia	65%	65%	66%	65%	66%
UAE	24%	24%	25%	27%	29%
USA	24%	22%	22%	21%	21%

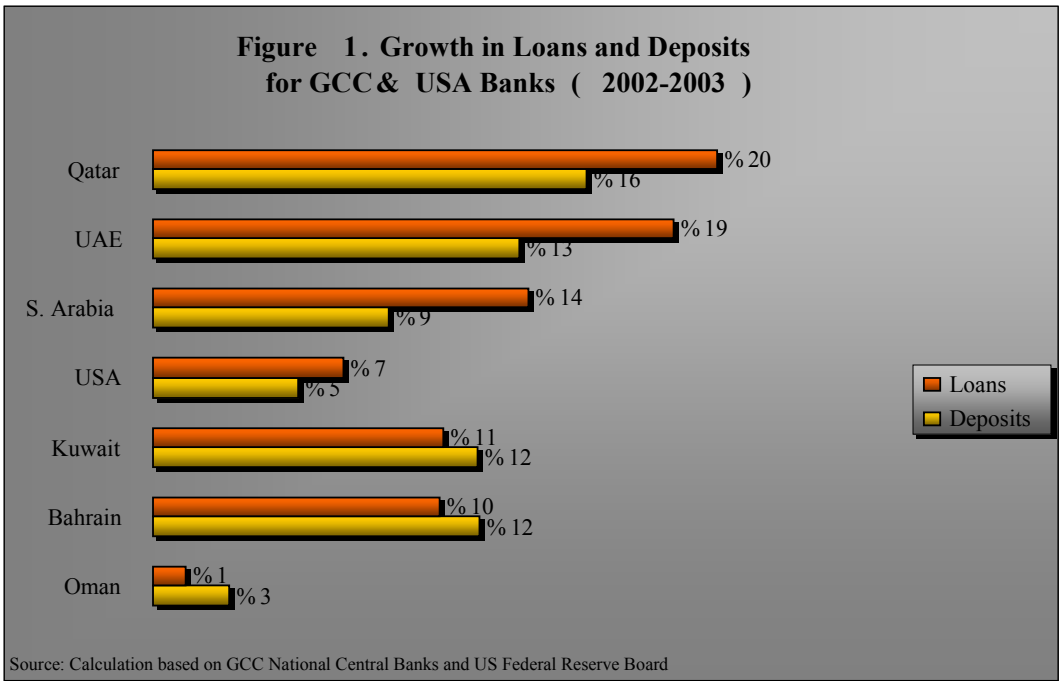
Source: GCC National Central Banks, US Federal Reserve Board

Although GCC countries (except Saudi Arabia) have somewhat reasonable ratios of "M1 to M2", USA is still performing better than them in terms of increasing public confidence in its financial sector as its ratio was declining over the period 1999-2003. In contrast, the ratios of Bahrain, Kuwait, Oman and UAE were gradually increasing during the same period. The most remarkable increase was that of the ratio of Qatar which almost doubled (from 16%in 1999 to 30% in 2003). The ratio of Saudi Arabia showed a more stable pattern during 1999-2003 but still maintained its high level (ranging between 65% and 66%). This failure in mobilizing long term financial assets, in contrast to the other GCC countries and USA, might be largely driven by the decline in public confidence in the Saudi financial system caused by the political instability.

Finally, according to "M1 to M2" ratio, the ranking of the above mentioned countries —based on the importance of long term banking and the degree of sophistication in their financial markets in 2003— is as follows (from higher to lower): USA, Kuwait, Oman, UAE, Bahrain, Qatar and Saudi Arabia.

4.4.2. Growth in Loans and Deposits

Banking performance can be assessed by looking at the size and the structure of loans and deposits. It is important to compare the growth of loans and deposits of the banking sector in order to identify whether the structure of loans and deposits is improving. Figure 1 shows to what extent GCC and USA bank loans have been developing compared with deposits. Saudi Arabia, Qatar and UAE showed a similar growth pattern between 2002 and 2003 in terms of bank loans: 20%, 19% and 14%, respectively. The bank deposits of the three countries grew by 16%, 13% and 9% respectively. Although consistent with US patterns, the growth in loans and deposits of these three countries were higher than those of the USA in which loans grew by 7% and deposits by 5%.



The rest of GCC countries showed a higher growth in bank deposits than loans. Kuwait and Bahrain showed a growth in bank loans of 11% and 10%, respectively, while the growth of bank deposits was of 12% in both countries. The lowest growth in bank loans and deposits amongst all countries was in Oman. Its banking loans grew only by 1% compared to 3% growth in deposits.
In sum, on the one hand, the structure of loans and deposits in three GCC countries (i.e. Qatar, UAE and Saudi Arabia) has improved in 2003 as their bank loans grew more than their deposits while the opposite holds for the rest of GCC countries (i.e. Kuwait, Bahrain and Oman). On the other hand, the structure of bank loans and deposits of the USA also improved.

4.4.3. Claims of Banking Sectors

In the previous section we saw how bank loans have increased in all GCC countries and USA as well. The present section attempts to identify whether the claims of GCC and USA banking systems are more orientated towards private or public sector. This helps in determining the role and dominance of the private and public sectors in the economic activities.

In some GCC countries such as Oman and UAE, the role of the private sector in the economic activities is remarkable as it constitutes a significant ratio of the banks total claims (93% and 85%, respectively). These two ratios are higher than the ratio of USA, which was 79% in 2003 (see Table 4). Although the claims on private sector in the rest of GCC countries were not very high, the private sector showed to play a considerable role in economic activities. In Saudi Arabia, the claims on private sector to total claims were about 56% while in Kuwait, Bahrain and Qatar, they were 50.3%, 47% and 46.5%, respectively.

Table 4: Claims on Private Sector to Total Claims for GCC and USA (1999-2003)

	1999	2000	2001	2002	2003
Bahrain	57.9%	57.8%	55.3%	51.7%	46.5%
Kuwait	43.1%	42.5%	45.5%	45.9%	50.3%
Oman	98%	97%	95%	93%	93%
Qatar	44%	49%	42%	45%	47%
S. Arabia	58%	58%	58%	58%	56%
UAE	85%	88%	86%	83%	85%
USA	78%	80%	80%	78%	79%

Source: GCC National Central Banks, US Federal Reserve Board, International Financial Statistics (IMF)

The limited role of the private sector in the economic activities and the dominant role of the public sector are clearly reflected in the ratio of claims on public sector to total claims for Qatar, which represented 53% in 2003 as shown in Table 5. Saudi Arabia banking sector has also shown to be active in lending to the public sector (44%). The ratios of both countries have been almost stable during the period 1999-2003 and maintained their high levels.

Table 5: Claims on Public Sector to Total Claims for GCC and USA (1999-2003)

	1999	2000	2001	2002	2003
Bahrain	7.5%	7.1%	8%	6.7%	8.6%
Kuwait	31.4%	26.3%	22.6%	19%	16.2%
Oman	2%	3%	5%	7%	7%
Qatar	56%	51%	58%	55%	53%
S. Arabia	42%	42%	42%	42%	44%
UAE	13%	11%	13%	16%	13%
USA	7%	6%	5%	6%	4%

Source: GCC National Central Banks, US Federal Reserve Board, International Financial Statistics (IMF)

The rest of GCC countries presented relatively small ratios of claims on public sector: Kuwait (16.2%), UAE (13%), Bahrain (8.6%) and Oman (7%). The ratio of Oman has increased slightly from 2% to 7% over the time while the ratio of Kuwait has almost halved (from 31.4% in 1999 to 16.2% in 2003). However, UAE and Bahrain showed more stable patterns.

In 2003, all GCC countries had ratios of claims on public sector higher than the USA which had only 4%. This low ratio reflects the insignificant role the public sector plays in economic activities due to the high level of privatization in the country.

4.4.4. Profitability and Performance

Once banking systems are liberalized, incumbent foreign banks endeavor to expand to reap more benefits while new entrants attempt to penetrate the local market. All these actions would result in increasing competition in the banking sector which usually affects the market structure. The market might witness for example joint ventures, mergers and acquisitions. In addition, if the liberalization of the banking sector leads to cutthroat competition, some players might be forced to leave the market.

Most economic theories are either implicitly or explicitly based on the following evolutionary argument: competition and exit assure that only the most efficient firms survive (Telser, 1966). Unfortunately, experience has shown that this is not always true because this argument implicitly relies on the existence of efficient markets. In the presence of market imperfections, efficient banks may be forced to exit due to predation by less efficient banks but which have deep pockets (e.g. large financial resources, retained earnings and profits). In this case, the natural selection leads to the survival of relatively less efficient foreign “fat” banks and the exit of some small, though “fit” local banks. These small efficient banks seem less likely to survive the liberalization shock, even after controlling for various measures of efficiency.

Next, some profitability indicators of both GCC and USA banks will be discussed; return on assets (ROA), return on equity (ROE) and nonperforming loans (NPLs).

ROA is a useful indicator of how profitable a bank is relative to its total assets. As shown in Table 6, ROA for Kuwait, Qatar, Saudi Arabia and UAE are higher than USA. In 2003, the most profitable banking sector was that of Qatar with ROA of 2.5%. UAE came second with 2.3% followed by Saudi Arabia and Kuwait (2.1% and 2%, respectively). Oman had a very low ROA (0.0021% in 2003) compared to other GCC countries and USA. This means that the Omani banking sector is not that attractive –in terms of profitability– when compared to the banking sectors of the other GCC countries.

Table 6: ROA for GCC and USA Banks (1999-2003)

	1999	2000	2001	2002	2003
Bahrain	-	-	-	-	-
Kuwait	1.8%	2%	2%	1.8%	2%
Oman	0.016%	0.013%	0.0011%	0.014%	0.0021%
Qatar	2.1%	1.4%	1.9%	2.3%	2.5%
S. Arabia	1.7%	2%	2.1%	2.1%	-
UAE	1.5%	1.8%	2.6%	2.2%	2.3%
USA	1.3%	1.2%	1.2%	1.3%	1.4%

Source: GCC National Central Banks, IMF Estimates

Another profitability indicator is ROE. In our case, ROE is useful in comparing the profitability of GCC banking sectors to the USA banking sector. Whereas the ROA measures the profitability of the overall bank, the ROE examines profitability from the perspective of the equity investor.

Similar to ROA, GCC banking sectors presented higher ratios of ROE than USA in 2003 (see Table 7). The highest ROE ratios were those of Qatar and Saudi Arabia (20.8% and 20.7%, respectively). ROE for the Kuwaiti banking sector was about 18.6% while UAE had 16.4%. Once again, high ROE for GCC countries reflexes the high profitability of their banking sectors.

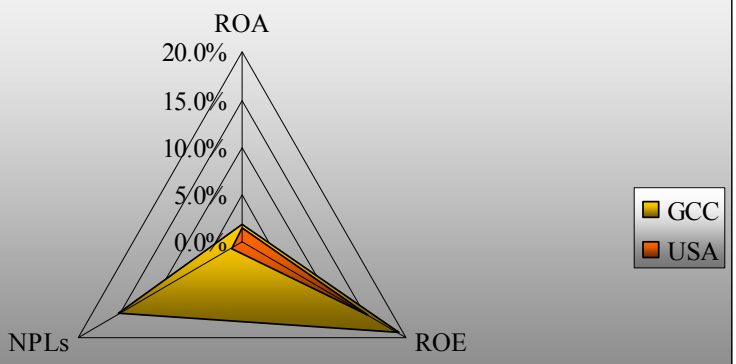
Table 7: ROE for GCC and USA Banks (1999-2003)

	1999	2000	2001	2002	2003
Bahrain	-	-	-	-	-
Kuwait	15.3%	17.6%	18.2%	17.4%	18.6%
Oman	-	-	-	-	-
Qatar	18.5%	12%	15.8%	19.4%	20.8%
S. Arabia	15.6%	21.2%	21.3%	20.7%	-
UAE	12.8%	14.9%	16.7%	15.6%	16.4%
USA	15.3%	14%	13.1%	14.5%	15.3%

Source: GCC National Central Banks, IMF Estimates

According to the two measures of banking profitability presented above (i.e. ROA and ROE), Kuwait, Qatar, Saudi Arabia and UAE have relatively profitable banking sectors. Furthermore, their profitability outweighs that of USA. This might make GCC banks a good acquisition targets for USA banks, especially when we compare the NPLs for GCC and USA banks. The NPLs of USA are estimated at 1.2% of total loans while those of GCC are ranging between 10% and 20%. UAE, for example, had NPLs of 14.3% in 2003. This ratio is considered quite high. Figure 2 shows how GCC banking sectors are more profitable than USA banking sector (in terms of average ROA and ROE), while the USA banking sector is more efficient than GCC banking sectors in terms of average NPLs. On the one hand, the average ROA for GCC banks in 2003 was about 1.8% compared to 1.4% in the USA. Average ROE for GCC banking sector was around 19.1% while in USA was 15.3%. On the other hand, NPLs for USA were about 1.2% compared to 15% in GCC banking sectors.

Figure 2. Profitability Indicators of GCC & USA Banks (averages 2003)



Reducing the level of NPLs by GCC banks would be a smart strategic move. In addition, mergers between GCC banks is one of the measures to face liberalization.

4.4.5. Liquidity Risk

Liquidity risk is the risk of not being able to raise cash at a reasonable cost when needed to do so. Liquidity takes on importance because of its implications for bank operations and, in the extreme, bank viability. Poor liquidity limits bank's flexibility. Acute liquidity problems can spell serious trouble for a bank when funds are not available to meet depositors' withdrawal demands. At that point, the bank is liquidity insolvent and can be closed down.

This section presents two criteria (i.e. loans/deposits ratio and loans/assets ratio) that measure the capacity of banks to fulfill their obligations, particularly towards their depositors, through holding appropriate portions of their assets in highly liquid form.

As shown in Table 8, USA had higher loans to deposits ratio than all GCC countries (130% in 2003). However, countries such as Oman, Kuwait and Saudi Arabia had ratios that are not that far from the USA. Specifically, the loans/deposits ratio of Oman banking sector was of 116% while Kuwait and Saudi Arabia had the same ratio of 114%. UAE and Qatar had comparative ratios (83% and 82%, respectively). Bahrain came last with 58% loans to deposits ratio in 2003.

Table 8: Loans to Deposits Ratio for GCC and USA (1999-2003)

	1999	2000	2001	2002	2003
Bahrain	61%	58%	55%	59%	58%
Kuwait	132%	123%	119%	115%	114%
Oman	123%	119%	121%	118%	116%
Qatar	93%	77%	80%	78%	82%
S. Arabia	113%	113%	84%	109%	114%
UAE	-	81%	79%	79%	83%
USA	136%	136%	128%	128%	130%

Source: Calculations Based on GCC National Central Banks and US Federal Reserve Board

According to the second indicator of liquidity presented in this section (i.e. loans to assets ratio), once again USA banking sector was shown to be more liquid than all banking sectors of GCC countries, as its ratio was about 81% (see Table 9). Slightly lower was the ratio of Kuwait (79%) followed by Saudi Arabia and Oman (74% and 73%, respectively). The banking sectors of the three other GCC countries had the lowest loans to assets ratio: Qatar (57%), UAE (54%) and Bahrain (39%).

Table 9: Loans to Assets Ratio for GCC and USA (1999-2003)

	1999	2000	2001	2002	2003
Bahrain	36%	38%	37%	41%	39%
Kuwait	88%	83%	82%	79%	79%
Oman	75%	75%	77%	75%	73%
Qatar	60%	56%	60%	58%	57%
S. Arabia	67%	66%	68%	70%	74%
UAE	-	50%	48%	50%	54%
USA	83%	82%	82%	81%	81%

Source: Calculations Based on GCC National Central Banks and US Federal Reserve Board

Finally, although the USA banking sector is considered more liquid than those of all GCC countries, the liquidity ratios of GCC banking sectors are quite high. Thus, their banking sectors are also flexible. Nonetheless, the liquidity ratios of the Bahraini banks may need some enforcement.

4.5. Conclusions and Recommendations

Supporters of financial liberalization point out that countries with open financial sectors have typically grown faster than those with closed ones. Although supporters state that opening domestic banking sector to foreign ownership will result in much needed capital and know-how, opponents argue that liberalization causes instability and volatility. That is, capital flows without controls and regulations are largely unpredictable and highly volatile.

The paper reveals that all GCC countries (except Oman) and the USA have high ratios of "M2 to GDP" ranging between 50% - 90%, showing that these countries are well monetized. This reflects the success of their financial sectors in attracting deposits.

The high degree of monetization demonstrates the high degree of confidence in the banks of these countries and their ability in providing advanced customer services.

Furthermore, the structure of loans and deposits in Qatar, UAE and Saudi Arabia has improved in 2003, as their bank loans grew more than their deposits. The opposite holds for Kuwait, Bahrain and Oman. The structure of bank loans and deposits of the USA has also improved.

The role of the private sector in Oman and UAE is remarkable as it constitutes a significant ratio of the banks total claims (93% and 85%, respectively). These two ratios are higher than the ratio of USA, which was 79% in 2003. Although the claims on private sector in other GCC countries were not very high, the private sector showed to play a considerable role in economic activities. In Saudi Arabia, the claims on private sector to total claims were about 56%, while in Kuwait and Bahrain they were 50.3% and 47%, respectively. The limited role of the private sector is clearly reflected in the ratio of claims on public sector to total claims for Qatar, which represented 53% in 2003.

According to the two measures of banking profitability presented in this paper (i.e. ROA and ROE), Kuwait, Qatar, Saudi Arabia and UAE have relatively profitable banking sectors. Furthermore, their profitability outweighs that of USA. This might make GCC banks good acquisition target for USA banks, especially when we compare the nonperforming loans (NPLs) for GCC and USA banks. The NPLs of USA are estimated at 1.2% of total loans while those of GCC are ranging between 10% and 20%.

Given that financial liberalization would result in opening local banking sectors to foreign banks, then, banks with relatively high ROA and ROE but with high ratio of NPLs are expected to draw the attention of US banks. Therefore, reducing the level of NPLs by GCC banks would be a smart strategic move. In addition, mergers between GCC banks are one of the tools to face liberalization as they increase efficiency. It might also be better to first liberalize the financial sector between GCC countries to foster cross-border financial operations and then go for international liberalization.

Moreover, the international experience showed that it is vital to strengthen the supporting institutional framework in parallel with domestic deregulation and liberalization: this is particularly true of the regulatory and supervisory functions of the country but it also applies to the use of the market in disciplining financial institutions. Both factors can play a crucial role in minimizing the potential risks of opening up, particularly when it comes to dealing with large NPLs.

Finally, although the USA banking sector is considered more liquid than those of all GCC countries –based on the liquidity criteria presented in this paper–, the liquidity ratios of GCC banking sectors are still quite high. Thus, their banking sectors are also flexible. Nonetheless, the liquidity ratios of the Bahraini banks may need some enforcement.

CHAPTER 5. EU-GCC FTA: AN OVERVIEW OF THE EXISTING LITERATURE

5.1. Introduction

Free Trade Agreement (FTA) negotiations between the Gulf Cooperation Council (GCC) countries and the European Union (EU) have started since 1988. However, there have been always obstacles that prevented the achievement of a final agreement. Furthermore, the on-going negotiations between the GCC and the EU reveal that the latter is targeting three major issues, among others: trade in goods and services, foreign direct investment (FDI) and government procurement.

According to our knowledge, the published studies regarding the proposed FTA impact assessment have been very few and are particularly prepared from the EU's economic perspective. In fact, these are only two. One is core, it has been published by the European Commission (EUC) and the second is an extension to it.

The objective of this report, is to present an overview of the literature and discuss their results regarding the proposed EU-GCC FTA. The applied empirical methodologies of these studies will also be discussed.

5.2. Overview of the Existing Literature

As mentioned earlier in the data and methodology section, there are four recent main papers focusing on the proposed FTA between the EU and the GCC countries. Next, we will have an overview of these papers and their main concerns. These papers can be divided into two categories: political economy papers and economic analysis papers.

5.2.1. Political Economy Papers

In the political economy field, many papers have been published regarding the relations between the EU and GCC (e.g., Saleh, 1999; Escribano-Francés, 2000; Chirullo and Guerrieri, 2002; Babood, 2003; and Fürtig, 2004). Somehow, these studies have pointed out the importance of establishing an FTA. They did so from various political angles, but they depart from the economic analysis viewpoint. Most recent papers in this field are those published in early 2005 by Luciani & Neugart and Escribano-Francés. However, this paper of Luciani and Neugart can be considered as an update of their previous paper written in 2001-2002. The updated paper includes not only the redrafting of the original version but also adding supplementary notes for some factual references as well as discussing a number of other intervening developments.

Luciani and Neugart (2005) argued that the conclusion of the FTA between the EU and the GCC countries is urgent, particularly, after the removal of the main formal obstacle of this agreement by the establishment of the GCC Customs Union (CU) in January 2003. They pointed out that the GCC is still neglected from the part of the European Commission (EC) in comparison with other regions of the world. This is considered a strategic mistake that must be corrected rapidly by devoting substantially greater human resources within the EC to the relations with the GCC. Luciani and Neugart asked for the elaboration of a new and imaginative "cooperation proposal" that goes much beyond the proposed FTA including for example opening other representative offices in the GCC capitals besides Riyadh and increasing significantly the political profile of the relationship. In line with this context, they proposed several areas of dialogue covering:

- Political and security dialogue.
- Good governance and human rights.
- Human resources and education.
- Trade and investment.
- Oil and gas.
- Financial markets.

Luciani and Neugart stated that cooperation with the GCC is not only required but is also likely to be fruitful from the EU perspective. Therefore, in order to integrate the GCC in the European

Neighborhood Policy (ENP)[13], the EU must move quickly. Even though the authors noted that there are certain aspects of social and cultural norms in some of the GCC countries that are difficult to understand or even to accept from the European viewpoint, they pointed out that the open political systems and the economies of the GCC countries are closer to European standards than those of several other countries that are already in the ENP framework.

The previous argument confirms explicitly the EU's desire to play a more relevant role in the GCC countries in the near future. Doing so is important to the EU given that the USA –as an economic rival– has penetrated the GCC region before the EU by already signing FTAs with two GCC countries: Bahrain and Oman. The difference, however, between the EU and USA is that the former is negotiating a FTA with the GCC as a bloc while the latter is negotiating individual FTAs with each GCC country apart.

The above presented paper by Luciani and Neugart (2005) did not devote many arguments regarding the USA's approach towards the GCC in particular (and the Middle East in general) under the light of the EU efforts with the GCC. Escribano-Francés (2005) did so. He proposed an upgrade of the status of the EU relations with the GCC in a complementary manner to the US efforts rather than a competitive one.

The existing divergences in EU and USA approaches towards GCC countries are making it difficult for the latter to adequately respond to their diverse incentives. For instance, lack of Transatlantic dialogue may turn the perception of EU and USA-GCC FTAs as non compatible, instead of mutually reinforcing, opening a kind of "agreement competition" that could be harmful at a collective level. All that put the GCC in a position of choosing between one agreement or another instead of viewing them as complementary.

[13] The European Neighborhood is the region beyond the frontier of the EU. It is comprised of primarily developing countries, who seek one day to become either component states of the EU itself, or more closely aligned to the economy of the EU. The EU offers financial assistance to countries within the European Neighborhood, as long as they meet the strict conditions of government reform, economic reform and other issues surrounding positive transformation. This process is normally underpinned by an "Action Plan", as agreed by both Brussels and the target country. The ENP does not cover countries which are in the process of joining the European Union and those covered by the Stabilisation and Association process that have the same aim. The ENP also does not cover the European Free Trade Association (EFTA) states and with Customs unions with the EU. For further information about the ENP see http://ec.europa.eu/world/enp/index_en.htm

From here emerges the major recommendation made by Escribano-Francés for the need to replace the EU current fragmented and low profile level approach by a better-defined EU approach to the Gulf, which must be complementary but distinct from the USA approach. The author pointed out that the EU-GCC relations should: (a) adopt a more sophisticated partnership model than Euro-Mediterranean Partnership; and (b) take into account the G8 strategy on the Middle East.

Furthermore, Escribano-Francés suggested a cultural dialogue to promote mutual respect and mutual understanding. He identified dialogue as a much-needed ingredient in any EU-GCC partnership. He also stated that the EU –given its backgrounds– is better equipped to conduct such a cultural dialogue than the USA.

In sum, Escribano-Francés argued that the EU must consider the GCC as a "partner" with whom to trade, cooperate and exchange political views, culture and scientific knowledge. This implies greater consultation with the GCC countries, enhanced economic cooperation, concluding a generous FTA deal, and an upgraded cultural dialogue.

Finally, although the political economy papers did not touch upon the detailed economic impact of the proposed FTA between the EU and GCC –given that it is not their scope– they have signaled its potential benefits. This paved the way towards a more profound economic analysis to be conducted by economic analysis specialists.

5.2.2. Economic Analysis Papers

Unlike the political economy papers presented in the previous section, the economic analysis papers focus more on the dimension of the economic impact of the proposed EU-GCC FTA. By doing so, a winner-loser scheme is drawn by measuring the potential economic effects resulting from the proposed FTA. Unfortunately, the EU-GCC FTA did not receive the same dedication from the economic researchers as it did from the political economy analysts. Both references are however limited. The reasoning behind that might be the fact that the EU-GCC cooperation agreement lies at the lowest rank of the EU economic preferences pyramid (see Hollis, 1997).

5.2.2.1. Impact Assessment Results

The first study to be discussed here is the one carried out by Price Waterhouse Coopers in 2004 (PWC) funded by the European Commission. Up to our knowledge, this is the most extensive study, if not the sole, that has been written to analyze several potential effects of the proposed EU-GCC FTA. Impact assessments conducted by PWC (2004) are not only limited to the economic domain but also cover the environment and social domains. All these are necessary to promote the sustainable development policies pursued by the EU.[14]

On the one hand, the environmental impact assessment focuses on issues such as environmental impact on trade in goods, water resources, coastal and marine areas, land use, natural resources, urbanization, and trade in services. On the other hand, the social impact assessment comprises of matters such as nationals and expatriates, women, education, gender, and health and welfare. The environment and social domains will not be discussed here as our paper merely concerns the economic impact assessment.[15]

Interestingly, the economic impact assessment in PWC (2004) quantifies the impact of the EU-GCC FTA by measuring its expected effect on each of trade creation, trade diversion, change in consumer surplus, change in producer surplus, and economic welfare. They used a Computational Partial Equilibrium model (CPE). Three FTA scenarios were measured in PWC (2004).[16] First, when GCC countries adopt a common external tariff set at 5% in each commodity category (FTA, 5% CET). Second, when GCC countries adopt a common external tariff set at the minimum tariff level for each commodity category, across member countries (FTA, Min CET). Third, when EU and GCC jointly pursue free trade on an MFN basis. Results of these scenarios are presented in Table 1 below.

[14] DeRosa and Kernohan (2004) summarize the results of the economic impact analysis of Price Waterhouse Coopers (2004). The former paper will not be focused here given that its model and results are mainly extracted from the latter study.

[15] For detailed impact assessments regarding the environment and social fabric domains please see PWC (2004) pages 118 and 133.

[16] PWC (2004) also measures the effect of other scenarios for the GCC customs union. However, these will not be highlighted in our report as we only focus on the FTA impact assessment.

Table 1: Expected Impact of EU-GCC FTA by Component and Region*

Expected Effect on:	Region	Scenario		
		FTA (5% CET)	FTA (Min CET)	MFN Basis
Trade Creation	GCC	2,979.0	3,041.2	3,003.1
	EU	24,552.6	23,899.0	43,728.8
Trade Diversion	GCC	5,615.6	4,132.6	0.0
	EU	230.4	272.3	0.0
Net Trade Creation	GCC	-2,636.6	-1,091.4	3,003.1
	EU	24,322.2	23,626.7	43,728.8
Change in Consumer Surplus	GCC	83.1	84.3	85.6
	EU	401.6	267.8	662.5
Change in Producer Surplus	GCC	7,494.9	7,617.8	8,117.8
	EU	17,532.2	19,806.2	45,392.6
Change in Economic Welfare (% GDP)	**GCC**	**7,030.4 (2.3)**	**6,985.8 (2.3)**	**8,203.3 (2.7)**
	EU	**17,807.4 (0.2)**	**19,916.8 (0.3)**	**45,055.0 (0.6)**

* Figures are in millions of US Dollars per annum, at 2000 prices.

Results of MFN basis will be focused on as they represent favorite FTA. Moreover, these results will make comparison with the other economic study that measures the EU-GCC FTA impact easier, which we will present later on in this section (i.e. Baier and Bergstrand, 2004).

In general, PWC (2004) results showed that the liberalization of the trade in goods under the proposed FTA will lead to an increase in economic welfare for the GCC (2.7% of GDP) while it will have a negligible overall welfare effect on the EU (0.6% of GDP). Trade creation for both the EU and GCC is solely driven by positive trade creation as no significant trade diversion is recorded for either the EU or the GCC. Furthermore, increase in consumer surplus for both economic blocs seems to be limited compared to increase in producer surplus, which indicates that producers will relatively benefit more than consumers from the proposed FTA.

Note that although economic welfare gains by the EU exceed considerably –in absolute terms– those of the GCC, the overall impact on the latter economic welfare as percentage of GDP

surpasses that of the former. In absolute terms, highest gains in GCC economic welfare are reaped by Saudi Arabia and the UAE. Nevertheless, Bahrain and the UAE top the list when gains are measured in terms of percentage of GDP (see Table 2).

Table 2: PWC (2004) FTA Impact on Economic Welfare of each GCC Member*

Expected Effect on:	Country	Scenario		
		FTA (5% CET)	FTA (Min CET)	MFN Basis
Change in Economic Welfare (% GDP)	Bahrain	430.7 (5.4)	431.0 (5.4)	475.0 (6.0)
	Kuwait	261.1 (0.7)	262.8 (0.7)	345.1 (0.9)
	Oman	463.0 (2.3)	448.1 (2.3)	540.2 (2.7)
	Qatar	218.0 (1.5)	222.0 (1.5)	275.8 (1.9)
	S. Arabia	4,183.4 (2.4)	4,722.6 (2.5)	4,722.6 (2.7)
	UAE	1,474.3 (3.2)	1,376.3 (3.0)	1,844.7 (4.0)
	GCC	**7,030.4** **(2.3)**	**6,985.8** **(2.3)**	**8,203.3** **(2.7)**

* Figures are in millions of US Dollars per annum, at 2000 prices.

Empirical results presented by PWC (2004) are the fruit of a CPE model used in their study. Some economists have criticized CPE models over the years by classifying them as "theory with numbers" because they estimate important parameter values in order to quantify expected trade creation and trade diversion effects of a FTA.[17] Researchers who criticized the CPE models tend to use "gravity equation" as an alternative, which compares actual post FTA trade flows against the natural level of trade suggested by an empirically estimated gravity equation combined with data. In line with this argument, Baier and Bergstrand (2004) attempted to complement the study of PWC (2004) by applying the gravity equation methodology to generate a complementary set

[17] For further details about the criticism regarding the Computational General and Partial Equilibrium models (CGE & CPE), see for example Baldwin and Venables (1995) and Pomfret (1997).

of estimates of the potential trade creation and trade diversion effects of the proposed EU-GCC FTA.

Baier and Bergstrand (2004) estimated several scenarios by introducing numerous specifications to their gravity equation. Here, we will only present results of the two main scenarios (restricted and unrestricted specifications) that have been discussed in their paper. The restricted specification stimulates a multilateral-like scenario based upon the mere elimination of tariffs. It comprises of a gravity equation with first-differenced data and time-varying multilateral resistance (MR) term. The unrestricted specification stimulates a deep integration scenario in which prices vary due to tariffs and other internal obstacles to trade removal. This second scenario extends the first scenario by introducing lags and time dummy variables.

The restricted scenario shows that the proposed FTA is expected to benefit the EU with a net trade creation of $ 2.8 billion while the GCC will undergo a net trade diversion of $ 4.3 billion. In contrast, the unrestricted scenario indicates that the proposed FTA will benefit the EU and GCC as both are expected to record a net trade creation of $ 28 and 27 billion, respectively. Interestingly, the $ 28 billion is less than 2% of the EU foreign trade whereas the $ 27 billion is more than 10% of GCC foreign trade.

Given that the restricted scenario in Baier and Bergstrand (2004) stimulates the effect of tariffs removal only, then it is very near in spirit to the PWC (2004) model of MFN basis case. Nevertheless, results regarding the FTA effect on the GCC are contradictory. In other words, while the MFN scenario shows a net trade creation of $ 3 billion for the GCC region, the restricted scenario predicts a net trade diversion of $ 4.3 billion. Whereas, although with different values as shown in Tables 4.1 and 4.2, both scenarios expect a net trade creation for the EU.

Furthermore, if the results of the unrestricted scenario in Baier and Bergstrand (2004) are compared to those in PWC (2004) MFN, then both scenarios indicate the same effect. That is, both EU and GCC are expected to record net trade creation. Nonetheless, the unrestricted scenario shows comparable net trade creation for the EU and GCC ($ 28 and 27 billion

respectively) while the MFN scenario shows remarkably high net trade creation for the EU compared to the GCC (i.e., $ 43.7 and 3 billion respectively), which indicates more benefits to the EU in absolute terms.

5.2.2.2. Description of Data and Methodologies

In estimating the potential effects of FTAs, both Computational General/Partial Equilibrium Models (CGE & CPE) and gravity equation are commonly used by researchers. As we have seen in the previous section, up to our knowledge, there are only two studies that have explicitly estimated the economic impact of the proposed FTA between the EU and the GCC. These are PWC (2004) and Baier and Bergstrand (2004). The former used a CPE model while the latter employed a gravity equation. Below we will have a more detailed look at their models and estimations.

PWC

PWC (2004) used a trade simulation model which is a simple Vinerian model[18] of world trade developed to quantify the economic impacts of the proposed EU-GCC FTA. The model is constructed as a Computational Partial Equilibrium (CPE) model that includes trade of the GCC, other MENA countries, EU, Japan, USA, other industrial countries, and other developing countries. The model used trade flows disaggregated by the 21 major sections of the harmonized system. The "small country" assumption is maintained throughout their model. That is, each country is assumed to be insufficiently large to affect its international terms of trade through variations in the volume of either its exports or imports. Database is compiled on an average basis for 1999-2001.

The model is based on familiar (log-linear) import demand and export supply functions for traded goods. Market clearing conditions for each category of traded goods determine international prices, and an equilibrium balance of payments condition determines the real exchange rate of each country. Representing an FTA in the model requires special consideration of price determination. In the basic model, the international price of a good (k) expressed as (P^*_k) is determined largely independently of the behavior of consumers and producers in any single

[18] For more information about the Vinerian model, see Viner (1950).

country or any small group of countries. However, under the FTA trade of member countries with nonmember countries might be largely diverted and an independent intra-bloc export price of good (k) expressed as (P^r_k) might be established so long as then intra-bloc export price falls within acceptable bounds to bloc producers and consumers who, notwithstanding their inclusion in the FTA, are assumed to continue recourse to international markets for traded goods. The model sets two bounds on intra-bloc prices:

- Lower price bound: if good (k) lies within the comparative advantage of member countries (i.e., the trading bloc is expected to remain a net exporter of good "k" to the world), then (P^r_k) cannot fall below international price (P^*_k).

- Upper price bound: if good (k) lies outside the comparative advantage of member countries (i.e., the trading bloc is expected to remain a net importer of good "k" from the world), then (P^r_k) may lie above (P^*_k) by a finite premium.

To enforce these two bounds on intra-bloc prices, their model set intra-bloc prices (P^r_k) based on considerations for the new trading bloc's comparative advantage and structure of external tariffs.

The model also computes trade creation and trade diversion in member countries of the proposed FTA in a cursive manner, after the basic model is first solved for equilibrium trade volumes, domestic and international prices, and exchange rates. Trade creation ($TC_{k(j)}$) of good (k) for an individual member country j occurs when the FTA causes the domestic price of imports of good k in country j ($P^m_{k(j)}$) to fall and imports of the good ($M^d_{k(j)}$) to rise. Thus, trade creation in the model is computed simply as the change in imports:

$$TC_{k(j)} = \Delta M^{d}{}_{k(j)} \qquad (a)$$

where Δ denotes change in variable between the base case (no FTA) and the FTA case.

Trade diversion (TD_k) of good (k) is equal to the total decrease in demand by member countries for imports of good (k) from nonmember countries. In the model, bloc-wide trade diversion is

computed simply as the increase in supply of exports of good (k) by member countries (j) expressed as ($X^{s}_{k(j)}$) in response to higher intra-bloc prices for exports of noncompetitive goods (k=nc).

$$TD_{k=nc} = \sum_{j} \left[\Delta X^{s}{}_{k(j)} \right] \qquad (b)$$

Trade diversion for individual (importing) members of the FTA is then calculated on an *ad hoc* basis, because the model does not explicitly determine changes in bilateral trade. Specifically, bloc-wide trade diversion for good (k) is apportioned to member countries whose external tariffs are greater than or equal to the intra-bloc export premium ($\tau^{r}{}_{k}$) according to their share in the total imports of good (k) under the FTA.

Finally, and in addition to determining changes in trade flows and import tariff revenues, the model computes changes in economic welfare based on familiar notions of consumer surplus and producer surplus. The change in consumer surplus corresponds to the change in national welfare occasioned mainly by trade creation while the change in producer surplus corresponds to the change in national welfare occasioned mainly by trade diversion. Nevertheless, their model does not explicitly account for non-tariff barriers.

Baier and Bergstrand

Baier and Bergstrand (2004) estimated with Ordinary Least Squares (OLS), a typical gravity equation using bilateral trade flows among 100 countries in 1995 as well as for two sub-samples using trade flows of only GCC countries (one sub-sample is GCC members' trade with other 94 countries and one is GCC members' trade with only EU members). See Equation 1 below.

$$PX^{g}_{ij} = \beta_0 (GDP_i)^{\beta 1} (GDP_j)^{\beta 2} (DIST_{ij})^{\beta 3} e^{\beta 4(ADJ_{ij})} e^{\beta 5(LANG_{ij})} e^{\beta 6(FTA_{ij})} \in_{ij} \qquad (1)$$

Where PX^{g}_{ij} is the log of sum of two countries' bilateral trade flows (country i and country j); GDP_i (GDP_j) is the level of nominal gross domestic product in country i (j); $DIST_{ij}$ is the

distance between the economic centers of countries i and j; ADJ_{ij} is a binary variable assuming the value 1 if countries i and j share a common land border and 0 otherwise; $LANG_{ij}$ is a binary variable assuming the value of 1 if countries i and j share a common language and 0 otherwise; FTA_{ij} is a binary variable assuming the value of 1 if countries i and j are members of the same FTA and 0 otherwise; e is the natural logarithm base; $\in_{ij}$ is assumed to be a log-normally distributed error term. Furthermore, for the two sub-samples using trade flows of only GCC countries, a dummy variable for GCC membership was added (GCC_{ij}). This variable takes the value of 1 if the two countries are members of the GCC and 0 otherwise.

Coefficient estimates of Equation 1 showed that the above used analytical and empirical framework can be fundamentally the same one used to analyze standard international trade patterns. However, endogeneity bias might arise in the above regression equation whenever any of the right-hand-side variables is correlated with the error term in the regression. In line with this argument, the authors introduced two modifications to the above equation estimation in order to offer potentially unbiased estimates of the effects of FTAs on trade flows. The modifications are using fixed effects to differentiate the economic data over time. In addition, lagged variables were also used for the FTA variable for example. This specification allows FTAs formed in the previous period to still have lagged impacts on the current period's trade flows. Finally, Baier and Bergstrand used resulting coefficients to estimate effects on trade creation and trade diversion of an EU-GCC FTA for the year 2000 (taken from PWC, 2004) discussed in the previous section.

Unlike PWC (2004), Baier and Bergstrand (2004) presented that results are limited to trade creation and trade diversion effects and do not cover economic welfare expressed by consumer surplus and producer surplus. In addition, results provide general estimations of change in foreign trade without further specification of main drivers of these increases (i.e. product categories) as it is the case in PWC (2004).[19] However, Baier and Bergstrand claim completing the estimates of PWC as they employ a gravity equation instead of the CPE model, which has

[19] For detailed results regarding changes in foreign trade of specific product categories please refer to the PWC (2004) paper.

been criticized by several economists. Nevertheless, it is worth mentioning that both methodologies are still being used by economists who want to predict FTAs potential impact.

Although both PWC (2004) and Baier and Bergstrand (2004) employed common methodologies in predicting the impact of the FTA, the data used is up to 2001, which imposes a relevant caveat. That is because starting January 2003, the GCC unified set all external tariffs at 5% as their Customs Union came into force. Therefore, trade patterns after that date have changed given the alteration in tariffs rates. Unfortunately, these changes are neither captured in PWC nor in Baier and Bergstrand studies.

5.3. Summary and Conclusions

The existing literature regarding the proposed FTA between the EU and GCC countries are divided into two categories; political economy literature and economic analysis. The first strand of literature analyzed the importance of establishing FTA from several angles with special attention to political factors. However, they also shed light on the importance of economic factors but without further discussions. Several political economy papers have been written in this line of research. Whereas, deeper economic analysis have not been made till early 2004.

Up to date, there are only two studies measuring the economic impact of the EU-GCC FTA. These are PWC (2004) and Baier and Bergstrand (2004). In general, both papers showed that the proposed FTA will increase economic welfare for both involved parties, but with different levels. More specifically, PWC (2004) showed that increases in economic welfare for the GCC will be around 2.7% of GDP, while it will have a negligible overall welfare effect on the EU (0.6% of GDP). No significant level of trade diversion was predicted by their model, which indicates that net trade creation for the EU and GCC is merely caused by trade creation. In addition, increase in consumer surplus for both economic blocs seems to be limited compared to increase in producer surplus, indicating higher benefits for producers.

On the other hand, Baier and Bergstrand's (2004) results are divided into two channels using two models; restricted and unrestricted. The restricted scenario shows that the proposed FTA is

expected to benefit the EU with a net trade creation of $ 2.8 billion while the GCC will undergo a net trade diversion of $ 4.3 billion. In contrast, the unrestricted scenario indicates that the proposed FTA will benefit the EU and GCC as both are expected to record a net trade creation of $ 28 and 27 billion, respectively. Interestingly, the $ 28 billion is less than 2% of the EU foreign trade whereas the $ 27 billion is more than 10% of GCC foreign trade.

Although both PWC (2004) and Baier and Bergstrand (2004) employed common methodologies in predicting the impact of the FTA, the data used is up to 2001, which imposes a relevant caveat. That is because starting from January 2003, the GCC unified set all external tariffs at 5% as their Customs Union came into force. Therefore, trade patterns after that date have changed, given the alteration in tariffs rates. Unfortunately, these changes are neither captured in PWC nor in Baier and Bergstrand studies. Therefore, similar economic impact estimations are required with more recent, up-to-date data.

REFERENCES

Adebiyi, M. (2002) Is Financial Liberalization the Cause of Banking Fragility in Nigeria? *African Review of Money Finance and Banking*, 23-40.

Alesina, A.; De Broek, M.; Prati, A.; and Tabellini, G., (1992), Default risk on government debt in OECD countries, In *Economic policy: A European forum*, 428-463.

Babood, A., (2003), Dynamics and determinants of the GCC states' foreign policy, with special reference to the EU, *Review of International Affairs 2*, 254-282.

Baier, S. and Bergstrand, J., (2004), Trade agreements and trade flows: Estimating the effect of free trade agreements on trade flows with an application to the European Union – Gulf Cooperation Council free trade agreement, Economic Paper No. 214, European Economy, European Commission, Brussels. Available for download from http://europa.eu.int./comm/economy_finance

Balassa, B. (1976), Types of economic integration world wide, regional, sectoral. In Machlup F., (ed.), *International Economic Association*, New York, Wiley, 1-31.

Baldwin, R.., and Venables, A., (1995), Regional economic integration, In Gene M. Grossman and Kenneth Rogoff (eds.), *Handbook of International Economics*, volume III, Elsevier Science Publishing, Amsterdam.

Bekaert, G. et. al., (2004), *Global Opportunities and Market Integration,* NBER Working Paper No. W10990, December 2004.

Bende-Nabende, A. (2002), Globalization, FDI, regional integration and sustainable development: Theory, evidence and policy, Aldershot, Ashgate.

Bhagwati, J. and A. Panagariya, (1996), The Theory of Preferential Trade Agreements: Historical Evolution and Current Trends, *American Economic Review*, Vol. 86 Issue 2.

Chirullo, M and Guerrieri, P., (2002), GCC-EU relations and trade integration patterns, European University Institute Policy Paper 02/5.

Cooper, C. A. and B. F. Massell, (1965), A New Look at Customs Union Theory, *Economic Journal*, Vol. 75, No. 300.

Demetriades, P. and Luintel, K. (1996) Financial Development, Economic Growth and Banking Sector Controls: Evidence From India, *Economic Journal* 106, 359-74.

Demetriades, P.; Fattouh, B., and Shields, K. (2001) Financial Liberalization and the Evolution of Banking and Financial Risks: The Case of South Korea, *Working Paper*, University of Leicester, Leeicester.

DeRosa, D. and Kernohan, D., (2004), Measuring the impact of an EU-GCC free trade agreement, *Working Document No. 206*, Centre for European Policy Studies (CEPS), Brussels.

Escribano-Francés, G., (2000), Euro-Mediterranean versus Arab integration: Are they compatible, Journal of Development and Economic Policies 3, Arab Planning institute, Kuwait.

Escribano-Francés, G., (2005), An international political economy view of EU-GCC partnership, paper presented at "the international conference on challenges of economic development for GCC countries", organized by the Kuwait Institute for Scientific Research (KISR) and sponsored by The World Bank, Kuwait City, 29-31 January.

Fischer, K. and Chénard, M. (1997) Financial Liberalization Causes Banking System Fragility, *Working Paper No 97-12*, Centre de Recherche en Économie et Finance Apliquée (CRÉFA), Université Laval.

Frankel, J. et. al., (1996), Regional Trading Arrangements: Natural or Supernatural? *American Economic Review*, Vol 86 Issue 1.

Fry, M. (1997) In Favour of Financial Liberalization, *Economic Journal* 107, 754-70.

Fürtig, H., (2004), GCC-EU political cooperation: Myth or reality, *British Journal of Middle Eastern Studies 31*, 25-39.

Hollis, R., (1997), Europe and Gulf security: A competitive business, in Long and Koch, eds., *Gulf Security in the XXIst Century*, Emirates Centre for Strategic Studies and Research/British Academic Press.

Jayaratne, J. and Strahan, P. (1996) The Finance-Growth Nexus: Evidence from Bank Branch Deregulation, *Quarterly Journal of Economics* 111, 639-670.

King, R., and Levine, R. (1993) Finance and Growth: Schumpeter Might Be Right, *Quarterly Journal of Economics* 108, 717-37.

Kondonassis, A. J. and A. G. Malliaris, (1996), NAFTA: Old and New Lessons from Theory and Practice with Economic Integration, *North American Journal of Economics & Finance*, Vol. 7 Issue 1.

Krauss, M. B., (1972), Recent Developments in Customs Union Theory: An Interpretive Survey, *Journal of Economic Literature*, Vol. 10 Issue 2.

Levine, R. (1996) Foreign Banks, Financial Development, and Economic Growth, in C.E. Barfield (ed.), *International Financial Markets: Harmonization versus Competition*, Washington D.C., American Enterprise Institute Press, 224-254.

Levine, R. (1997) Financial Development and Economic Growth: Views and Agenda, *Journal of Economic Literature* 34, 688-726.

Lloyd, P. J. and D. Maclaren, (2004), Gains and Losses from Regional Trading Agreements: A Survey*, The Economic Record*, Vol. 80, No. 251.

Loehr, W., (1975), Notes on Lipsey's Theory of Customs Union*, Journal of Common Market Studies*, Vol. 13 Issue ½.

Luciani, G. and Neugart, F., (2005), The EU and the GCC: A new partnership -an update, paper presented by Bertelsmann Stiftung, Centre for Applied Policy Research (CAP) and the Robert Schuman Centre for Advanced Studies (RSCAS), Gütersloh.

Pomfret, R., (1997), The economics of regional trading arrangements, *Oxford University Press*, Oxford.

PriceWaterHouseCoopers, (2004), Sustainability impact assessment (SIA) of the negotiations of the trade agreement between the European Community and the countries of the Cooperation Council for the Arab States of the Gulf (GCC), *Framework Contract EC TRADE 02-F3-03,* Centre for European Policy Studies (CEPS), Brussels. Available for download from (www.sia-gcc.org).

Rettab, B. and A. Istaitieh, (2005), *The Effects of Customs Union Formation Between GCC Countries on Dubai's Trade,* Foreign Trade Report, Dubai Chamber of Commerce and Industry.

Rettab, B. and M. Morada, (2005), *Customs Union and UAE's trade with GCC Member States*; Foreign trade Monitor Series, 34-01-04-05.

Sachs, J. and Warner, A. (1995) Economic Reform and the Process of Global Integration, *Brookings Papers of Economic Activity* 25, 1-118.

Saleh, N., (1999), The European Union and the Gulf States: A growing partnership, *Middle East Policy Council Journal 7*, 50-71.

Shaw, E. (1973) *Financial Deepening in Economic Development*, Oxford University Press, New York.

Singh, A. (1997) Financial Liberalization, Stock Markets and Economic Development, *Economic Journal* 107, 771-82.

Siu-Hung Yu et. Al., (1975), Domestic Distortion and the Theory of Customs Unions, *Southern Economic Journal*, Vol. 42 Issue 2.

Syropoulos, C., (2002), On Tariff Preferences and Delegation Decisions Customs Unions: A Heckscher-Ohlin Approach, *The Economic Journal*, 112.

Telser, L. (1966) Cutthroat Competition and the Long Purse, *Journal of Law and Economics* 9, 259-277.

Thirwall, A. P., (2000), *Trade Agreements, Trade Liberalization and Economic Growth: A Selective Survey,* African Development Bank 2000. Blackwell Publishers, Oxford, UK.

Viner, J.,(1950), *The Customs Union Issue*, Carnegie Endowment for International Peace, New York.

World Bank (1997) *Private Capital Flows to Developing Countries: The Road to Financial Integration*, Oxford University Press, Oxford.

APPENDIX I

This chapter uses available data on non-oil foreign trade of the UAE for 2000 to 2004, and extends to 2005 for Dubai, in as much as Dubai accounts for more than 70 percent of UAE's non-oil trade. Data are at the 2-digit HS classification and by trading partner. Thus, the lowest level of information, x_{ijk}, refers to the value of UAE's trade by flow (i = 1 for imports, 2 for exports, and 3 for re-exports), by type of goods (j refers to the 2-digit HS classification, j = 1, 2, …, 97), and by trading partner/country. For example, $X_{1,02,3}$ = value of UAE's imports (i = 1) of live animals and animal products (HS Code = 02) from Oman (country code = 3).

The analysis compares the UAE's trade performance for two periods 1) the ex-ante period or the period prior to the implementation of the CU, and 2) the ex-post period or the period during the implementation. Levels and structure of trade for the ex-ante period are generated from data for 2000 to 2002, while corresponding measures for ex-post period are generated from data for 2003 to 2005. The limitation of data for ex-ante period to data for the last two most recent years prior to implementation has been done to minimize extraneous factors that could influence the differentials that would be observed between the sets of estimates for the two periods.

Common measure of trade performance of an economy in a given market is based on the change in the value of trade. At the aggregate level, the measure is normally dictated by the changes in the levels of trade on major products, as changes in the value of minor products do not bring about substantial effects on the aggregate. At the product level, however, changes in the values of trade on minor products could be very high as the base values are relatively very small. Thus, while the change in the aggregate level tends to ignore indications of increasing product diversification resulting from expansion in trade of minor

products, the change in the product values could overstate the contribution of the minor products to market expansion.

The performance score used in this analysis is a combined measure based on growth in the value of trade and on the diversification of product composition; i.e.,

performance = f (change in value, change in composition)

The measure of change used is the annual rate of change, r_t, given by the following formula:

$$r_t = [(x_t - x_{t-1})/ (x_{t-1})] * 100 \quad (1)$$

where, t = specified year, say 2004

x_t = *value of trade(in AED) in year t*

x_{t-1} = *value of trade(in AED) in year t-1*

Thus, rate of change of trade on product k is given by:

$$r_{k,t} = [(x_{k,t} - x_{k,t-1})/ (x_{k,t-1})] * 100$$

where $x_{k,t}$ = value of trade on the product group k at year t,

$x_{k,t-1}$ = value of trade on the product group k at year $t-1$,

Diversification of product composition of trade is measured in terms of the relative importance of the various product groups to the total trade with the partner; i.e., trade is less diversified if only a very few product groups contribute significantly to the value of total trade. On the other hand, in a more diversified product composition, many product groups have significant shares to the total value of trade. Relative importance of a product group is measured in terms of its share to the total trade at a given time, $s_{k,t}$, given by:

$$s_{k,t} = (x_{k,t}/x_T) * 100 \ , \quad (2)$$

where $x_{k,t}$ = value of trade on the product group k at year t,

x_T = total value of trade at year t.

Combining the two measures, the performance score of a specific product group ***k*** during the year ***t***, $p_{k,t}$, is given by:

$$p_{k,t} = r_{k,t} * s_{k,t} \quad (3)$$

Thus, the performance score in a given partner, ***i***, is given by the summation of the product scores for all products traded with the country; i.e.,

$$P^{i}_{t} = \Sigma (r^{i}_{k,t} * s^{i}_{k,t}) \text{ , for all } k \quad (4)$$

When $P^{i}_{k,t}$ is negative, the numerical sum of the negative performance scores exceeds the sum of the positive performance scores. Thus, the overall performance score is negative (or low) in the market considered. On the other hand, the more positive the statistic is, the better is the performance of trade in the market. Increasingly positive performance can result from the following:

1. Increasing trade on the dominant product group/s, implying the strengthening of the niche market; or
2. Increasing diversification of the product composition, with the share of and growth of lesser traded products posting substantial increases; or
3. A combination of the above scenarios; i.e., there is both niche market strengthening and product diversification.

Extension of the method is applied in the computation of the performance score for a group of countries/trading partner. Thus, UAE's trade performance score in the GCC in year ***t***, $P^{GCC}_{t,}$ is the sum of the scores for each GCC member country; i.e.,

$$P^{GCC}_{t} = \sum_{i} \sum_{k} (r^{i}_{k,t} * s^{i}_{k,t}) \quad (5)$$

where ***i*** refers to member countries.