



EU-GCC Trade and Investment Relations: What Prospect of an FTA between the Two Regions?

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1. Creation of the GCC and its Relations with the EU

1.1. GCC integration: drivers, objectives and progress to date

The Gulf Cooperation Council (GCC) is a regional grouping bringing together Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates. Home to a population of 43 million people in 2012, the region exhibits high heterogeneity in socioeconomic development. With GDP per capita of between €34,000 and €54,000, Qatar, Kuwait and the United Arab Emirates are the wealthiest countries, whereas Saudi Arabia, Oman and Bahrain are less wealthy with GDP per capita ranging from €12,000 to €13,000. Human capital is highest in Bahrain, Kuwait and Qatar, with literacy rates of between 91% and 94%, whereas in the other countries literacy rates are lower (Annex 4). The GCC is well known for its hydrocarbons endowments, but since their discovery and the beginning of oil exploitation in the 1970s, reserves have decreased substantially in most countries, which has led governments to engage in economic diversification policies. The remaining hydrocarbons are concentrated in a few countries: in 2013, Saudi Arabia and Kuwait accounted for 16% and 6% of world's oil reserves, respectively, and Qatar for 13% of global natural gas reserves (Annex 5).

Security motives were the driving force behind the GCC's creation. In the aftermath of the first Gulf War between Iran and Iraq, the countries of the Arabian Peninsula decided to initiate a move towards regional integration with a view to dealing with possible security threats. Countries in the region share many characteristics, but notwithstanding their commonalities, some important differences exist. For example, Bahrain and Kuwait have somewhat open political systems with parliamentary elections and a written constitution, whereas Saudi Arabia more closely resembles an absolute monarchy.

After the GCC's creation on 25 May 1985, besides reinforcing security cooperation, states in the region have initiated a move towards regional integration similar to that of the EU, with the objectives of creating a customs union and adopting a single currency by 2010. To do so, they established a Secretariat General in 1981, as well as a number of technical organisations

subsequently: the GCC Patent Office (1992), the GCC Standardization Organisation (2001) and the Monetary Council (2009). Despite their willingness to become a unified regional grouping, progress has been slow and uneven. The GCC customs union was only established in 2005, Bahrain and Oman signed free trade agreements (FTAs) with the US in 2004 and 2006 respectively, and, after numerous postponements, talks on the creation of the common currency have been frozen after Oman and the United Arab Emirates decided to opt out. Nevertheless, the process of regional integration advanced, and in 2008 member countries established a common market with the creation of the Gulf Customs Union.

Several factors can be put forward to explain why progress in regional integration has been slow. As oil and hydrocarbons producers, the GCC countries are competitors, which renders the necessary coordination of industrial policies in the region difficult. This similarity in production structures translates into very low rates of intra-regional trade; intra-GCC trade (imports and exports) averaged 7% between 1995 and 2011, compared to 63% for the EU and 23% for ASEAN countries (Figure 1). In the same vein, the region's exposure to oil price volatility and the imperative of income diversification makes coordination of monetary policies difficult. GCC economies appear to be highly state-dominated, with governments holding important shares in the industrial and services sectors. For example, GCC governments retain significant ownership stakes in the country's hydrocarbon sectors (Kombargi et al. 2011), and state-owned banks accounted for an average of 22% of total banking assets in the region between 2003 and 2011, compared to 12% in the EU15 (Ayadi and Groen 2013). Combined with the high degree of similarity in production structures, the state's presence in their respective economies is likely to complicate diversification and regional integration efforts, as governments might be reluctant to conduct important privatisation programmes¹, despite their willingness to support the development of the private sector.

With reducing hydrocarbons dependence a key challenge for the GCC countries, governments in the region have undertaken different strategies to meet this objective. The region's biggest oil producer, Saudi Arabia, has chosen for example to develop manufacturing activities close to the oil sector, such as plastics, polymers and fertilisers, via the state-owned SABIC company. Bahrain and the United Arab Emirates have chosen to develop tourism, manufacturing and financial activities, while Qatar has opted to strengthen its gas and financial sector (Sturm et al. 2008). These efforts seem to have yielded some results, as recent evidence shows that countries in the region are reducing their dependence on commodities and are less vulnerable than before to fluctuations in the price thereof (Basher 2010).² More precisely, the Kuwaiti and Saudi Arabian manufacturing sectors appear to have "decoupled" from the oil sector, while the Qatari economy is still affected by oil price swings (with the exception of its manufacturing sector).

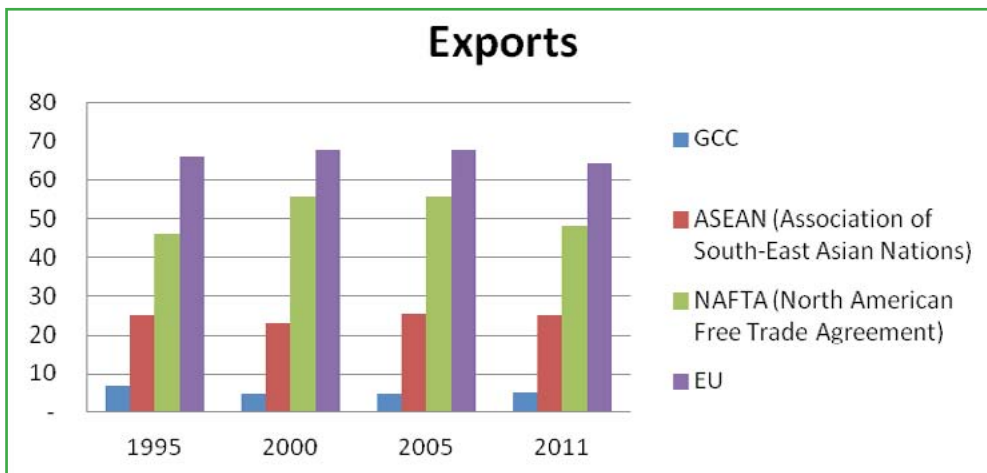
¹ Here, privatisation refers to the transfer of ownership of property or a business from a government to a privately-owned entity.

² To assess whether the GCC countries have diversified, Basher (2010) uses as a measure the degree of business cycle synchronicity between different economic sectors.

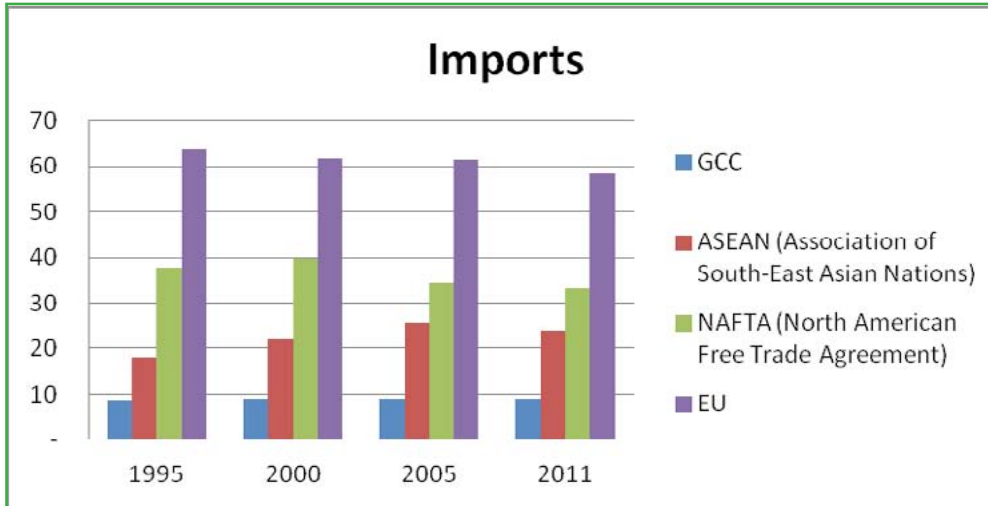
As far as the patterns of GCC international trade in goods are concerned, exports show a high degree of concentration. Compared to other economies, the GCC countries appear to be the most dependent on oil and gas. This suggests that their recent efforts to move away from oil dependence have failed to achieve meaningful results (Figure 2, Annex 1).

Trade protection, measured by the Overall Trade Restrictiveness Index (OTRI) developed by Kee, Nicita and Olarreaga (2009),³ is low by international standards (Figure 3). Given that GCC tariffs averaged 5% in 2009, the low value of the index suggests that countries in the region do not resort excessively to non-tariff barriers for protectionist purposes. The low values of the OTRI could also be a reflection of the GCC countries' specialisation in hydrocarbons. Since the countries in the region are locked into the production of oil and its derivatives, overly high levels of trade protection can be detrimental to diversification efforts since inputs would cost more, removing incentives for companies and governments to foster the development of alternative production. Also, high tariff levels can lead to inflationary pressures in oil-producing countries, thus complicating macroeconomic management while running a risk of social unrest.

Fig. 1. Intra-regional exports and imports of selected trading blocs, 1995-2011 (% total trade in goods)

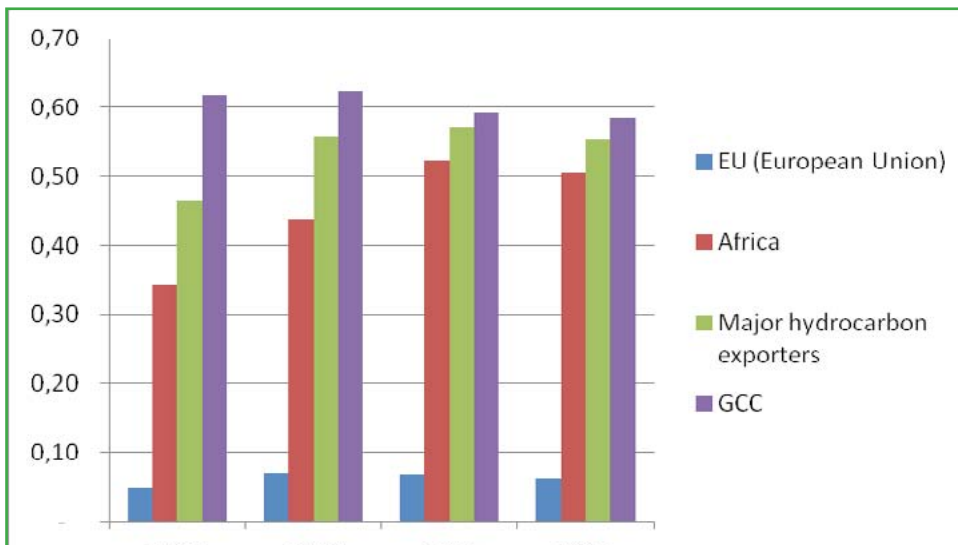


³ The OTRI measures the uniform tariff equivalent of the tariff and non-tariff barriers (NTB) that would generate the same level of import value for a country in a given year. Tariffs can be based on Most Favored Nation (MFN) tariffs, which apply to all trading partners, or applied tariffs, which take into account bilateral trade preferences. The *ad valorem* equivalents of NTBs have been estimated by Kee, Nicita and Olarreaga (2009). See World Bank (2012a) and Annex 2 for a brief technical summary of the methodology.



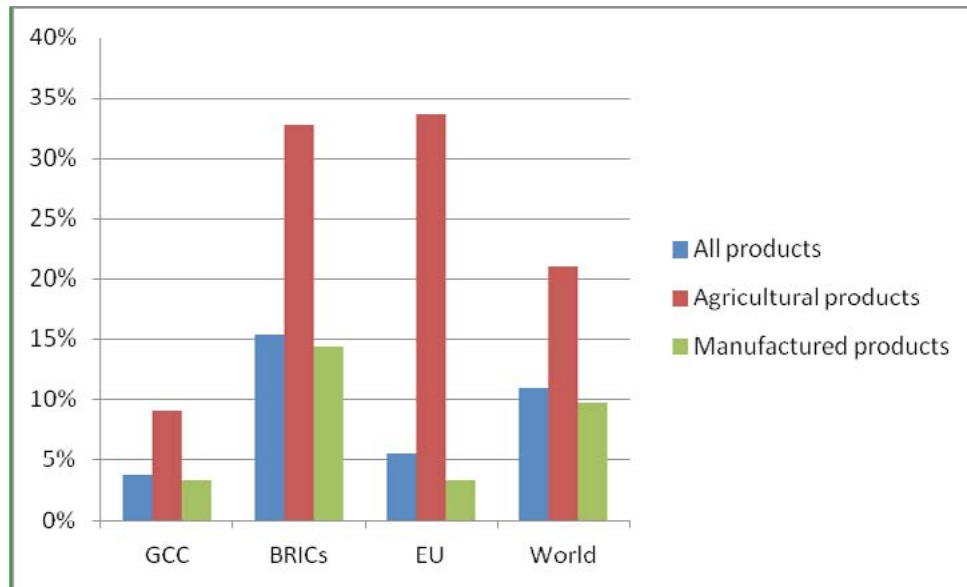
Note: see Annex 6 for country groupings used in this paper.
 Source: UNCTADstat.

Fig. 2. Concentration index of GCC and other economies' exports, 1995-2011



Source: UNCTADstat.

Fig. 3. GCC countries' OTRI, 2009 (average tariff equivalent of tariff and non-tariff barriers across agricultural and manufactured products)



Source: World Bank (2012a).

In addition to structural economic factors rendering regional integration difficult, geopolitical factors can also explain why the GCC countries fail somewhat to behave as a unified bloc, despite their many common institutional characteristics. In 2004, for example, before the establishment of the customs union in 2005, Bahrain sidelined its other partners and signed an FTA with the US while reinforcing the US military presence in its territory in a bid to contain Iranian influence.

The GCC region's resource endowments, the weaknesses in its economic integration and its growing importance in the Arab world have resulted in the development of important commercial and political links with other countries, chiefly with the US, which established itself as the guarantor of regional security against the threats to the region represented by Iran and Iraq. As a result of their international clout and their importance in their neighbourhood, GCC countries have concluded a number of international agreements, and participate in regular international summits and negotiations.

1.2. GCC relations with the EU: drivers, objectives and progress to date

While the GCC has privileged the US as an international partner thanks to the latter's engagement in the region since the discovery of hydrocarbons, the region has attracted the attention of EU policymakers since the 1970s as a result of a mix of geopolitical and commercial interests. The first initiative structuring relations between EU countries and the GCC countries dates back to 1974, when France pushed for the launch of the Euro-Arab Dialogue, following the Arab-Israeli War of 1973 and the first oil crisis. The initiative did not target the GCC countries exclusively, but sought to establish a permanent dialogue between European countries and members of the Arab League. Eventually, the initiative collapsed

in 1989 without any significant achievement in terms of deepened or comprehensive cooperation.⁴

Between the end of the 1970s and the middle of the 1980s, European countries sought to strengthen relations with the Arabian Peninsula and, in 1983, both sides reached a framework agreement aimed at freeing and increasing commercial exchanges between the two regions. Over the 1980s, the scope of the framework agreement was gradually extended and, as trade relations grew between the two regions, negotiations for a Cooperation Agreement concluded in 1988. This multilateral agreement sought to “promote overall cooperation between equal partners on mutually advantageous terms in all spheres between the two regions and further their economic development, taking into consideration the differences in levels of development of the parties”⁵

At the time of the conclusion of the Cooperation Agreement, the motivations of the EU countries were quite straightforward. The GCC countries were important suppliers of hydrocarbons and no less important as an export market for European economies. Besides its economic dimension, the Agreement also had a minor political dimension in which the EU saw the GCC grouping as an important actor for the promotion of stability in the region. To achieve this aim, cooperation was established in a wide range of fields: economy and trade, agriculture and fisheries, industry, energy, science and technology, investment and the environment. Nowadays, the rationale for having close relations with the GCC countries is different and perhaps stronger, as trade and investment relations have grown due to the region housing the biggest sovereign investment vehicles, which have emerged since 2008 as important purveyors of emergency finance for distressed EU financial institutions.

However, despite its ambitious framework and the underlying motives for strong relations, little has been achieved in any of the fields covered by the Agreement. In fact, the Gulf countries were not included in the EU’s external cooperation programmes until 2007, when the Council adopted Regulation (EC) No 1934/2006 establishing a financing instrument for cooperation with industrialised and other high-income countries and territories (ICIHI) for the years 2007-2013. The instrument is allocated a small envelope of €172 million and targets, besides the GCC countries, other industrialised nations such as Australia, Canada, Japan, and the United States. The fields of intervention of the ICIHI are broadly the same as those envisaged in the Cooperation Agreement.⁶

⁴ *The initiative collapsed for two reasons. First, Arab countries withdrew after the signature of the Camp David Accords in 1979. Second, despite French tentative attempts to revive the process, the Gulf War and inter-Arab divisions de facto collapsed it.*

⁵ *Quoted from the preamble to the EU-GCC Cooperation Agreement, Official Journal L 054 of 25 February 1989, p. 3-15, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:1989:054:0003:0010:EN:PDF>.*

⁶ *The activities covered by the ICIHI are: promotion of cooperation, partnership and joint undertakings between economic, academic and scientific actors in the EU and the partner countries; stimulation of bilateral trade, investment flows and economic partnership; promotion of dialogue between political, economic and social actors and NGOs; promotion of people-to-people links, education and training programs, intellectual exchanges and the enhancement of mutual understanding between cultures and civilizations; promotion of co-operative projects in the areas of research, science and technology, energy, transportation and environmental matters; raising awareness about and understanding of the European Union and its operations in partner countries; and support for specific initiatives, including research work, studies, pilot schemes and joint projects.*

In the field of political dialogue, the Cooperation Agreement created the Joint Cooperation Council, comprising representatives of both sides who meet at least once a year. The Joint Cooperation Council's aim is to achieve the objectives set out in the Cooperation Agreement and to ensure it operates smoothly. In practice, the bulk of communiqués made by the Joint Cooperation Council have only been political statements on international stability and terrorism, on which both parties share the same views. As regards technical cooperation, besides some support in the form of technical assistance provided by the EU for the regional integration process of the GCC, very little has been achieved, mostly due to the numerous hesitations on the part of the Gulf countries in their regional integration process (Baabood 2006).

2. Trade and Investment Patterns Between the EU and the GCC: What Diagnosis?

2.1. EU-GCC trade in goods

If political dialogue and technical cooperation have failed to achieve meaningful results, trade and investment relations have flourished, driven by high oil prices and the Gulf countries' development imperatives. However, the economic and financial crisis of 2008 put a halt to the development of EU-GCC trade relations; as the emerging economies of Brazil, Russia, China, and India (the BRICs) proved more resilient to the financial turmoil, they outperformed the EU and in 2009-10 became the Gulf's top suppliers and primary export market (Figure 4). The emerging markets' immunity to the financial turmoil has influenced the figures on trade growth; between 1995 and 2011, the compound average growth rate (CAGR) of GCC exports to the BRICs amounted to 21%, compared to 12% for the EU and 14% for the entire world.

Despite the important growth in GCC-BRICs trade, the region has maintained a structural trade deficit with the EU. Trade patterns between the two regions are stable and show that GCC exports to the EU are mainly oil, gas, and related petrochemical products, while the region imports chiefly manufactured products and transport equipment from the EU.⁷ While EU-GCC trade patterns have a strong resemblance to those of other GCC trading partners, GCC imports from the EU have a significantly higher value added and technological content. On average over the period 1995-2011, 28% of EU exports to the GCC were knowledge-intensive manufactured products (see Annex 7 for the product classification). In contrast, the BRICs, and chiefly China, continue to export mostly low- and medium-technology goods to the GCC region, although Chinese knowledge-intensive exports averaged a growth rate of approximately 10% over the period.

⁷ France, Germany and the UK account for approximately 70% of EU exports to the GCC countries.

These patterns are evolving rapidly, however. Knowledge-intensive⁸ exports from China to the GCC recently increased by 5%, moving from 15% to 20% of total exports between 2004 and 2011. The increase in high-tech imports from China, and the concomitant narrowing of the GCC region's trade balance with the EU, suggest that bilateral flows between China and the Gulf countries are going up in the value chain. This preliminary evidence notwithstanding, a definite assessment of whether imports from China are taking over over the EU's position in the region would require more in-depth analysis.

The shifting trade patterns of the GCC region have translated into a narrowing of the trade balance with the EU of €27 billion, moving from €40 billion in 2009 to €15 billion in 2008 (Figure 5). Besides the upward move in the value chain of China's exports to the region, the narrowing of the GCC region's trade balance with the EU could be explained by the financial crisis. Between 2008 and 2009, the financial crisis resulted in a lower demand for hydrocarbons from the EU, while GCC countries' demand for European goods remained stable.

The figures for EU-GCC trade notwithstanding, from a European perspective the Gulf countries are minor trading partners. Between 2000 and 2011, their share of total EU exports amounted to approximately 3%, and their share of total imports averaged 2%. Also, reflecting the diversification of the EU's hydrocarbon supplies, the GCC countries' share of total hydrocarbons imports averaged 8%. Within the machinery and transport equipment category, the GCC countries accounted for a small share of total exports (3% between 2000 and 2011).

Looking at the figures at the country level, EU-GCC trade relations are concentrated among a small group of countries: France, Germany and the UK trade mainly with Qatar, Saudi Arabia and the United Arab Emirates, and these countries accounted for 70% of bilateral trade flows over the period 1995-2011. The close relations between these countries are further underscored by the number of defence contracts they have concluded since the 1990s. For example, the UK supplied significant quantities of military equipment to Saudi Arabia through a series of Al Yamamah deals, and the French defense consortium EADS built an air fence system along the Saud-Yemeni border.⁹ Although a latecomer compared to France and the UK, Germany has sold military planes to the region and deepened its engagement with the GCC.¹⁰

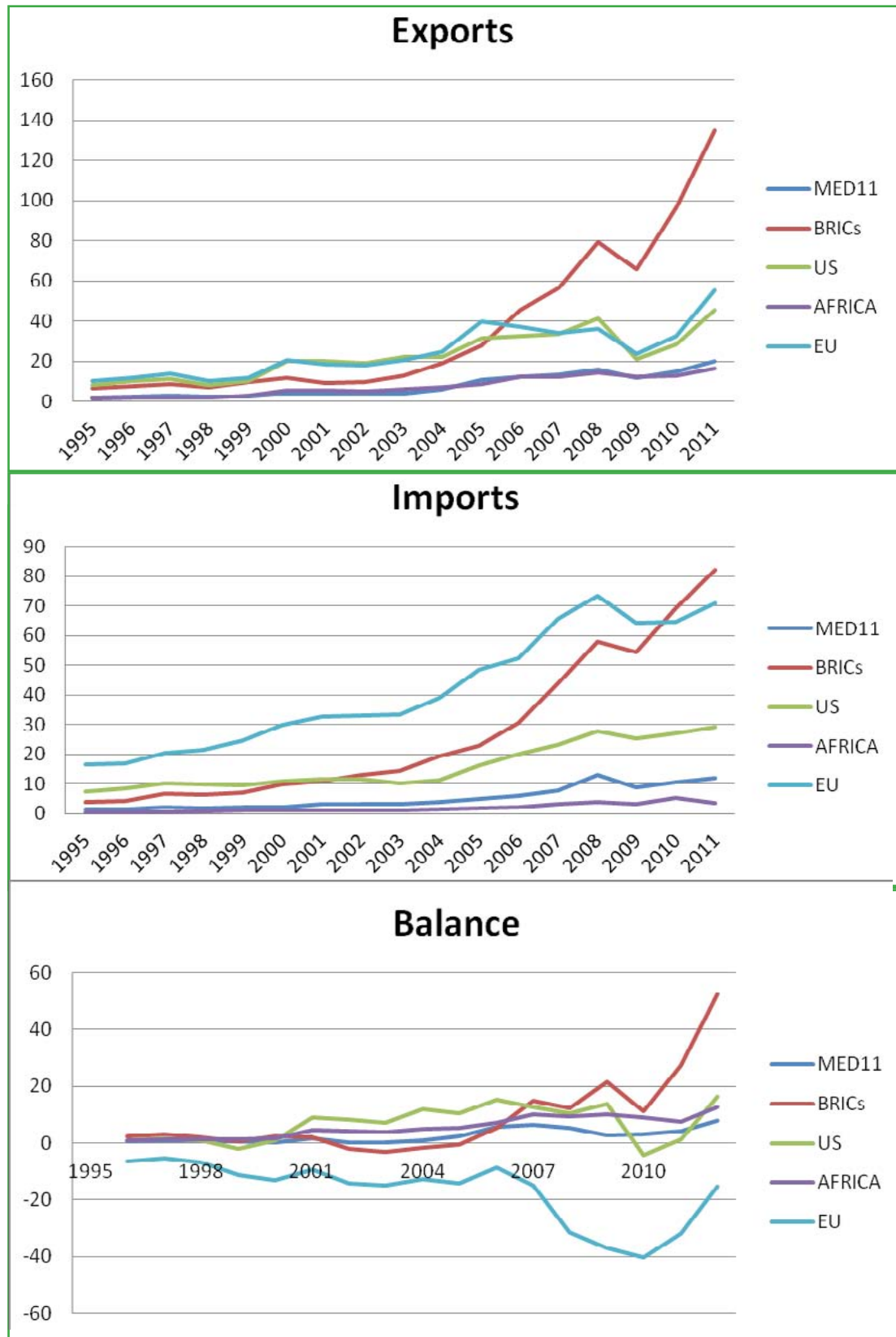
⁸ This classification is based on the OECD's definition of technological intensity in manufacturing products. High technology goods are produced by industries with the highest share of R&D spending in the manufacturing sector. For more information see OECD (2011). See also Annex 7 for a classification of knowledge-intensive manufactured products.

⁹ "World's Barriers: Saudi Arabia", BBC News, 5 November 2009, http://news.bbc.co.uk/2/hi/middle_east/8342890.stm.

¹⁰ Germany did not get involved in the Gulf wars, but agreed to participate in military operations involving GCC countries in the Middle East as long as they complied with United Nations resolutions.



Fig. 4. GCC exports and imports to selected regions (€ bn)¹¹



Source: UNCTADstat.

¹¹ GCC exports to China consist mainly of oil and related products.

In recent years, trade between the GCC countries and China has soared, driven by Beijing's need for hydrocarbon resources and an increase in its exports' value added. Despite this rise, the EU still remains an important partner for the GCC but, looking to the future, Chinese exports are likely to compete increasingly with those from the EU.

2.2. EU-GCC trade in services

While bilateral flows of trade in goods have been explained by a country's comparative advantage, its factor endowments (Stolper and Samuelson 1941), product differentiation (Krugman 1979), trade costs (Krugman 1980) and, more recently, by productivity differentials among firms (Melitz 2003), these theories seem somewhat ill-suited to explaining patterns of trade in services, due to the latter's inherent non-storability. As a result, theories explaining trade in services patterns emphasise the fragmentation of companies' production networks, demand, and total factor productivity (see Hoekman 2006, for a review). The non-tradability of services has led authors to develop a typology of services based on the four modes of services supply (Sampson and Snape 1985):

- **MODE 1:** Cross-border supply refers to services for which supply does not require the seller or buyer to meet physically to conclude a transaction. Telecommunications enter into this category.
- **MODE 2:** Consumption abroad applies to services for which the consumer or the supplier must move the other's physical location to supply the service. This is the case for tourism.
- **MODE 3:** Commercial presence concerns those services requiring either persons or firms to move to the location where consumers reside. Retail services are illustrative of this category.
- **MODE 4:** Movement of natural persons brings together services for which persons need to move to supply the service. This is the case for education and professional business services, for example.

This standard international classification was integrated in the WTO General Agreement on Trade in Services (GATS) but to analyse the characteristics of a country or region's trade in services, services categories are more illustrative. Also, from a liberalisation perspective, focusing on services categories rather than on modes of supply is more relevant since some different services under the same mode of supply might be subject to different regulations. For example, retail sales and banking services fall both under Mode 3, as they require opening a branch in the country. However, the regulations affecting these two activities are different, as banking and financial regulations have a prudential nature and, as a result, regulations affecting the entry of foreign suppliers in the host economy are likely to be different.

Partly as a reflection of the difficulties experienced in moving away from oil- and hydrocarbon-based economies, the performance of GCC countries on exports of services is poor, but their imports are substantial. The 1995-2011 cumulative value of GCC exports of services amounted to €2.3 billion, compared to €2.3 trillion for the BRICs and €20 trillion for

the EU. On the import side, the cumulative value of services imports by GCC countries was €0.75 trillion between 1995 and 2011. Since the GCC imports substantially more services than it exports, figures on the share of trade in services over GDP give a blurred picture of the region's performance in global services markets. Indeed, the GCC region's total trade in services over GDP represented a share of between 15 and 19%, on a par with the EU.

Turning to the sector composition of the GCC region's trade in services, the region's exports mainly consist of construction, financial services and insurance (Figure 5). Given the region's surpluses and the willingness to diversify sources of income, the GCC's relative specialisation in the export of capital-intensive activities sustained by financial services is not surprising. It is also very likely that a significant share of these exports has fuelled real estate projects, acquisitions and investments in other Arab countries and the EU.¹² On the import side, the region is an important importer of transport, travel and government services, with these three categories accounting for a total of €731 billion over the 2000-2011 period (Figure 6).

The magnitude of transport activities' share of total imports of services is likely to be closely linked to the region's imports of goods, as importers might pay for the shipments of goods.

Also, data on imports of travel services are very likely to reflect both the region's diversification efforts, which seek among other goals to create a vigorous tourist hub and become a bridge between Europe and Asia. The data may also reflect the importance of the yearly Hajj pilgrimage to Saudi Arabia, which brought 1.7 million people to the country in 2012. What is most striking in services imports, however, is the importance of government services. According to the Extended Balance of Payments Classification, this category encompasses expenses for embassies and consulates, military units and agencies, as well as other miscellaneous government services. Given the importance of security deals in the region and of this market for arms exporters in the EU, the significant share of this category is very likely a reflection of payments for items such as training of military staff in the region, costs related to the maintenance of military bases in the region, etc.¹³

In as far as EU-GCC trade in services is concerned, the Gulf region does not rank highly among the EU's trading partners, either in terms of exports or imports. However, as with trade in goods, the EU maintained a surplus with the GCC of €63 billion between 2006 and 2011 (Figure 7).¹⁴

In addition to the region's comparative advantage in hydrocarbon industries, other factors can explain the modest performance of GCC economies in trade in services. On the export side, the relatively low level of human capital in the region due to past neglect of education systems and trade in services policies that restrict the movement of persons prevents a vigorous service-driven economy from emerging. For example, on average, only 6% of GCC

¹² Examples include Qatari Diar, a company specialized in real estate projects with projects developed in the UK, Morocco, Tunisia, and Egypt among others.

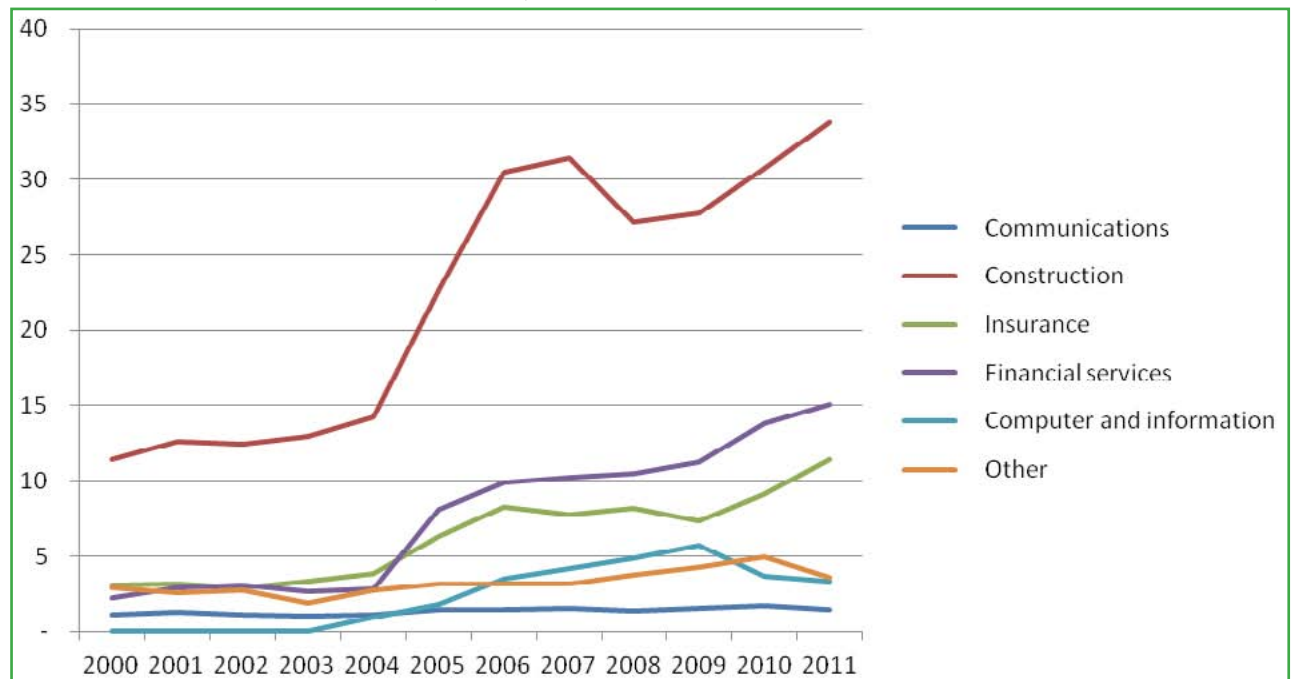
¹³ Unfortunately, UNCTADstat provides neither a detailed breakup of services imports by sub category, nor a breakup by category and partner.

¹⁴ Sectoral breakup of trade in services is not available.

citizens aged over 25 have completed tertiary education, compared to 18% for Cyprus, 20% for Belgium and 24% for Japan. In addition, restrictive migration policies in the region prevent skilled workers from entering the GCC countries, limiting knowledge spillovers and the potential for increasing human capital in the region.¹⁵

On the import side, based on an index of services trade restrictiveness,¹⁶ Gulf countries' markets appear to be the most protected in the world relative to their level of income across almost all services categories (Borchert, Gootiiz and Mattoo 2012, Figure 8). Widespread restrictions are found to apply such as minority ownership requirements for foreign suppliers willing to enter some segments of GCC telecommunications markets. It is likely that these restrictions play a significant role in the level of entry of foreign investors in the region.¹⁷ Also, restrictions on foreign suppliers of services and discriminatory treatment are likely to hinder the GCC region's diversification efforts as strong, competitive, and open services sectors have been found to be essential in supporting such endeavours (Ianchovichina, Gourdon and Kee 2011).

Fig. 5. GCC exports of services to the world by category, 2000-2011 (€ bn)



Note: "Other" services refers to: travel; personal, cultural and recreational services; and other business services.
 Source: UNCTADstat.

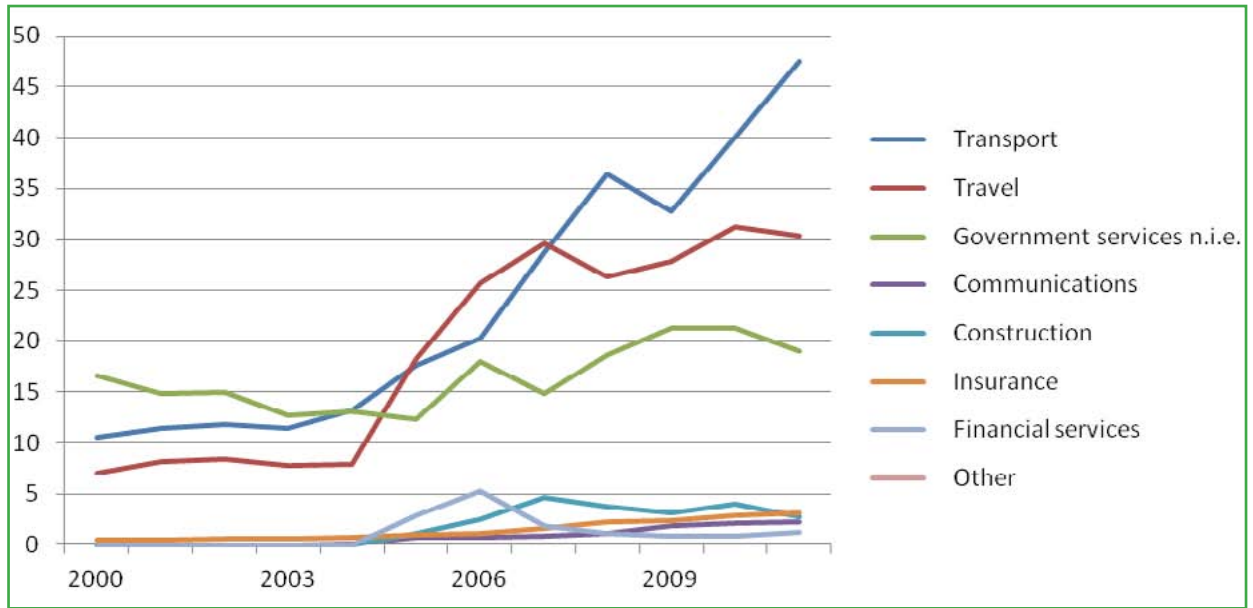
15 Figures quoted originate in the Barro and Lee Educational Attainment Dataset, <http://www.barrolee.com>.

16 The STRI was developed by Borchert, Gootiiz and Mattoo (2012) and the World Bank with the view to propose a comparable measure of policy barriers affecting international trade in services. It is based on an inventory of regulations affecting the mode of entry of foreign companies completed with a questionnaire administered to local law officials on laws affecting foreign service suppliers and when possible on their scope of implementation. After verification, the questionnaire proceeds were then treated to create an index measuring the degree of services trade restrictiveness for each country and sector. The STRI database covers a total of 103 countries and 5 sectors: financial services (banking and insurance); telecommunications; retail distribution; transportation; and professional services. With a view to providing the most detailed information possible, these sectors were further disaggregated into subsectors, the results of which are not reported here for simplicity purposes. The higher the value of the index in a particular sector, the more closed a country is in this sector. See Annex 3 for a brief methodological summary of the construction of the STRI.

17 Using a small panel of mergers and acquisitions over the period 2003-2009 in the communications, construction, insurance, financial services, computer and information services, travel, cultural, and other business services, services sectors, Borchert, Gootiiz and Mattoo (2012) find that restrictions on the entry of foreign services' suppliers exert a negative and significant impact on inflows of direct investment.



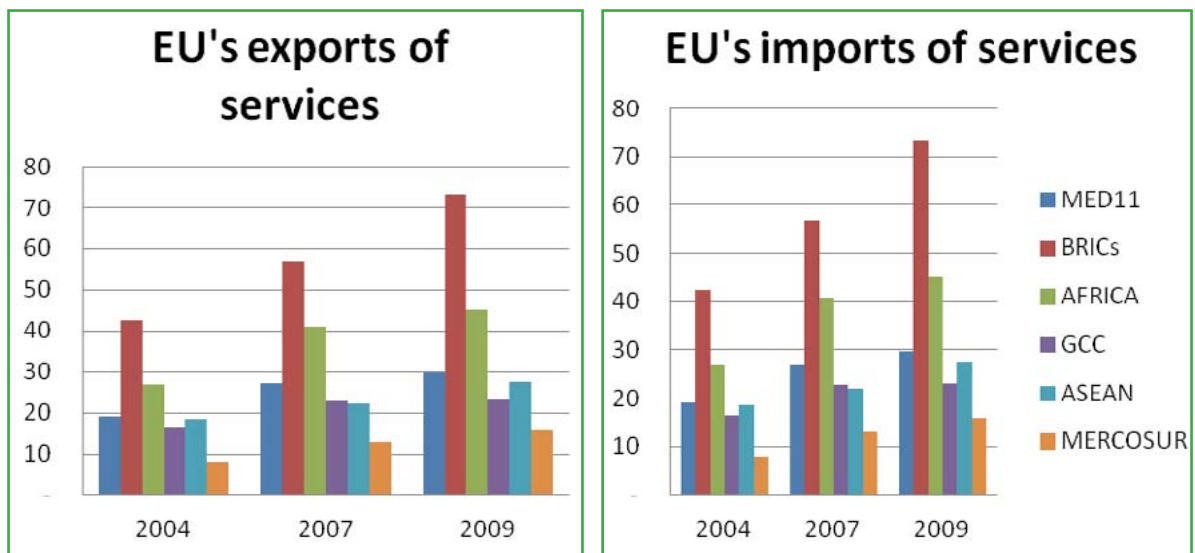
Fig. 6. GCC imports of services by category, 2000-2011 (€ bn)



Note: "Other" services refers to: computer and information services; royalties and license fees; other business services; cultural and recreational services; other business services; and government services.

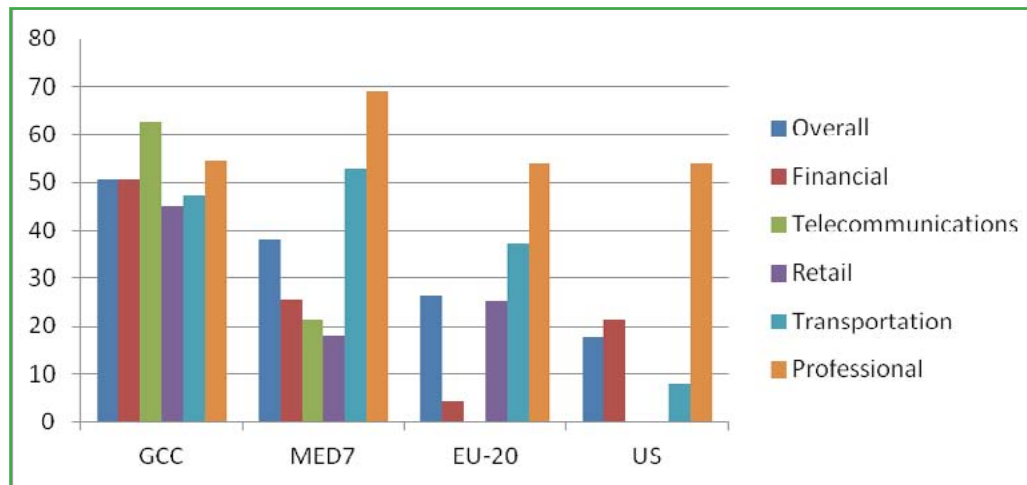
Source: UNCTADstat.

Fig. 7. EU-GCC trade in services with selected regions and trading blocs, 2000-2011 (€ bn)



Source: EuroStat.

Fig. 8. Values of the Services Trade Restrictiveness Index (STRI) across regions and services sectors, 2009



Source: World Bank 2012b.

GCC countries' exports of services are low, and consist mainly of construction activities, a result of their significant foreign exchange reserves. On the import side, the region is a significant importer of government services, the amounts of which are likely explained by the number of defense contracts the region has concluded with the US and EU member states. The GCC appears to be among the least open regions to trade in services, which can be explained by the governments' eagerness to diversify and favour the emergence of non-oil activities. However, the high level of restriction applied in some sectors can hinder this objective, preventing knowledge spillovers and negatively affecting the entry of foreign investors in these economies.

2.3. FDI between the EU and the GCC

The *Balance of Payments Manual* 5th edition, published by the International Monetary Fund (IMF), gives the following definition of foreign direct investment (FDI) flows: "Direct investment is the category of international investment that reflects the objective of a resident entity in one economy obtaining a lasting interest in an enterprise resident in another economy" (IMF 1993:86). Direct investment implies the right to vote in a company's general assembly of shareholders and comprises flows of capital related to the initial transaction and all subsequent transactions between the affiliated companies, both incorporated and unincorporated. According to the recipient country's legislation and the preferences of the investing company, the investment in the host country can result in a joint venture, a wholly owned subsidiary, a branch, and so on. The foreign investor also has the choice of entering the host country either via the establishment of production facilities or via the acquisition of existing structures. Although no consensus exists regarding these definitions, the former is generally qualified as "greenfield" investment, whereas the latter is referred to as "brownfield" investment. The IMF definition of FDI does not focus on the entry mode of the investor and adopts as a sole criterion the voice in management with data on inflows from international

sources (from, for example, the IMF, World Bank or UNCTAD) comprising both greenfield and brownfield FDI (realised direct investments, reinvested earnings, etc.).

In addition to FDI flows, FDI stocks are also important in assessing the attractiveness of a country. According to UNCTAD, FDI stocks are the value of the share of companies resulting from the investment “capital and reserves (including retained profits) attributable to the parent enterprise (this is equal to total assets minus total liabilities), plus the net indebtedness of the associate or subsidiary to the parent firm. For branches, it is the value of fixed assets and the value of current assets and investments, excluding amounts due from the parent, less liabilities to third parties”.¹⁸ Consequently, a rising stock of FDI is a signal of increased profitability of already established companies in the host market and/or increased investment activity.

In the economic literature, industrial organisation theories emphasise microeconomic characteristics as the main motivation for a company to engage in FDI, which is seen as an alternative mode of internationalisation to exporting. For a company to engage in FDI, it must first possess a specific asset (for example, knowledge), direct investment must be the cheapest way to internationalise, and economies of scale should exist in the host market (Caves 1971).¹⁹ Other theories posit that internationalisation through FDI will only take place for companies producing highly standardised goods, since for such goods transaction costs are lower (Buckely and Casson 1981).²⁰ While the theories derived from microeconomic approaches succeed in explaining why and when a company internationalises through direct investment abroad, they fail to explain a firm’s localisation choice. Dunning (1988, 2000) encompasses previous explanations of direct investment in the ownership location internalisation (OLI) or “eclectic” paradigm.²¹ For a firm to invest abroad, it must possess a competitive advantage (a patent, for example), it must have an incentive to invest in a particular location (significant market size, fiscal incentives, etc.), and there must be a market failure translating into positive transaction costs inducing the firm to internationalise and produce abroad. While companies engage in FDI for different reasons, these three reasons need to be simultaneously satisfied for FDI to occur. A corollary of the OLI paradigm is that there can be three sources of FDI - resource seeking, market seeking and efficiency²² seeking (for the rationalisation of the production process through business process outsourcing, for example).

In the Gulf region, inward FDI is most likely to be motivated by resource-seeking and, to some extent, market-seeking motivations due to the region’s endowment in natural resources and the high levels of per capita GDP. Efficiency-seeking FDI is likely to be a minor phenomenon, since it requires either a cheap or educated labour force, both of which are rather scarce in the GCC countries.

18 UNCTAD FDI Stock definition at <http://unctad.org/en/Pages/DIAE/FDI%20Statistics/Sources-and-Definitions.aspx>.

19 For Caves, these three conditions must be fulfilled at the same time for a company to invest abroad.

20 This theory of international investment departs from Vernon’s product cycle theory.

21 A paradigm is defined as a set of assumptions, concepts, values, and practices that constitutes a way of viewing reality for the community that shares them, especially in an intellectual discipline.

22 Efficiency is defined as the accomplishment of or ability to accomplish a job with a minimum expenditure of time and effort.

Between 1995 and 2011, GCC countries attracted a total of €237 billion in FDI inflows, compared to €3.8 trillion for the EU and €792 billion for the world's major oil and gas exporters (Figure 9). Saudi Arabia, the United Arab Emirates and, to some extent, Qatar are the most attractive countries for foreign investors and have between them attracted 90% of total inflows to the region since 2004. The GCC countries' share in world inward FDI inflows is negligible; on average over the period 1995-2011 they accounted for a mere 1.7%, compared to 5% for the major oil and gas exporters and 26% for the EU. This modest performance notwithstanding, the 2000s and the creation of the customs union seem to have had a positive impact on the region's ability to attract FDI relative to the rest of the world. By creating a customs union and abolishing tariffs between themselves while enacting a common external tariff, the GCC countries are likely to have reduced transaction costs for foreign investors, thus exerting a positive influence on foreign capital inflows. At the same time, the rise in FDI observed in the early 2000s is likely to have been influenced by the privatisation programmes conducted in the region, and especially in Saudi Arabia's hydrocarbon sector. However, considering the share of inward direct investment relative to their size, the GCC countries significantly outperform the EU and other economies; inward inflows for the period 1995-2011 accounted, on average, for 17% of GDP, compared to 2% and 3% for the EU and hydrocarbons exporters, respectively. Inward investments in these countries represent approximately 50% of trade in goods and services, compared to levels close to 10% for the EU and hydrocarbons exporters. The region does not appear to be particularly dependent on foreign investment, as inflows account for an average of 10% of gross domestic fixed capital formation, a figure in line with hydrocarbon exporters and the EU.

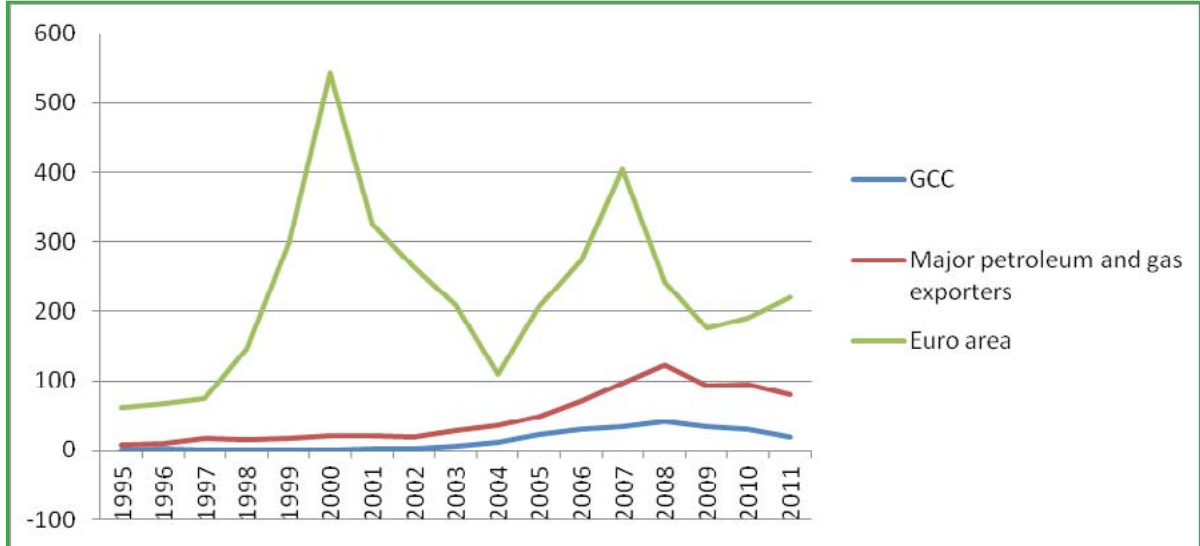
The small amounts of FDI in the region can be explained by the resource-seeking nature of direct investment in the GCC region, as well as the importance of the public sector in hydrocarbons. Despite moves towards privatisation in the 2000s, the GCC governments maintain significant ownership in their hydrocarbons sectors, restricting the entry of foreign investors to only minor ownership. For example, Saudi Arabia, the country which attracted the most FDI with €126 billion over 1995-2011, imposes equity restrictions on foreign participation allowing foreign investors to hold only minority ownership and ranks fourth among the countries least open to FDI after China, Russia, and Iceland (Kalinova, Palerm and Thomsen 2010).²³

The same broad trends can be observed in the region's inward FDI stocks (Figure 10). Over 1995-2011, inward FDI stocks totalled €1.4 trillion, compared to €6.3 trillion for oil and gas exporters and €40 trillion for the EU. These amounts represented an average of 134% of the GCC region's GDP, compared to 14% and 17% for oil and gas exporters and the EU, respectively. The high profitability of companies investing in the region illustrates the resource- and market-seeking opportunities from direct investment in the GCC countries,

23 The ranking is based on the FDI restrictiveness index, developed by Kalinova, Palerm and Thomsen (2010) and maintained under the OECD. Based on a surveys and desk research, the index ranks countries' openness to FDI along 4 criteria: equity restrictions, screening, key personnel, and operational restrictions. From a 0 to 1 score, 1 being completely open, Saudi Arabia is the only GCC country represented and obtained an overall score of 0.35 in 2012. See OECD, FDI Regulatory Restrictiveness Index, <http://www.oecd.org/investment/fdiindex.htm>.

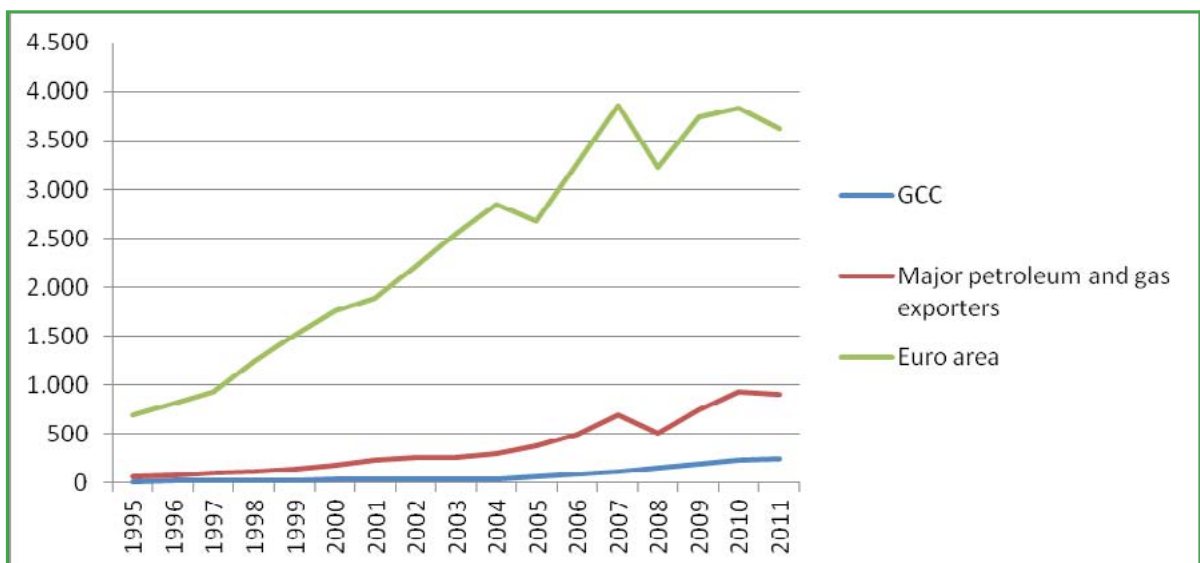
as the increase in companies' profitability could be a consequence of higher oil prices and a vigorous internal demand.

Fig. 9. Inward FDI inflows in the GCC, major hydrocarbons exporters and the eurozone (€ bn)



Source: UNCTADstat.

Fig. 10. Inward FDI stocks in the GCC, major hydrocarbons exporters and the eurozone (€ bn)

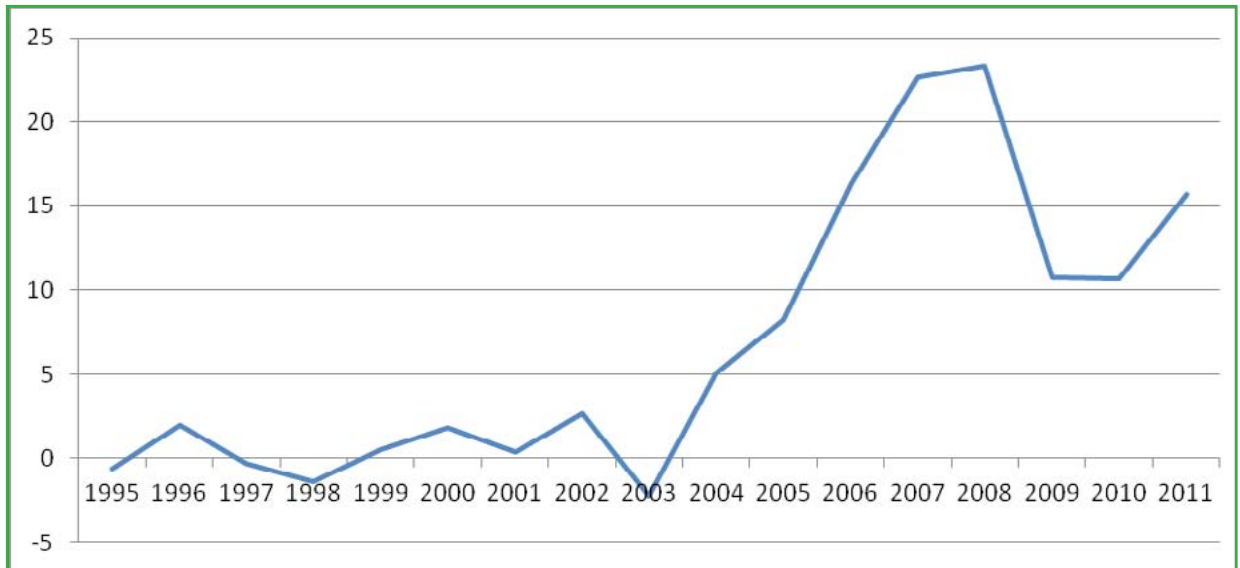


Source: UNCTADstat.

Turning to the GCC region's outward direct investment, the data show that Gulf countries were passive foreign investors until 2006. After that, yearly direct investments from the region were above the €15 billion mark and reached a peak of €26 billion in 2008. In the following years, foreign investment decreased to its 2006 levels, very likely as a consequence of both the international financial crisis and the Dubai crisis. Outward investments are on the rise again, however (Figure 11). At the country level, it appears that Saudi Arabia and the United Arab Emirates are the most significant exporters of capital in the region; their outward FDI

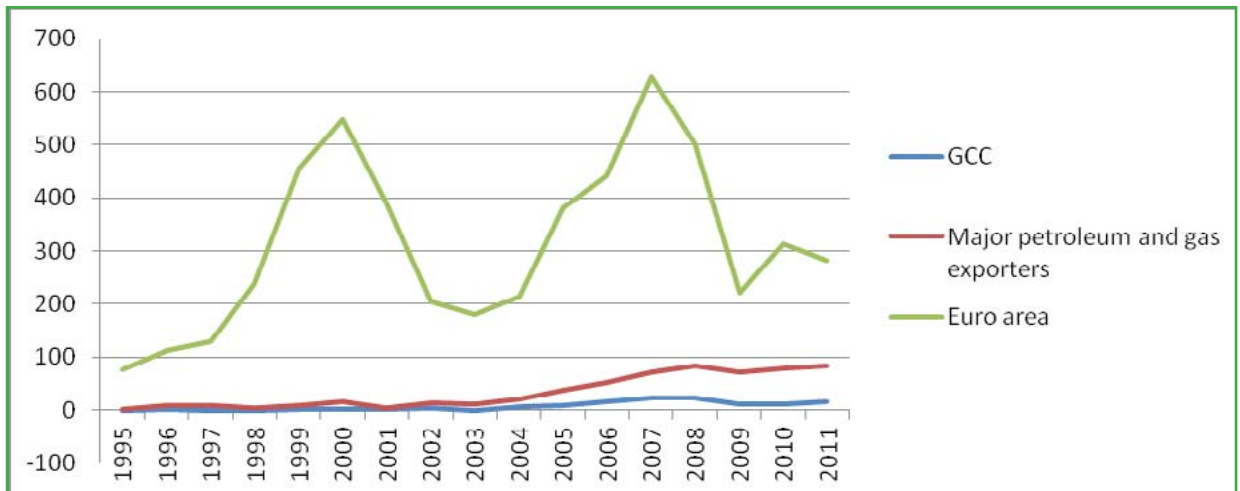
flows have amounted to 50% of total outward FDI from the GCC countries. Compared to other countries, the performance of the GCC region in terms of foreign investment was modest over the 1995-2011 period, and EU countries significantly outperformed the region (Figure 12). As with direct investment inflows, GCC countries appear to be high exporters of foreign capital relative to their income and trade levels.

Fig. 11. GCC outward FDI flows, 1995-2011 (€ bn)



Source: UNCTADstat.

Fig. 12. Outward FDI flows from the GCC, major hydrocarbons exporters and the eurozone, 1995-2011 (€ bn)



Source: UNCTADstat.

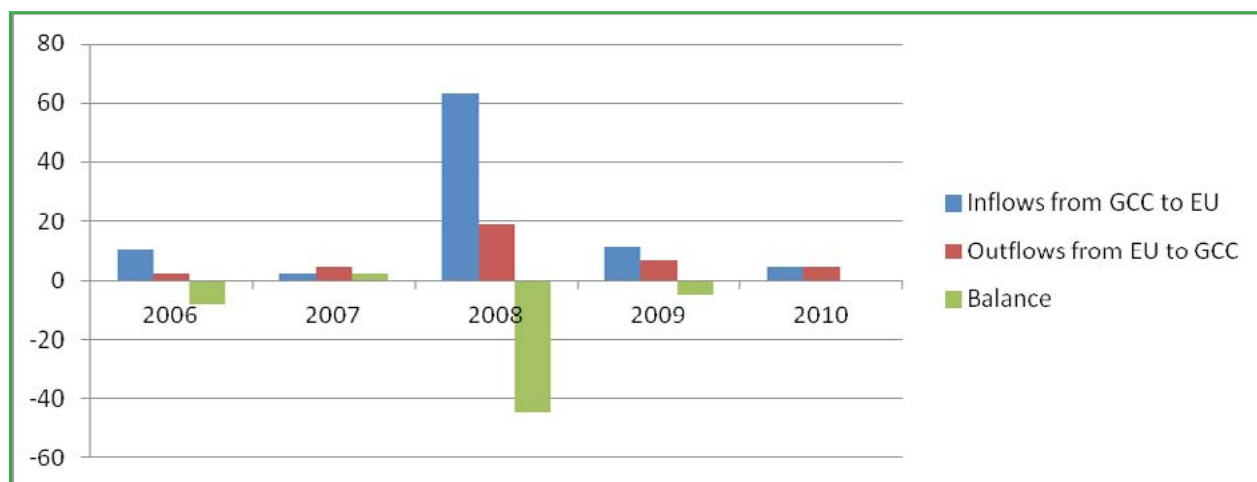
Outward FDI from the GCC region is the result of several motivations, chiefly the need for economic diversification. As major hydrocarbons producers and exporters, GCC countries need to protect themselves from the “Dutch disease”²⁴ syndrome by “recycling” their large

²⁴ In economics, the Dutch disease is the apparent relationship between the increase in exploitation of natural resources and a decline in the manufacturing sector (or agriculture). The mechanism is that an increase in revenues from natural resources will make a given

surpluses through the diversification of their sources of income, which can be accomplished through the acquisition of foreign assets. While data on the sectoral and geographic distribution of foreign investments are not available, it is very likely that a significant share of Gulf countries' investments is directed towards highly profitable markets and companies since their total outward FDI stocks have represented an average of 58% of their GDP, a significantly higher proportion than in hydrocarbon exporters and the EU (at 10% and 38%, respectively).

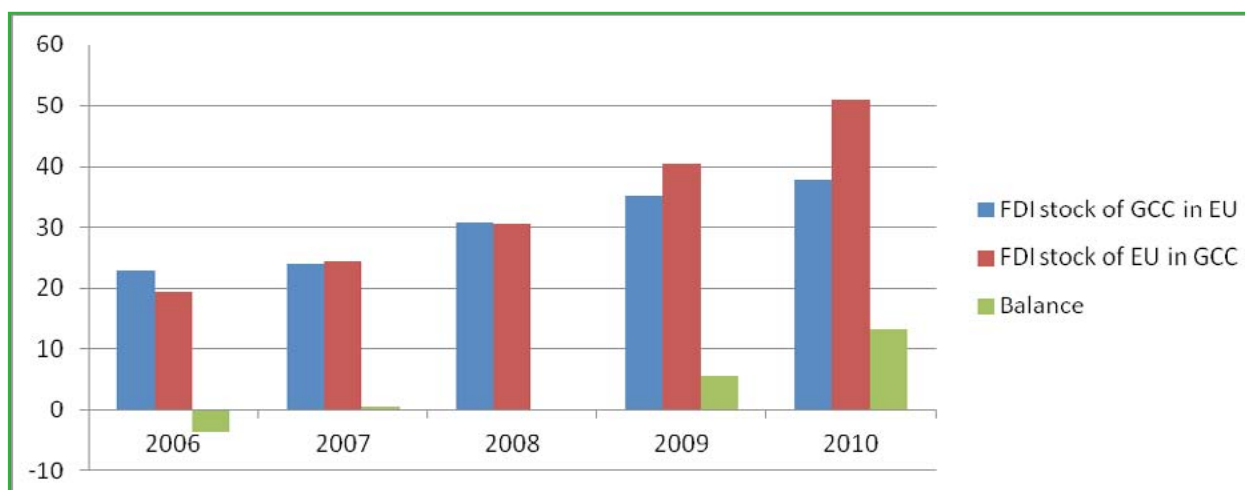
Turning to EU-GCC FDI,²⁵ data on inflows show that the EU invests less in the GCC than the Gulf countries invest in Europe (Figure 13). While a direct comparison with total amounts of direct investment received by Gulf countries is not possible, the EU's investments in the region are likely to represent an important share of total investment. On the other hand, GCC countries' FDI in the EU represents a minor share of direct investment inflows. Turning to stocks, it appears that both destinations are lucrative for foreign investors as magnitudes of FDI stocks are close, and appreciated over the period 2006-2010. The FDI balance between the EU and the GCC region appears to be close to zero, meaning that the investment inflows of both regions are on a par. Turning to stocks, however, the balance is positive in favour of the EU, suggesting that companies located in that region are increasingly profitable.

Fig. 13. Bilateral FDI flows and stocks in EU from GCC countries (€ bn)



nation's currency stronger compared to that of other nations, resulting in the nation's other exports becoming more expensive for other countries to buy, making the manufacturing sector less competitive.

25 Aggregate FDI data used in this paper originate from UNCTAD, whereas bilateral EU-GCC FDI data come from Eurostat. Both organisations compile data according to the guidelines of the IMF's Balance of Payments Manual (IMF 1993), but the European statistical office complies with the OECD Benchmark Definition of Foreign Direct Investment, Third Definition. The OECD's methodology, meanwhile, allows for dissecting inflows and outflows between the various components of inward and outward FDI (equity investment, intra company loans, retained earnings) and gives the sectoral breakup of international investments, coverage of GCC countries in the database is low. Hence, in what follows, we chose to rely on aggregate figures released earlier by the European Commission Directorate General for Trade (DG Trade) in order to provide the reader with an idea of the magnitude of bilateral FDI inflows. Since European sources use EU member states' balance of payments statistics and UNCTAD reporting economies' data, there are discrepancies between data sources.



Source: European Commission DG TRADE (2010, 2012).

Relative to their size, the GCC countries have attracted significant amounts of foreign capital, although the absolute magnitude of inflows has been low and probably below its potential level. Outward capital flows from the Gulf economies were also very low until the beginning of the 2000s, when the region dramatically increased its exports of capital. The picture of this rise of the GCC region as a foreign investor in the EU and in other regions can be misleading, however, as outflows from the region could be more significant than depicted in the statistics from international institutions.

2.4. Sovereign wealth fund investments

Due to statistical definitions and the presence of sovereign wealth funds (SWFs), the levels of GCC countries' FDI in the EU may underestimate the real magnitude of their investments. While there is no widely accepted definition of SWFs, economists agree on a number of characteristics distinguishing them from other investment vehicles. SWFs are investment vehicles created by governments and financed by transfers of foreign exchange reserves proceeding from balance of payments surpluses, commodity exports, privatisation receipts, fiscal surpluses and foreign currency operations. They are generally, though not always, managed by government authorities or related entities. Their objectives can be manifold – SWFs can be used as mechanisms for smoothing the negative effects of volatile revenues on the economy, for promoting transparency in public spending, for fiscal discipline or for pursuing economic diversification objectives.

The establishment of SWFs in the GCC countries is not a new phenomenon, as some were set up as early as the 1970s. However, the majority were set up in the beginning of the 2000s as oil prices and subsequent foreign exchange reserves increased, and governments in the region created funds to invest in assets overseas and to diversify the region's sources of income beyond hydrocarbons. Growing foreign exchange reserves and the establishment of these sovereign vehicles coincided with the implementation of development plans in

the region as well as important investments in infrastructure, financial services, education, tourism and petrochemicals (Bahgat 2011).

EU countries have been important destinations for overseas investment by the GCC regions' SWFs, although it is virtually impossible to quantify their investment due to the high level of secrecy surrounding the SWFs and their lack of transparency. It is nevertheless estimated that their total assets range between \$800 billion and \$1 trillion (between €600 billion and €1 trillion in 2008) (Bahgat 2011), and that over the period 2000-2006, approximately €76 billion of their €490 billion total surplus was invested in EU markets with an important focus on the financial sector (Table 1).

Table 1. Selected examples of GCC SWF acquisitions in the EU

Target	Fund	Value (\$ mn)
OMX (Sweden)	Dubai Investment Financial Corporation	3,551.4
Paris Saint Germain Football Club (France)	Qatar Investment Authority	193.6
British Petroleum (UK)	Kuwait Investment Authority	2,800
ACWA (UK)	Public Investment Fund (Saudi Arabia)	undisclosed

Source: Gugler and Chaisse (2009); Quintin (2011); Rasooldeen (2013); SWF Institute, Linaburg-Maduell Transparency Index, <http://www.swfinstitute.org/statistics-research/linaburg-maduell-transparency-index>.

Their significant participation in the marketplace raised concerns among EU policy-makers after GCC SWFs acquired stakes in strategic industries such as aerospace, defence, utilities, and electrical engineering companies. As SWFs are non-transparent actors (Table 2) that do not disclose information on their investment strategies, assets under management, governance or mandates, policy-makers feared their acquisitions could be backed by political agendas and result in the transfer of strategic assets. Fears were renewed when unofficial estimates put their investment stock in the EU at €400 billion, making them among the largest foreign stakeholders in Europe (Hertog 2007).

Table 2. GCC SWF characteristics

Country	Fund name	Assets under management (\$ bn, 2013)	Inception	Origin	LM index*
UAE - Abu Dhabi	Abu Dhabi Investment Authority	627.0	1976	Oil	5
Saudi Arabia	SAMA Foreign Holdings	675.9	n/a	Oil	4
Kuwait	Kuwait Investment Authority	386.0	1953	Oil	6
Qatar	Qatar Investment Authority	115.0	2005	Oil	5
UAE - Dubai	Investment Corporation of Dubai	70.0	2006	Oil	4
UAE - Abu Dhabi	International Petroleum Investment Company	65.3	1984	Oil	9
UAE - Abu Dhabi	Mubadala Development Company	55.5	2002	Oil	10
Oman	State General Reserve Fund	8.2	1980	Oil & Gas	4
Bahrain	Mumtalakat Holding Company	7.1	2006	Non-commodity	9
Oman	Oman Investment Fund	6.0	2006	Oil	n/a
Saudi Arabia	Public Investment Fund	5.3	2008	Oil	4
UAE - Ras Al Khaimah	RAK Investment Authority	1.2	2005	Oil	3
UAE - Federal	Emirates Investment Authority	n/a	2007	Oil	3
UAE - Abu Dhabi	Abu Dhabi Investment Council	n/a	2007	Oil	n/a

* The Linaburg Maduell index has been developed to score SWFs' transparency performance. The more information the fund provides, the higher the score. For more information see SWF Institute, Linaburg-Maduell Transparency Index, <http://www.swfinstitute.org/statistics-research/linaburg-maduell-transparency-index>.

Source: SWF Institute, *Fund Rankings*, updated September 2013, <http://www.swfinstitute.org/fund-rankings>.

As Gulf SWFs' investments in the EU grew, EU member states adopted protectionist stances against them, especially due to national security concerns. As early as 2005, France issued a decree listing 11 sectors in which foreign investment would be subject to approval due to concerns over "national defence interests". German Chancellor Angela Merkel pushed for similar legislation in April 2008, allowing policy-makers to scrutinise foreign investments, most notably those emanating from SWFs, irrespective of their origin. At the multilateral level, the growing role of SWFs was addressed in 2008 by the creation of the International Working Group on SWFs (IWG).²⁶ Most notably, the IWG established 23 Generally Accepted Principles and Practices (GAPP) in the form of a Code of Conduct – the Santiago Principles – to foster understanding on SWF practices and dismiss fears over politically motivated investments. While the initial proposal for such a document was frowned upon by several GCC SWFs such as the Kuwait Investment Authority (KIA), which argued that with over 50 years in existence its investments were by no means politically motivated, recipient countries were also integrated into an OECD initiative to ensure non-discrimination and reciprocity to foreign investors – the Guidelines for Recipient Country Investment Policies Relating to National Security.²⁷

However, the worldwide crisis dampened EU concerns, as GCC SWFs emerged as important purveyors of emergency financing to distressed banks. For example, in 2008 the Abu Dhabi Investment Authority, an Emirati SWF, invested \$6 billion in the British Barclays Bank. In 2011, Qatari Prime Minister Hamad bin Jassim bin Jaber bin Muhammad Al Thani announced his country's SWFs stood ready to invest €300 million in the troubled Spanish savings banks (cajas de ahorros). Dismissing arguments over politically motivated investments after buying important equity stakes in Citigroup, the KIA sold a significant proportion of its initial acquisition in 2009 (Bahgat 2011). Illustrating the profit-driven nature of SWF investments, in November 2012, Italy and the Qatar Holding Company LLC, a subsidiary of the Qatar

Investment Authority (QIA), announced the creation of a jointly owned fund mandated with investing in the Italian luxury and tourism industries, with investment commitments that could be beyond the €2 billion mark (Fondo strategico italiano 2012). Similarly, the Qatari ruler committed to creating a joint fund with Greece endowed with €1 billion to invest in Greek small and medium-sized companies (SMEs).

The previous cases notwithstanding, the secrecy surrounding SWF investment and their strategy renders substantiating claims over politically motivated investments difficult. Occasional examples of SWF investments are sometimes interpreted as being illustrative of SWFs' willingness to acquire strategic assets.

²⁶ The IWG was established as an autonomous entity following a meeting at the IMF with representatives from SWFs, the OECD, recipient countries and the European Commission.

²⁷ At the EU level, the Commission communication on a common European approach to SWFs highlights the response to member states' concerns over strategically motivated SWF investments. While stressing the commitment to capital mobility, the document notes that member states can take legal action against SWF investments in cases where public security, plurality of the media or prudential regulations are compromised in accordance with the EU Treaty. In other cases, the Communication notes that the Commission shall inform member states of their right to restrict direct investments from SWFs on a case-by-case basis. Also, it notes that the EU can take unilateral measures affecting direct investments by qualified majority, and that restrictive measures on direct investment can be taken by unanimity within the Council (European Commission 2008).

In 2008, for example, the QIA bought a French electrical engineering company, Cegelec, raising fears that such an acquisition would provide Qatar with a competitive advantage in strategic industries such as transport, communications, and utilities.²⁸ However, a few months later the Gulf SWF concluded a deal with Vinci, a French utility company, under which the Qatari fund swapped Cegelec shares for Vinci equity, realising a loss of 17% on the initial investment value. Analysts interpreted the move as illustrative of both the willingness of GCC countries to use their SWFs as a tool for industrial diversification and their incapacity to play an active role in knowledge-intensive target companies. Yet, it is not clear whether allegations of the SWF's lack of human capital are founded. Due to their significant size, it is likely that these funds can hire top-level managers able to play an active role in the management of investment companies. Moreover, by being an important shareholder of Vinci, the fund is still close to Cegelec since it is owned by Vinci (Touazi 2010).

In the near future, the role of GCC SWFs in EU markets could increase for two reasons. First, oil prices are set to remain above \$100/barrel, generating important surpluses that will increase the capacity of the region's investment arms. Second, as the economic and financial crisis worsens, investment opportunities are likely to emerge, as shown by the Citigroup example. Whether their investments will be backed more than before by political agendas remains an open question, since countries in the region will be increasingly under pressure to diversify their economies and provide employment prospects to their populations to contain the potential of social unrest while, at the same time, their SWFs are likely to gain the capacity to manage increasingly complex portfolios (Behrendt 2008).

As a matter of fact, France provides an illustration of an increase in a country's capabilities to manage new types of investment. At the beginning of September 2012, Qatari investment arms announced their willingness to fund a project in France's neglected urban suburbs and the Ambassador to France announced his country stood ready to invest up to €10 billion in French listed companies with a view to developing partnerships in the country and overseas. The Ambassador added that the countries would create a joint fund endowed with €300 million to invest in French small and medium-sized enterprises (SMEs).²⁹

These examples show that GCC SWF interest in the EU is growing, and that the crisis is likely to further increase their presence in the region. EU member states have consistently deplored the lack of transparency of these investment vehicles and fears about politically motivated investments have often been raised. However, as the region's surpluses are expected to grow in the coming decades and the interest of these funds in the EU is expected to grow, the two regions could launch a bilateral dialogue seeking to reinforce mutual confidence by devising measures to enhance the transparency of SWF investments and avoid protectionist reactions, for example, by creating an EU-GCC code of conduct for international investment.

28 The French company is a major actor in the infrastructure and utilities industries. It has operations in Latin America, West Africa, North Africa, the Middle East and South Asia, and employs more than 20,000 workers. Since it has activities in the energy industry and infrastructures, the QIA's investment was interpreted as illustrative of the Sheikhdom's willingness to use its financial muscle to strengthen its international position in the energy and infrastructure sectors. These concerns have been further strengthened as the country is set to host the World Cup in 2020 and will have to engage in important infrastructure works.

29 "Le Qatar veut investir 10 milliards dans les entreprises françaises", Le Monde, 6 November 2012, http://www.lemonde.fr/economie/article/2012/11/06/le-qatar-veut-investir-dans-les-entreprises-francaises_1786620_3234.html.

3. The EU-GCC FTA: Motivations and Expected Impact

The EU and the GCC have limited political relations and rather stable bilateral trade and investment patterns, although emerging countries – chiefly China – are increasingly competing with the EU in the region. At the end of the 1980s, the EU and the GCC initiated negotiations for an FTA that would have been the first region-to-region trade deal ever concluded. The agreement sought to reinforce integration between both regions and went beyond shallow integration and tariff dismantlement to address issues such as trade in services liberalisation, investment regulations and government procurement rules. Despite the wide scope of the agreement, the parties failed to reach a consensus, resulting in the failure of the negotiations. This calls for an assessment of EU and GCC motivations for and potential benefits from the proposed agreement.

3.1. EU and GCC interests in the FTA

Economic theory emphasises mutual gains from reciprocal trade liberalisation as a sufficient condition for engaging in tariff dismantlement, but it seems that non-economic motivations likely play a more prominent role in EU-GCC relations than in other trade talks, mostly due to the Gulf's importance as a hydrocarbons supplier and to its economic and political influence in the Arab world (Rouis et al. 2010).

For the EU, these geopolitical considerations are likely to take precedence over economic interests, and trade negotiations with the GCC should rather be seen as part of a wider effort aimed at reinforcing its policies towards the Arab world. Until the end of the 1980s and the beginning of the 1990s, the EU's policy frameworks towards the Arab world had neglected the Gulf and the wider Middle East,³⁰ centring de facto on former colonies in the Arab Mediterranean region. The different policy frameworks for relations with the latter rested on the idea that trade liberalisation, regional integration and the promotion of a set of good governance standards were the keys to achieving peace and stability. As a result, under the Global Mediterranean Policy (GMP) and the Renovated Mediterranean policy (RMP), the EU offered assistance to partner countries in exchange for the implementation of economic reforms and trade liberalisation. Relations with the southern Mediterranean³¹ were further deepened in 1995 with the creation of the Barcelona Process and in 2003 with the European Neighbourhood Policy (ENP) (Ayadi and Gadi 2013). Meanwhile, the GCC countries' relations with the EU were structured around the 1988 Cooperation Agreement, of narrower scope than Association Agreements between the EU and southern Mediterranean countries. As a result of these different policy frameworks, the extent of the EU's presence and influence in the Arab world is based around the GCC/ENP divide, even though the southern Mediterranean and the Gulf share some common characteristics. Concluding an FTA with the region would thus be the first step towards a more unified presence in the Arab world while allowing the EU to potentially gain more influence in the region.

³⁰ Wider Middle East refers here to Iran and Iraq.

³¹ Southern Mediterranean countries are: Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, Palestine, Syria, Tunisia and Turkey, alternatively referred to as MED11.

Another related motivation is referred to as “ideational”. Since the EU-GCC FTA would be the first region-to-region FTA³², its conclusion would be a strong signal of the effectiveness of EU external policies, as it would underscore the success of the EU’s regional integration and trade liberalisation strategy (Antikiewicz and Momani 2009).

On the economic side, while the GCC is a growing high-income market, the region has consistently represented a minor portion of EU international trade, well behind the US, other developed economies and, increasingly, emerging economies such as China. Concluding an agreement with the region would only be beneficial for certain industries such as machinery, transport equipment, and manufactured goods, since these are the EU’s main exports to the region. For the EU, the main economic motivation to conclude a wide-ranging free trade deal with the GCC would be trade in services, as this remains closed and the GCC relies heavily on services imports to meet its needs.

For GCC countries, on the other hand economic drivers seem to play the prominent role in explaining the motivations for an FTA with the EU. Abdul Rahman Al-Attiah, the former GCC secretary general, summarised in 2002 the region’s interests in developing closer relations with Europe: “GCC countries are a historical partner of Europe. Europe needs us and we need them. We need their technical know-how. They need our resources. We have a mutual interest” (Baabood and Edwards 2007:539). However, it is not clear whether a trade structure based on oil supplies against knowledge transfer still holds as EU hydrocarbon supplies are increasingly diversified and GCC-China trade grows and moves up the value chain. Within the scope of the FTA, GCC countries would benefit from enhanced market access for their petrochemical industries, thus supporting their vertical diversification efforts. In turn, better market access for EU goods and some degree of opening up in the services sector could generate spillovers and technology transfers supporting GCC economies’ objectives of diversifying beyond oil and related products.

To reach the diversification objective, governments have engaged in economic planning exercises whose outcomes are highlighted in their respective development plans and “visions”, in varying degrees of detail.³³ Gulf countries have enjoyed substantial oil rents in the preceding decades, and states in the region have predominantly redistributed the ensuing wealth to their population through generous welfare policies, while locking their production systems in the oil industry. Hence, diversification for GCC countries entails not only the development of activities decoupled from oil prices, but also an institutional shift from states redistributing rents to states providing incentives for the development of private sector activities (Hvidt 2013).

³² One exception is the association agreement with the Andean Community (Bolivia, Colombia, Ecuador and Peru). However, Colombia and Peru retired from negotiations before they concluded. See a list of concluded FTA in the European Commission Enterprise and Industry website: <http://ec.europa.eu/enterprise/policies/international/facilitating-trade/free-trade/#h2-1>.

³³ Due to the lack of information on the methodologies used in GCC’s development plans, this section omits quantitative information for comparability purposes and relies instead on a general qualitative assessment. Interested readers can refer to Bahrain EDB (2008), Kuwait SCPD (2010), Oman MoI (2011), Qatar GSDP (2008), Saudi Arabia MoEP (2010), UAE (2010).



If countries in the region vary regarding the degree of detail of their economic planning exercises, they all share common objectives in their diversification strategies and consider similar pathways towards reaching their goals. Increasing participation by GCC nationals in the labour force and human capital are the overarching objectives of the countries in the region. Each GCC country has created a vast public sector to employ its workforce in high-wage positions, leaving the private sector to an expatriate workforce and, as hydrocarbon resources deplete, it will prove increasingly difficult to maintain the current living standards of the population, eventually threatening the long-term sustainability of the GCC states. Favouring the emergence of a local, competitive workforce will be difficult, as recognised in the development plans themselves, since GCC citizens have been accustomed to almost guaranteed high-pay jobs in the public sector.

Two main channels are envisaged to boost both the development of non-oil activities and local labour force participation. First, all GCC countries seek to attract more FDI to foster economic diversification as this is seen as the preferred way to gain knowledge, foster innovation and align with international best practices. In this regard, several countries, including the United Arab Emirates and Saudi Arabia, have relaxed foreign ownership regulations and allowed for more foreign participation in local companies. However, as evidenced by the STRI and by the significant presence of the state in the region's productive systems, there seems to be a lot of room for manoeuvre for greater foreign participation in these economies. Second, almost all countries in the region seek to encourage the development of locally owned and globally competitive SMEs. The high-technology services sector is singled out in the region's development plans, as creating a competitive advantage in the small-scale non-oil manufacturing sector will prove impossible to achieve due to the region's reliance on hydrocarbons. Also, well aware of the negative environmental impacts of specialisation in hydrocarbons, GCC countries have added an environmental layer to their development plans, vowing to preserve natural resources, chiefly water and air quality.

While the objective of economic diversification has been high on GCC countries' agendas since the 1970s, progress towards meeting it has been slow and uneven. For example, progress in Saudi Arabia, where economic planning has been in place for several decades, has been very slow compared to that in Qatar and the UAE (Hvidt 2013).

GCC countries have ambitious development objectives and, as hydrocarbon resources deplete, the pressure on them to accomplish these goals will be higher. However, it is not clear whether the EU-GCC FTA could prove to be a strong supportive factor in their diversification strategies, as studies have failed to reach concluding evidence on its impact.

3.2. Studies on the impact of an EU-GCC FTA

Conventional wisdom derived from international trade theories suggested that trade liberalisation always had superior welfare effects to protectionism. However, by the 1950s and the subsequent conclusion of multilateral and preferential trade agreements, economists cast doubt on the validity of such a prescription, demonstrating that the welfare enhancing



effects of trade liberalisation between two partners would depend on the extent of trade creation and trade diversion (Viner 1950). Trade creation refers to the sourcing of imports of a given good from the most efficient country, whereas trade diversion refers to the opposite, i.e. the sourcing of imports of a given good from a less efficient location. Intuitively, the net effect of an FTA between two partners is given by the difference between trade creation, trade diversion and forgone tariff revenue. This theoretical framework has inspired empirical studies quantifying the effects of trade integration via partial equilibrium analyses, which seek to calculate the equilibrium in terms of quantities and prices of goods between two partner countries given different assumptions of trade liberalisation. The use of partial equilibrium analyses, while practical due to their minor data requirements compared to other approaches, falls short in addressing the interactions between different goods and trading partners other than those engaging in trade liberalisation.

In another stream of the literature, researchers resort to general equilibrium modelling in a bid to overcome these shortfalls and provide a more comprehensive picture of the impacts of trade liberalisation. General equilibrium analyses consider interactions between liberalisation of different goods as well as between different trading partners and directly derive estimations of changes in welfare, as opposed to partial equilibrium ones. The main difficulty in using these models for trade analysis lies in their significant data requirements, generally constraining this type of analysis to developed countries. Moreover, as with partial equilibrium approaches, they are static and do not provide indications of the dynamic gains of trade liberalisation (Ghoneim et al. 2012).

A third approach lies in the use of gravity models of trade. While these were initially used to conduct ex post analysis of the impacts of trade policy, they are increasingly used by economists to provide ex ante³⁴ analysis of trade liberalisation. Gravity models assume that bilateral trade flows are determined by a set of variables such as distance, the existence of a common language and borders between trading partners, and institutional characteristics, in addition to a number of economic variables. While these types of models have been criticised for lacking theoretical foundations, their important explanatory power compared to other approaches has fuelled their use in trade policy analysis.

Despite the relative strengths of these three types of models, statistically based approaches all fail to address qualitative aspects of the conclusion of an FTA between trading partners, especially as the recent waves of preferential trade agreements move beyond reciprocal trade liberalisation to integrating clauses on legislative approximation and the removal of “behind-the-border” obstacles to trade. As a result, to guide policy-makers and negotiating authorities in the process of FTA negotiations, quantitative modelling approaches are complemented by qualitative information gathered through consultations between stakeholders to add expert judgement (Plummer, Cheong and Hamanaka 2010).

³⁴ Ex ante refers to “beforehand”. Ex post refers to “after the fact”.



As far as EU-GCC trade is concerned, only three studies have been conducted to assess the impact of an FTA between the two regions. While their figures vary according to the methodology adopted, all three conclude that the GCC countries would be the main beneficiaries from trade liberalisation with the EU. In a first study using partial equilibrium techniques, DeRosa and Kernohan (2004) found that the proposed FTA would benefit the GCC countries in two ways: first, by expanding their exports of petroleum and mineral products due to exchange rate depreciation; and second, by making a higher number of manufactured products available to GCC consumers at a lower price. On the other hand, this study finds negative results on a very small scale for the EU resulting from trade diversion and the loss of tariff revenue. While the authors had conjectured that the EU-GCC FTA would provide a boost to the Gulf's non-oil sectors, the evidence shows that such an agreement would not allow the countries to meaningfully overcome their reliance on oil.

Using a gravity equation augmented with trade costs, Baier and Bergstrand (2004) again found that the proposed FTA would entail net trade creation for the GCC countries, but also for the EU. This result is explained by the authors' methodology that includes a term to proxy for trade costs between the two regions (the "multilateral trade resistance term"). In their specification, the gains experienced from the conclusion of the FTA result from the elimination of behind-the-border obstacles to trade and the possibility to benefit from more information flows between both regions' governments, producers and consumers.

The third study, undertaken by PricewaterhouseCoopers, used the European Commission's methodology for trade impact assessments³⁵ (PwC 2004). It relied on a partial equilibrium analysis supplemented with qualitative information to assess the impact of an EU-GCC FTA. The results show that the GCC countries would be the main beneficiaries from the FTA with net welfare gains of 3% of GDP per annum, and a small welfare loss for the EU. In addition to tariff dismantlement simulations, the study undertook two sector-specific assessments on the GCC region's petrochemical and aluminum industries, given their importance in the region's exports to the EU and their potential for expansion. These two case studies provided more details on the mechanisms at play behind GCC countries' projected increase of welfare and highlighted that both industries would be the main beneficiaries of the agreement. Driven by the availability of inputs and economic diversification policies, the petrochemical industry in the GCC region is expected to expand massively in the next years. Within the GCC states, Saudi Arabia has the biggest potential in petrochemicals. The national petrochemical firm SABIC is the regional leader in the industry and the FTA would foster its activity in Europe, whereas other GCC countries would enjoy only minor gains. For the regional industry in general, and for the Saudi petrochemical company in particular, the conclusion of the FTA would result in the rapid acquisition of world-class technology potentially challenging the EU's competitive advantage and global market power, (PwC 2004). As regards aluminium, also a strategic sector for the region, GCC exporters demand duty-free access to the European markets. The region's aluminum industries are expanding, supported by national investment programmes and low energy prices. Trade liberalisation

³⁵ For more information about the European Commission's methodology for sustainability and impact assessments of trade negotiations, see European Commission (2006).



effects for aluminum have to be assessed on the basis of their short- and long-term benefits. In the short run, profit margins of GCC producers will increase due to tariff reduction, and in the long run, the market power of GCC producers will increase. At the country level, United Arab Emirates and Bahrain are the countries most likely to benefit from the FTA. The projected expansion of these two industries was among the reasons for the negotiations failing (see Box 1).

Box 1 | Insights on the failure of the EU-GCC FTA

Three reasons can be put forward to explain the failure to conclude the FTA after 20 years of negotiations. First, the EU's petrochemical lobby forcefully fought against trade liberalisation, resulting in European governments blocking duty-free access for petrochemicals from the Gulf for many years. The reason behind this protectionist stance was that the EU's petrochemical suppliers argued that the double pricing policy of raw materials by GCC countries constituted an implicit subsidy which would result in dumped imports entering the EU. This policy allowed GCC producers to enjoy input prices 30% lower than export prices, with GCC governments arguing this was due to added costs to exports (pipeline transportation, refrigeration, storage and terminal facilities) (Antikiewicz and Momani 2009). Second, the human rights and illegal migration clauses embedded in the FTA were rejected by the GCC states, which claimed that Brussels was bringing issues to the table that had nothing to do with trade (Echagüe 2007). However, according to other research, the rejection of such clauses is only a "smokescreen", as noted by a former EU diplomat in the region. Instead, it was the reluctance of the GCC countries to abandon subsidising their energy industry that was responsible for the stalemate in negotiations (Youngs 2009, Kombargi et al. 2011). Third, the GCC countries were reluctant to meet the EU's demands to liberalise services and government procurement. As a result, the GCC suspended negotiations unilaterally in 2008, but informal contacts between negotiators continue to take place.

The impact assessment study also projected wider environmental and socioeconomic effects of the FTA for GCC countries. First, the expansion of heavy industries, such as petrochemicals and aluminum, is expected to drive a rural exodus and urbanisation that, if left uncontrolled, would exert a toll chiefly on the region's air and water quality. As regards the agreement's socioeconomic impacts, the study notes that the expansion of the petrochemical and aluminum industries could lead to a small number of additional jobs for high-skilled GCC workers, but that overall the FTA's impact on labour is expected to be at best marginal.

Finally, the authors note that the detrimental side effects of the agreement on the GCC countries could be mitigated through some level of opening up of the services sector. In the area of environmental management, for example, the negative effects of polluting industries could be mitigated by a strong regulatory framework as well as by the opening up to international competition of environmental and business services.

These prospective outcomes for the GCC economies need to be taken with caution, however, for a number of reasons. First, the lack of available data on the region's countries forced



the studies to resort to partial equilibrium and gravity analysis, therefore not accounting for the interaction between productive sectors. Along the same lines, the lack of robust statistics on the services sectors – a constraint relevant to other economies as well – results in an underestimation of the agreement’s impact in this area and its contribution to the diversification objectives of the region’s economies. Also, due to the different modes of entry highlighted above, available studies fail to address the potential for increased investment flows in the region as well as their impact on the balance of payments and exchange rate, two subjects of great importance for the region. Second, the validity of these results should also be re-examined in light of the international economic and political context after the 2008 financial crisis and the 2011 political upheavals in the Arab world. All three studies cited here were conducted in 2004 and used 2003 data; it is probable that more recent statistics would yield different results. For example, when the previous studies were conducted, GCC’s trade with China was lower than with the EU by some 50% and the unrest experienced in the region has since radically changed some countries economic policies, as witnessed in Saudi Arabia. After several episodes of social discontent in 2011, the kingdom announced it would implement a benefit package of \$130 billion (€100 billion), roughly equivalent to the GCC’s total exports to the BRICs in 2010.

Despite negotiations for an FTA having been frozen, prospective studies seeking to quantify such gains should be undertaken in order to provide up-to-date information on its potential impact. Given the importance of services for the region, such studies should build on state-of-the-art methodologies, and also aim to explore the wider socioeconomic implications of a deeper commercial integration between the region and the EU.

4. Prospects and Recommendations for Improving EU-GCC Trade and Investment Relations

4.1. Prospects for concluding the EU-GCC FTA

As previously shown, the EU has geopolitical motivations for signing an FTA, whereas the GCC countries see the FTA as a supportive factor in their economic diversification strategies. Divergences over the content of the FTA and the 2008 financial crisis have frozen EU-GCC trade talks while, at the same time, GCC-China trade has soared and moved up the value chain. The outbreak of the Arab Spring and the unrest spilling over from Egypt and Tunisia to the Gulf region further complicates the prospects for concluding trade negotiations with the EU.

Countries in the region have responded to demonstrations by their populations demanding political opening up and better socioeconomic development prospects with significant welfare packages, especially those where the potential for protracted unrest and destabilisation is the highest, namely Bahrain, Oman and Saudi Arabia. The Bahraini ruler, King Hamad al Khalifa, announced in 2011 that each family would be granted a \$3,000 subsidy (approximately €1,800) to cover their needs and promised to create 20,000 jobs in

the public sector for citizens. In Oman, Sultan Qaboos promised to create an unemployment benefit scheme, while increasing financial support for the country's students and increasing the minimum wage by 40%. Saudi Arabia's response to the unrest within its borders has resulted in a welfare package estimated at \$130 billion (approximately €100 billion), in addition to the construction of 500,000 new houses and the creation of 60,000 jobs in the public sector for Saudi nationals. Other countries proved no exception to this trend of state patronage, though their welfare packages were comparatively smaller; in Qatar, they have amounted to \$8 billion (approximately €6 billion) and in Abu Dhabi to \$2 billion, mainly covering pay rises in the public sector and the construction of new houses (Colombo 2012).

Several reasons can be put forward to explain why the Arab Spring is likely to have a negative impact on the prospects of improving EU-GCC trade and investment relations. From an economic point of view, the upsurge in public spending is likely to divert public funds away from policies fostering economic diversification and the emergence of a strong private sector. Indeed, the countries' various responses show that the public sector will retain a major role in their economies, compromising the governments' efforts to create incentives for the population to work outside of public administration or publicly owned companies. At the same time, liberalisation of trade in services and foreign investment regimes, two long-standing demands of the EU, stand little chance of happening. As the GCC countries increase public spending, any far-reaching reforms that could result in substantial inflows of capital are likely to be delayed, since they could result in currency appreciation and inflationary pressures, which could fuel unrest in the region, especially in the absence of effective inflation targeting monetary policy regimes.³⁶

Also, the EU has insisted on GCC countries' economic integration as a condition for concluding the FTA, but such deeper integration is unlikely in the near future, not only because the countries are set to remain competitors due to similar specialisations, but also because reaching common negotiating positions regarding tariff revenue-sharing mechanisms will be more challenging. In addition, as the countries have enacted significant public spending packages to calm public discontent, they will all have an incentive for maximising their allocation, thus raising the likelihood of non-cooperative strategies.

Furthermore, the EU's standard clauses on respect for human rights, democracy, counter-terrorism and the like will continue to be rejected by the GCC countries, especially in the context of socioeconomic instability in the region. The 2011 protests in the Gulf were due not only to economic grievances, but also to political demands for more democratic societies. Given the GCC countries' repression of protests, any attempts by international agents to tie the signature of trade agreements to such clauses are very likely to be rejected.

To sum up, several factors rule out the prospect of concluding an FTA with the EU in the medium term. First, China is an increasingly important commercial partner for the Gulf, decreasing the likelihood of a reinforcement of trade links with the EU. Second, domestic

³⁶ *Monetary policies in the GCC region resort to pegged exchange rate regimes combined with a variety of instruments such as loan-to-deposit ratios and reserve requirements.*

instabilities spilling over from the unrest in the southern Mediterranean compromise the ability of the Gulf countries to achieve their diversification objectives, since public spending has been diverted towards large-scale benefits packages. Third, research on the prospective impact of an EU-GCC FTA is out-dated and does not provide either region's authorities with an incentive to explore further negotiating options. Nevertheless, given the increase in investment linkages between the regions and the diversification needs of the GCC countries, there is a need for more knowledge of both sides in order to appreciate the respective benefits of a region-to-region FTA.

4.2. Recommendations for improving EU-GCC trade and investment relations

Despite the low likelihood of concluding the EU-GCC FTA in the near future, the EU and the GCC can nevertheless undertake joint actions to reinforce their trade, investment and overall economic links. Such actions are mainly concerned with supporting the diversification efforts and economic planning capabilities of the Gulf countries, updating the evidence regarding the impact of a possible FTA, and facilitating travel of GCC business people to the EU.

First, as shown by their development plans, most GCC countries have rather limited economic planning capacities. Some countries (such as Qatar and the United Arab Emirates) do conduct in-depth studies on the socioeconomic development challenges they face and the policies foreseen to meet them, but the others rely on rather general documents spelling out policy directions to support their diversification efforts. To move forward in its objective of reinforcing its policies towards the Arab world, the EU could support these countries in improving their economic planning capabilities, given its own and its member states' experiences in such activities. Such support could take two forms. First, EU institutions and GCC countries could create a programme of study visits and exchanges between EU, member state and GCC officials from relevant ministries to foster economic planning best practices. Second, both parties could also jointly fund long-term prospective studies on the diversification options, costs, benefits, and mitigation measures for adverse effects in order to guide policy-making in this area.

Along the same lines, both regions could develop a series of targeted programmes assessing the contribution of liberalisation of trade in services to economic diversification. Most GCC countries see the services sector as a key contributor supporting their diversification efforts. Data also show that, despite being important, trade in services is below its potential in the region, possibly due to overly restrictive policies. While a fully-fledged opening up of the sector is neither realistic nor suitable for balance of payments reasons, a gradual opening up of targeted services could prove beneficial for the GCC countries. In this regard, both regions should launch a study programme assessing the benefits and costs of liberalisation of selected services. The programme should devote particular attention to regulatory aspects, as services regulation is in part prudential. A particular aim of this programme

should be to identify, in the services considered, the potential for regulatory enhancements and openness to foreign trade.

Third, while the conclusion of an FTA is not a likely future prospect and its conclusion should not be a precondition for deepening relations between the two regions, studies on its prospective impact should be updated. Previous research was conducted between 2003 and 2004 and is now out of date, as the financial crisis and the Arab Spring have significantly changed the world's economic and geopolitical outlook. The new impact assessment should also pay attention to the services sector and its contribution to the GCC economies. The study should devote particular attention to the issue of data availability, as the lack of statistical evidence on services hinders robust analysis of the service sector's impact on the region's economic performance.

Last but not least, and beyond trade and investment considerations, the Arab Spring and the responses of both actors have shown a shared interest in preserving security and sustainable socioeconomic development in their neighbourhood, the southern Mediterranean. The improvement in commercial relations between the two regions could go hand-in-hand with an open dialogue between the EU and GCC countries on the means for supporting socioeconomic transition in the Mediterranean region.

Conclusion

The EU and the GCC formalized their relations in 1988 with the conclusion of a Cooperation Agreement which aimed at deepening cooperation between the two regions in a number of areas and conclude a free trade agreement (FTA). The process was driven by the EU's willingness to expand its policy frameworks in the Arab world and by Gulf countries' needs to secure access to foreign technologies in order to diversify their production structures. However, many years of negotiations for this region-to-region FTA have failed to lead to an agreement, due to divergent stances on market access of GCC exports to the EU and Gulf countries' reluctance to open their services sectors to European companies. Meanwhile, EU-GCC trade and investment patterns have remained stable, but data show that emerging countries, and chiefly China, are increasingly important trading partners of Gulf countries. While previous analyses have showed that the GCC would stand as the main beneficiary of an FTA with the EU, the prospects of deepening EU-GCC trade and investment relations beyond the current frameworks are low: as GCC countries are increasingly confronted by the risks of social unrest stemming from the Arab Spring, governments in the region are unlikely to commit to an opening of their economies. The low likelihood of an EU-GCC FTA notwithstanding, each partner should nevertheless reassess the costs and benefits of an economic rapprochement. Indeed, previous analyses have failed to take into account the importance of the services sector for Gulf countries and this sector's potential contribution to their diversification efforts. At the same time, both regions would gain from exploring cooperation possibilities in the Southern Mediterranean, as they have both a major interest in ensuring sustainability in their neighbourhood.

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Annexes

ANNEX 1. CONCENTRATION AND DIVERSIFICATION INDICES

The concentration index is a measure of the degree of market concentration. It has been normalised to obtain values from 0 to 1 (maximum concentration), according to the following formula:

$$H_j = \frac{\sqrt{\sum_{i=1}^n \left(\frac{x_i}{X}\right)^2} - \sqrt{1/n}}{1 - \sqrt{1/n}}$$

Where: H_j = country group ; x_i = value of exports of product i ; n = number of products (SITC Revision 3 at 3-digit group level) and :

$$X = \sum_{i=1}^n x_i$$

Source: Quoted from UNCTADstat Definitions and Metadata.

ANNEX 2. BRIEF TECHNICAL SUMMARY FOR CALCULATING THE OTRI

The OTRI provides a uniform metric of a country's trade protection structure at the tariff line level that leaves its welfare constant for any given level of imports of a good. It solves two important aggregation problems in trade policy analysis. First, as countries resort to different policy instruments such as tariffs and non-tariff barriers (NTBs), a direct comparison between trade policies is not possible. Second, as trade policy measures are applied at the tariff line level, any comparison between different countries' trade policies needs to take into account the level of each country's imports of a good. For example, a particular good n might be subject to high tariff and a number of NTBs in the form of technical requirements, sanitary and phyto-sanitary measures etc., but its imports in a country c might be low. Hence, any measure failing to take into account the quantity effect of imports of the good would give a biased measure of trade protection.

The construction of the OTRI follows a three step procedure. First, Kee, Nicita and Olarreaga (2009) estimate average tariff equivalents (AVEs) of NTBs. NTBs are a set of regulations any exporter located in country c needs to fulfil to export a good n in country b . NTBs consist of "core" and "non-core" measures protecting local producers and consumers respectively. They (core and non-core NTBs) are classified in 16 categories: sanitary and phyto-sanitary

measures (SPS), technical barriers to trade (TBT), other technical measures, price control measures, quantity control measures, para-tariffs, finance measures, anti-competitive measures, export related measures, trade and investment measures, distribution restrictions, restrictions on post-sale services, subsidies, government procurement measures, intellectual property rights and rules of origin. Data on NTBs is available in UNCTAD's TRAINS database. The basic formula for estimating AVEs consists in differentiating the following equation with respect to $Core_{n,c}$ and $\ln DS_{n,c}$ after estimating $\beta^{Core}_{n,c}$ and $\beta^{DS}_{n,c}$:

$$\ln m_{n,c} = \alpha_n + \sum_k \alpha_{n,k} C_c^k + \beta_{n,c}^{Core} Core_{n,c} + \beta_{n,c}^{DS} \ln DS_{n,c} + \varepsilon_{n,c} \ln(1 + t_{n,c}) + \mu_{n,c}$$

Where:

- $m_{n,c}$ is the import value of a good m in country c , evaluated at world prices
- α_n are tariff line dummies for good specific effects
- C_c^k is a vector of variables controlling for country specific characteristics (GDP, population, etc.)
- $\alpha_{n,k}$ are parameters capturing country characteristics
- $Core_{n,c}$ is a dummy capturing the presence of NTBs on a good n in a country c
- $\ln DS_{n,c}$ is the logarithm of domestic support to the agricultural sector
- $\beta^{Core}_{n,c}$ is the parameter capturing the impact of a core NTB on imports of the good n in country c
- $\beta^{DS}_{n,c}$ is the parameter capturing the impact of domestic agricultural support on the good n in country c
- $t_{n,c}$ is the ad-valorem tariff of good n in country c
- $\varepsilon_{n,c}$ is the import demand elasticity of good n in country c
- $\mu_{n,c}$ is the independently and identically distributed error term.

In a second step, once AVEs have been obtained, before calculating the OTRI, Kee, Nicita and Olarreaga calculate the Trade Restrictiveness Index, which measures the impact of trade protection (comprising tariffs and NTBs) on a country's own welfare. The TRI can be found by differentiating the following equation and using second order linear approximation to calculate welfare costs in equilibrium:

$$TRI_c : \sum_n W_{n,c}(TRI_c) = \sum_n W_{n,c}(T_{n,c}) = W_c^0$$

Where:

- $W_{n,c}$ is the country's welfare associated with its imports of the good n
- $T_{n,c}$ is the country's uniform tariff equivalent of tariffs and NTBs for good n
- W_c^0 is the current level of a country's aggregate welfare

Finally, the OTRI can be found solving for this equation in a partial equilibrium set-up:

$$\text{OTRI}_c : \sum_n m_{n,c}(\text{OTRI}_c) = \sum_n m_{n,c}(T_{n,c}) = m_c^0$$

Where:

- m_c^0 is the current level of a country's total imports of all goods.

Source: Kee, Nicita and Olarreaga (2009).

ANNEX 3. BRIEF TECHNICAL SUMMARY FOR CALCULATING THE STRI

The STRI ranks countries' different services sector policies according to the restrictions applied by governments on foreign suppliers. It is constructed from the perspective of a foreign supplier willing to supply services in a country through cross-border supply (mode 1), commercial presence (mode 3), and temporary movement of natural persons (mode 4). Consumption abroad (mode 2) is not considered. Information comes from two sources: for OECD countries, the index builds on publicly available sources; for developing countries, a questionnaire was addressed to national authorities. In both cases, after gathering the relevant policy information, local authorities were consulted in a second stage to evaluate how the different policies were implemented in practice. Data was collected for each combination of service sector, subsector and mode of supply. For example, in the case of banking, the data considers restrictions on foreign suppliers for lending and deposit acceptance through cross-border supply and commercial presence. While the index is subjective to the choice of sectors and subsectors, Borchert, Gootiiz and Mattoo (2012) conduct robustness checks to assess the validity of their results. Broadly, the authors find that consistent with trade theories, a greater level of openness in the services sector is simultaneous with higher total factor productivity and GDP per capita.

The index is constructed using a three-step methodology to derive a sector/country-level as well as a total country measure of restrictiveness. After identifying the different policies regulating the presence of foreign suppliers across each sub category of services and mode of supply, the authors rank the different policy regimes assigning a score from 0 to 100, denoted S_{jmc} . Five levels of restrictiveness are used in the database:

- Completely open (score=0)
- Virtually open with some restrictions (score=25)
- Virtually closed but with some possibilities to operate (score=75)
- Completely closed (score=100)
- Non stringent regulations (score=50). Most countries/sub-sectors fall under this category as regulation of some services is of prudential nature.

Once a score has been attributed to each subsector, there is an aggregation across services sub-sectors to derive a sector index of restrictiveness, and another one to derive country/sector indices. The aggregations are based on two criteria:

- The relative importance of supply modes for each subsector. For example, in the case of professional services, regulations affecting the movement of natural persons are more relevant than regulations affecting the cross-border supply of services. To take this into account, authors assign a weight to each mode of supply. The more stringent the regulations, the higher the weight denoted by w_{jm} .
- The relative importance of a service sector in a country's economy. For example, in some countries, professional services might be more important than retail, and aggregating restrictiveness scores across these two categories would give a biased measure of policy barriers affecting international trade in services. To take this into account, authors consider the share in value added of each sub sector in a country's value added, denoted w_j .

Two services sector restrictiveness indexes follow:

- The country sector index:

$$STRI_{ej} = \sum_m w_m^{(j)} S_{jmc}$$

- The overall country STRI:

$$STRI_c = \sum_j w_j STRI_{ej}$$

Source: Borchert, Gootiiz and Mattoo (2012).

ANNEX 4. EU AND GCC ECONOMIC AND SOCIAL INDICATORS, 2010

Country	Currency	GDP (Eur. bn)	GDP per capita (Eur.)	GDP growth (annual %)	Inflation	Trade (% GDP)	Stocks traded, total value (% GDP)	Population (millions)	Life expectancy at birth, total	Adult literacy rate (%)
Bahrain	Bahraini Dinar BHD	17.31	13,716.68	6.3	1.96	140 (2009)	4.16 (2009)	1.26	75.02	91.35 (2009)
Kuwait	Kuwaiti Dinar KWD	93.80	34,273.81	4.3 (2007)	4.02	89 (2009)	63.88 (2009)	2.74	74.60	93.91 (2008)
Oman	Omani Rial OMN	43.64	15,682.91	1 (2009)	3.20	94 (2009)	12.44 (2009)	2.78	73.12	86.62 (2008)
Qatar	Qatari Rial QAR	96.05	54,610.86	8.6 (2009)	-2.43	48 (2009)	25.94 (2009)	1.76	78.10	94.72 (2009)
Saudi Arabia	Saudi Rial SAR	340.04	12,388.50	3.7	5.34	78 (2009)	46.75	27.45	73.85	86.13 (2009)
United Arab Emirates	United Arab Emirates Dirham AED	224.52	29,889.64	1.4	...	144 (2009)	9.22	7.51	76.57	
GCC*	815.35	18,743.79	4.2	2.42	99	27.06	43.50	75.21	90.5
EU	Euro	12,181.77	24,251.85	2	1.9	71	58	502.3	80	99

*Regional averages, except for population and GDP; Data are for 2010 unless otherwise stated

Source: World Bank 2010.

ANNEX 5. EVOLUTION OF GCC COUNTRIES' HYDROCARBONS ENDOWMENTS

Oil: Proved reserves										
	1980	1990	2000	2010	2012	1980	1990	2000	2010	2012
	Billion barrels					% of world total				
GCC	272.4	462.8	479.8	494.0	494.6	39.9	45.0	38.1	30.5	29.6
Bahrain										
Kuwait	67.9	97.0	96.5	101.5	101.5	9.9	9.4	7.7	6.3	6.1
Oman	2.5	4.4	5.8	5.5	5.5	0.4	0.4	0.5	0.3	0.3
Qatar	3.6	3.0	16.9	24.7	23.9	0.5	0.3	1.3	1.5	1.4
Saudi Arabia	168.0	260.3	262.8	264.5	265.9	24.6	25.3	20.9	16.3	15.9
United Arab Emirates	30.4	98.1	97.8	97.8	97.8	4.4	9.5	7.8	6.0	5.9
European Union (excl. former USSR)	11.8	8.1	8.8	6.8	6.8	1.7	0.8	0.7	0.4	0.4
US	36.5	33.8	30.4	35.0	35.0	5.3	3.3	2.4	2.1	2.1

Source: BP 2013.

Natural gas: Proved reserves										
	1980	1990	2000	2010	2012	1980	1990	2000	2010	2012
	Trillion cubic metres					% of world total				
GCC	9.7	11.8	23.3	36.0	36.3	12.0	9.4	15.1	23.6	22.7
Bahrain	0.2	0.2	0.1	0.2	0.2	0.3	0.1	0.1	0.1	0.1
Kuwait	1.1	1.5	1.6	1.8	1.8	1.3	1.2	1.0	1.0	1.0
Oman	0.1	0.3	0.9	0.9	0.9	0.1	0.2	0.6	0.5	0.5
Qatar	2.8	4.6	14.4	25.0	25.1	3.5	3.7	9.4	14.1	13.4
Saudi Arabia	3.2	5.2	6.3	8.0	8.2	3.9	4.2	4.1	4.5	4.4
United Arab Emirates	2.4	5.6	6.0	6.1	6.1	2.9	4.5	3.9	3.4	3.3
European Union (excl. former USSR)	3.7	3.4	3.8	2.3	1.7	4.6	2.7	2.5	1.3	0.9
US	5.6	4.8	5.0	8.6	8.5	7.0	3.8	3.3	4.8	4.5

Source: BP 2013.

ANNEX 6. COUNTRY GROUPINGS

AFRICA		EU 20	Major Hydrocarbons exporters	MED 11 - MED 7	ASEAN	MERCOSUR	NAFTA
Algeria	Madagascar	Austria	Algeria	Algeria (MED 7)	Brunei	Argentina	Canada
Angola	Malawi	Belgium	Angola	Egypt (MED 7)	Cambodia	Bolivia	Mexico
Benin	Mali	Bulgaria	Iran	Israel	Indonesia	Brazil	United States
Botswana	Mauritania	Czech Republic	Iraq	Jordan (MED 7)	Laos	Paraguay	
Burkina Faso	Mauritius	Denmark	Kazakhstan	Lebanon (MED 7)	Malaysia	Uruguay	
Burundi	Mayotte	Finland	Kuwait	Libya	Myanmar	Venezuela	
Cameroon	Morocco	France	Libya	Morocco (MED 7)	Philippines		
Cape Verde	Mozambique	Germany	Nigeria	Palestine	Singapore		
Central African Republic	Namibia	Greece	Norway	Syria	Thailand		
Chad	Niger	Hungary	Oman	Tunisa (MED 7)	Vietnam		
Comoros	Nigeria	Ireland	Qatar	Turkey (MED 7)			
Congo	Rwanda	Italy	Russian Federation				
Côte d'Ivoire	Saint Helena	Lithuania	Saudi Arabia				
Dem. Rep. of the Congo	Sao Tome and Principe	Netherlands	United Arab Emirates				
Djibouti	Senegal	Poland	Venezuela				
Egypt	Seychelles	Portugal					
Equatorial Guinea	Sierra Leone	Romania					
Eritrea	Somalia	Spain					
Ethiopia	South Africa	Sweden					
Ethiopia (...1991)	Sudan	United Kingdom					
Gabon	Sudan (...2011)						
Gambia	Swaziland						
Ghana	Togo						
Guinea	Tunisia						
Guinea-Bissau	Uganda						
Kenya	United Republic of Tanzania						
Lesotho	Western Sahara						
Liberia	Zambia						
Libya	Zimbabwe						

Sources: UNCTADstat methodologies and country/product groupings; World Bank (2012b).

ANNEX 7. KNOWLEDGE-INTENSIVE PRODUCTS

Product name (SITC Rev 3)

Hydrocarbons, n.e.s., & halogenated, nitr. derivative
Alcohols, phenols, halogenat., sulfonat., nitrat. der.
Carboxylic acids, anhydrides, halides, per.; derivati.
Nitrogen-function compounds
Organo-inorganic, heterocycl. compounds, nucl. acids
Other organic chemicals
Inorganic chemical elements, oxides & halogen salts
Metallic salts & peroxy salts, of inorganic acids
Other inorganic chemicals
Synth. organic colouring matter & colouring lakes
Dyeing & tanning extracts, synth. tanning materials
Pigments, paints, varnishes and related materials
Medicinal and pharmaceutical products, excluding 542
Medicaments (incl. veterinary medicaments)
Essential oils, perfume & flavour materials
Perfumery, cosmetics or toilet prepar. (excluding soaps)
Soaps, cleansing and polishing preparations
Fertilizers (other than those of group 272)
Polymers of ethylene, in primary forms
Polymers of styrene, in primary forms
Polymers of vinyl chloride or halogenated olefins
Polyethers, epoxide resins; polycarbonat., polyesters
Other plastics, in primary forms
Waste, parings and scrap, of plastics
Tubes, pipes and hoses of plastics
Plates, sheets, films, foil & strip, of plastics
Monofilaments, of plastics, cross-section > 1 mm
Insectides & similar products, for retail sale
Starche, wheat gluten; albuminoidal substances; glues
Explosives and pyrotechnic products
Prepared addit. for miner. oils; lubricat., de-icing
Miscellaneous chemical products, n.e.s.
Aircraft & associated equipment; spacecraft, etc.
Optical instruments & apparatus, n.e.s.
Instruments & appliances, n.e.s., for medical, etc.
Meters & counters, n.e.s.
Measuring, analysing & controlling apparatus, n.e.s.
Photographic apparatus & equipment, n.e.s.

Cinematographic & photographic supplies
 Cinematograph films, exposed & developed
 Optical goods, n.e.s.
 Watches & clocks
 Arms & ammunition
 Office machines
 Automatic data processing machines, n.e.s.
 Television receivers, whether or not combined
 Radio-broadcast receivers, whether or not combined
 Sound recorders or reproducers
 Household type equipment, electrical or not, n.e.s.
 Parts and components for electrical and electronic goods
 Parts, accessories for machines of groups 751, 752
 Telecommunication equipment, n.e.s.; & parts, n.e.s.
 Apparatus for electrical circuits; board, panels
 Cathode valves & tubes

Source: UNCTADstat, SITC rev.3 products, Manufactured goods by degree of manufacturing groupings, http://unctadstat.unctad.org/UnctadStatMetadata/Classifications/UnctadStat.SitcRev3Products.DegreeOfManufacturing.Classification_En.xls.

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ABOUT SHARAKA

Sharaka is a two-year project implemented by a consortium led by Istituto Affari Internazionali (IAI).

The project, partially funded by the European Commission, explores ways to promote relations between the EU and the Gulf Cooperation Council (GCC), through the implementation of policy-oriented research, outreach, training and dissemination activities.

The overall project aim is to strengthen understanding and cooperation between the EU and the GCC, with particular attention to the strategic areas identified in the Joint Action Programme of 2010, such as trade and finance, energy, maritime security, media and higher education.

For more information visit www.sharaka.eu