

### EU-GCC relations in the era of the second oil boom

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Steffen Hertog

# EU-GCC Relations in the Era of the Second Oil Boom

This paper originated within the framework of the “Europe and the Middle East” project which is being conducted jointly by the Center for Applied Policy Research and the Bertelsmann Stiftung. Steffen Hertog is lecturer in Political Economy in the School of Government and International Affairs at Durham University, UK.

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## **Introduction: rationale for a new EU-GCC initiative**

The monarchies of the Gulf Cooperation Council (GCC) have been ever more clearly emerging as the hub of the whole Middle East region. This has been obvious in economic terms, as during the current boom their relative weight – always large – has further grown and they are the leaders in a new phase of regional economic liberalization and cross-border investment. Their ascendancy has also unfolded, more subtly, on the political level, as Gulf monarchies are starting to throw around their diplomatic weight to pursue their vested interest in political calm and economic cooperation in the wider Middle East.

While emerging as the most sophisticated and resourceful player in the region, the Gulf has been gradually reorienting itself geo-economically: away from the US and towards Asia. The role of Europe in this shift is yet unclear. The European Union runs the danger of missing out in a crucial period of in which the decks in the Middle East are reshuffled, old players lose importance and new players emerge. This is although the EU has a number of comparative advantages vis-à-vis other regions that could be played out much more systematically to position itself towards the GCC.

Despite somewhat increased interest in recent years, the EU is still badly neglecting the GCC compared to other, arguably less important regions. This is partially to do with the absence of post-colonial links to the Gulf among core EU countries, but also with the fact that the GCC is not a region in acute crisis. This however should be seen as a chance rather than as a reason for comparative disengagement. To contain the crises in the non-Gulf Middle East, the EU will require strong partnerships with the more stable local players. These are found in the Gulf.

Among GCC elites, there is considerable interest in the EU and its capacities. The GCC is working towards economic integration, and its individual governments have been trying to reform their administrations and economies at a heightened pace. In its relationship with the Gulf, the EU should be much more proactive in drawing on its unrivaled experience with institution-building, regulatory reform, assisted transformation, multi-level cooperation and cross-border integration.

Economic opening and sectoral reforms in the Gulf have opened up opportunities for private and public cooperation on many more levels than was thinkable only a few years ago. Economic reform is in some cases tied up with social change that in turn makes new forms of collaboration possible. Interest in the EU as a paradigm of integration in the Gulf is high and should be drawn on as a basis for cooperation, provided the important differences between Gulf and European conditions are taken into account.

In the post-Iraq war era, just being different from the US already counts as a plus in the Gulf region. Although this should not be the explicit rationale of engagement, and replacing the US is not a desirable or realistic aim, the new geopolitical atmosphere offers a chance that EU policy-makers need to be aware of. Other emerging powers, such as China and India, have already been seizing it much more actively than any European power, not to speak of the EU itself.

## **Executive summary**

The main results of my below analysis of recent developments in the GCC and the chances they offer for the EU are as follows:

- The GCC has emerged as a hub of supreme economic and political importance, overshadowing the rest of the MENA region, but at the same time becoming increasingly integrated with it. As economic powers, GCC countries have a vested interest in regional peace.
- A much deepened European commitment towards EU-GCC cooperation is needed, and needs to be explicitly reconciled with large EU members' bilateral strategies and interests.
- The EU needs to formulate a clear vision and benchmarks of cooperation, draw in high-level commitment, and create follow-up mechanisms for its GCC policies, which thus far have been too haphazard.
- The EU will have to overcome certain hurdles in multilateral cooperation with the GCC and needs to pursue a differentiated approach that allows for bilateralism when it is necessary, but strives for collective solutions where it is possible.
- It needs to recognize both its diplomatic advantages and its limits towards the GCC: While its economic influence and its technocratic prestige are considerable, its political leverage will always be very limited, even more so than in other parts of the Middle East.
- Yet, the liberalization processes that have unfolded during recent years in the Gulf provide new access points for cooperation on reform in places as different as Kuwait, Bahrain and Qatar. The EU needs to play up its comparative advantages as multilateral body with wide regulatory experience, as something the GCC itself aspires to become.

## **The 2005 report and how I add to it**

This report builds in many regards on the EU-GCC policy paper issued by the Bertelsmann Foundation in 2002 and 2005, and will at various take up analytical points and policy ideas which have been adumbrated there.<sup>1</sup> What has happened since the last report is that some of the trends observed there have been deepened and accelerated probably even more than the authors (or most other observers) had anticipated: The Gulf's economic growth and its emergence as regional hub have surpassed the expectations of most analysts. While political liberalization has not accelerated, it has in some regards been consolidated. The ongoing catastrophe in Iraq has further underlined the GCC's value as island of tranquility in the Middle East. Its geopolitical repositioning towards Asia has emerged as an irrevocable secular trend, while the economic reforms described in the 2005 report have been deepened.

## **EU-GCC relations: an overview**

The GCC is an inter-governmental body constituted in 1981 by six authoritarian governments which have been cautiously guarding their sovereignty. It does not have supranational competencies and its secretariat is a rather weak body with limited resources and not even a budget of its own. The unequal size and power of members – pitting dominant Saudi Arabia against the smaller sheikhdoms – has at times engendered considerable mutual distrust. Yet the GCC regimes have a shared interest in stability and calm in a very dangerous regional environment: are all rich, conservative and relatively under-populated and face aggressive powers such as Iran, Iraq and, in the past, the Egyptian republic. They therefore have a strong underlying incentive to stick together, and despite all hiccups the GCC nowadays is the only successful sub-regional organization in the Middle East. A shared liberal economic outlook has helped to advance economic integration on the Arabian Peninsula far beyond what other parts of the wider region have witnessed. The GCC has achieved a high integration of capital, service, goods and labour markets, and in terms of regulatory standardization is far ahead of its neighbours. Especially in recent years, it has also tightened its cooperation on internal security matters. Even if some of the flagship projects such as the GCC monetary union and the customs union have got stuck either on the diplomatic level or the level of bureaucratic implementation, the trend has clearly gone towards greater integration. The GCC summit in December 2007 set the ambitious target of implementing a common market – inspired not least by the EU paradigm – by 2008.

The first major milestone of EU-GCC multilateral engagement is the 1989 cooperation agreement which set the stage for negotiations of a free trade agreement (FTA) and stipulated annual meetings of EU and GCC foreign ministers through a joint council/ministerial meeting. Cooperation in energy, industry, trade and services, agriculture, fisheries, investment, science, technology and the environment were envisaged, all in line with the primarily economic nature of EU-GCC relations.

The process has moved along very slowly, with both sides devoting limited attention to it. Various attempts to revive it have met with partial success at best. A 1995 EU initiative to strengthen EU-GCC relations, among other things through “decentralized cooperation” and a regular political dialogue, yielded scant results. The free trade negotiations which were re-launched in 2002 on a more comprehensive basis yet have to be concluded. At the 2004 joint council meeting it was agreed that both parties would refocus their activities on a limited number of areas, i.e. the free trade area, business matters and energy cooperation, while deciding to insert clauses on human rights and migration into the FTA.

In 2003/2004 the EU also declared its intention to link EU-GCC cooperation with its broader (and more ambitiously pursued) Euromediterranean dialogue, but this once again has not been implemented particularly vigorously. The EU's 2004 “Strategic Partnership with the

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<sup>1</sup> Giacomo Luciani and Felix Neugart (eds.), *The EU and the GCC: An Update*, Bertelsmann Foundation Strategy Paper 2005; Giacomo Luciani and Felix Neugart (eds.), *The EU and the GCC: a New Partnership*, Bertelsmann Foundation Working Paper 2002. Download: <http://www.cap-lmu.de/publikationen/2005/eu-gcc.php>.

Mediterranean and the Middle East” suggested that the EU would consider bilateral engagement with individual Gulf states wishing to cooperate on issues of reform, arguably a response to the US’ own Middle East Partnership Initiative. As of now, the Strategic Partnership largely remains a “hollow framework”<sup>2</sup>, as EU states have different interests and priorities within the region. From the GCC end, human rights initiatives, civil society partnerships and governance projects have often been rejected or killed through neglect, further undermining the EU’s limited enthusiasm for decentralized cooperation on political issues.

### **Recent GCC political developments**

Much of this had to do with the underdeveloped nature of formal civil society institutions in the GCC countries and their regimes’ sensitivity to external potential interference. Yet in recent years, civil society and governance issues have been among the fields that have seen the most dynamic developments among GCC countries – if not always in substantial terms, then at least on a formal-institutional level. New interest groups such as professional associations, unions and worker groups, women’s groups, consumer advocates and human rights organizations have been licensed and several states have reformed their NGO regulations.

Several regimes have either held elections for the first time or have enhanced electoral franchise and status of their parliaments. A number of governments have also moved towards bureaucratic reform and have tried to create new mechanisms to guarantee administrative accountability and responsiveness to citizen demands. The dynamics of all these changes vary strongly from one case to another: While reforms have been introduced in a very top-down fashion in the UAE, Qatar and Oman, where “bottom-up” civil society initiatives are weak or absent, the regimes in Bahrain and Kuwait have been under much stronger pressure from well-organized groups in society to provide a wider political space. Saudi Arabia is somewhere in between, with a generally quiescent society, but a well-organized Islamic sector that on occasion voices demands for participation.

These differential dynamics have to be recognized to understand conditions for and limits to external political engagement on the level of human rights, institutional reform and civil society cooperation. In all cases, however, there is now a more institutionalized setting of interest groups to cooperate with, and also a stronger demand among ruling elites to get an international stamp of approval for their liberalizing initiatives. While external players have to be careful not to be utilized as a figleaf for cosmetic reform, they can potentially also use institutions and organizations as new channels of access, to gauge actual reform progress and to nudge the regimes to live up to their liberalizing rhetoric.

Whatever the different levels of liberalization in the Gulf, the GCC countries have probably seen more substantial steps of political decompression than most other MENA states (where in some cases, such as Egypt and Jordan, the screws have actually been tightened). With the exception of Bahrain and perhaps Kuwait, GCC regimes feel less cornered and are more confident in increasing political freedoms without having to fear instability than their peers in the region. As monarchies which stand above the political fray, moreover, they are arguably in a better strategic position to engineer a more substantive political transition in the long run. This however remains speculative.

On the regional diplomatic level, the GCC has markedly sharpened its profile. Qatar and the UAE have taken various initiatives of peace-making and economic diplomacy in the region. Most of all, however, Saudi Arabia has become the diplomatic powerhouse of “moderate” Arab states, taking the role that Egypt seems to have left vacant. Although it has not managed to resolve any of the major political issues of the region – Palestine, Iraq, Lebanon – it has, after years of dithering, taken highly visible diplomatic steps on all of them, the majority of them constructive. Even if Saudi Arabia cannot solve the region’s problems alone,

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<sup>2</sup> Ana Echagüe, *The European Union and the Gulf Cooperation Council*, FRIDE working paper, 1 May 2007.

it has also become clear that there will be no effective peace diplomacy without it on any of the problems mentioned. The GCC has also taken reasonably coherent collective positions towards the Iranian nuclear issue and could play an important role in an eventual settlement.

### **The GCC as global economic player**

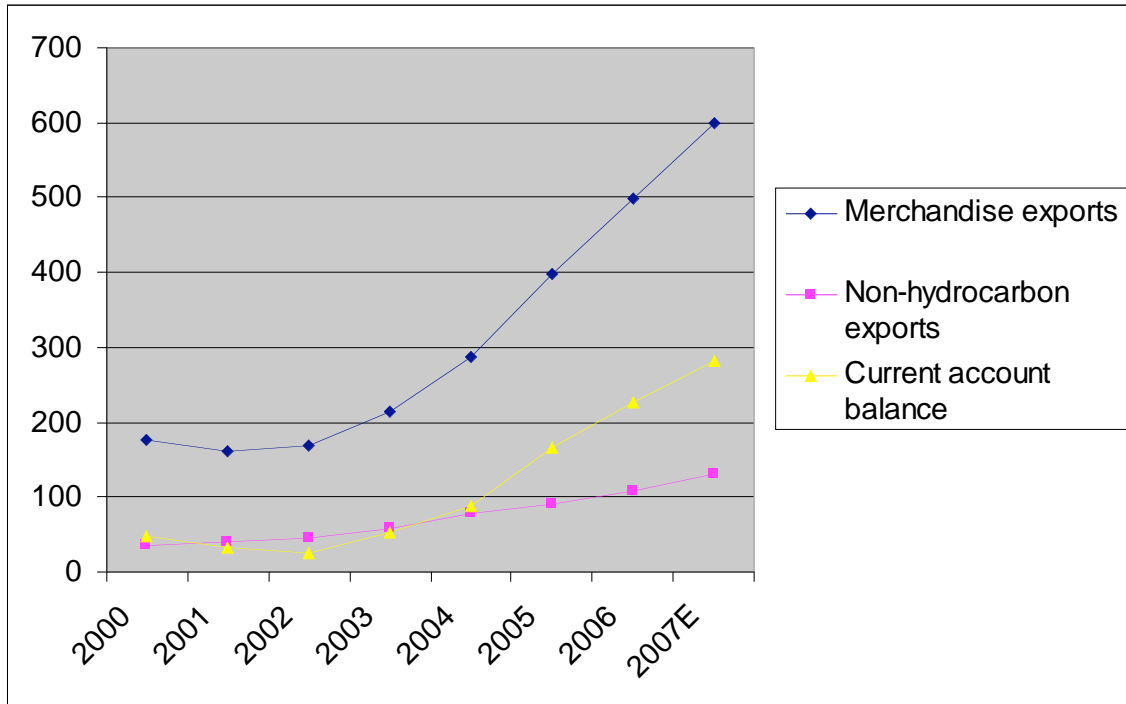
An even more momentous development from an international perspective is the GCC's emergence as global economic hub. After two decades of economic stagnation, the Gulf has emerged as a pivotal player on the world economic stage. In a time of a structurally tight global oil market, its role as the only reliable supplier capable of substantial production capacity increases is more important than ever before. 42 and 23% of global oil and gas reserves respectively are controlled by the GCC. Both numbers are greater than the current share in global exports, which means that the GCC's importance as energy exporter is only bound to increase.

Yet the GCC's significance is not exhausted with fossil fuel exports: The region's economic capacities and linkages are much more sophisticated than they were during the boom of the 1970s and early 1980s. For one, patterns of petrodollar recycling are much more sophisticated than they were 30 years ago. Whereas back then most money was simply parked in US government paper, today both public and private investors are much more actively involved in managing a much more diversified global portfolio, notably through a number of high-profile sovereign wealth funds.

The Institute of International Finance estimates that some 542 billion \$ of surpluses have accrued – and been allocated – between 2002 and 2006 alone, reflecting both fiscal prudence and increasing muscle on international markets. Total foreign asset holdings held by the Gulf states are estimated at amount 1.6 trillion \$. Compare this with China's foreign exchange reserves of 1.1 trillion – so far the main concern of economists worried about global imbalances. The figures indicate that the Gulf has become arguably the most important player on international currency markets, and one of the most important sources of foreign direct investment (FDI) in the world economy. Investment decisions made in Riyadh, Abu Dhabi or Kuwait City can have a strong influence on the fate of whole currencies and national economies – including European ones. Recent concerns about the uncoupling of GCC currencies from the US dollar have highlighted the issue.

Graph 1 below shows the explosive growth of exports and current account surpluses in the GCC. Two trends stand out: First, in relative terms the value of non-oil exports has grown even more rapidly than that of oil exports, reflecting the GCC's successful diversification into energy-and feedstock-intensive heavy industries – a phenomenon that makes the current boom very different from the last one. Secondly, there is a consistent growth trend that is set to continue throughout 2007 and beyond. Although exports and surpluses are likely to level off after 2007, the tightness of global oil markets is likely to continue for years to come, making a collapse of exports as after the 1979-1981 boom unlikely. Considerable surpluses will continue to accrue, even if annual GDP growth in the GCC will slow down from the incredible nominal rates of 20% and more seen during the last four years. The combined GDP of the GCC is now in the range of that of major players like India or Brazil, while its role on international asset markets is much bigger.

**Graph 1: GCC exports and current account balance since 2000 (billion \$)**



Source: IIF/Lehman Brothers

### **The Gulf's changing position in the global political economy**

Compared to the last boom, the GCC's international economic linkages have become considerably more diverse. Remarkably, the EU has suffered only marginally in this process, reflecting the potential of economic cooperation between the two blocs.

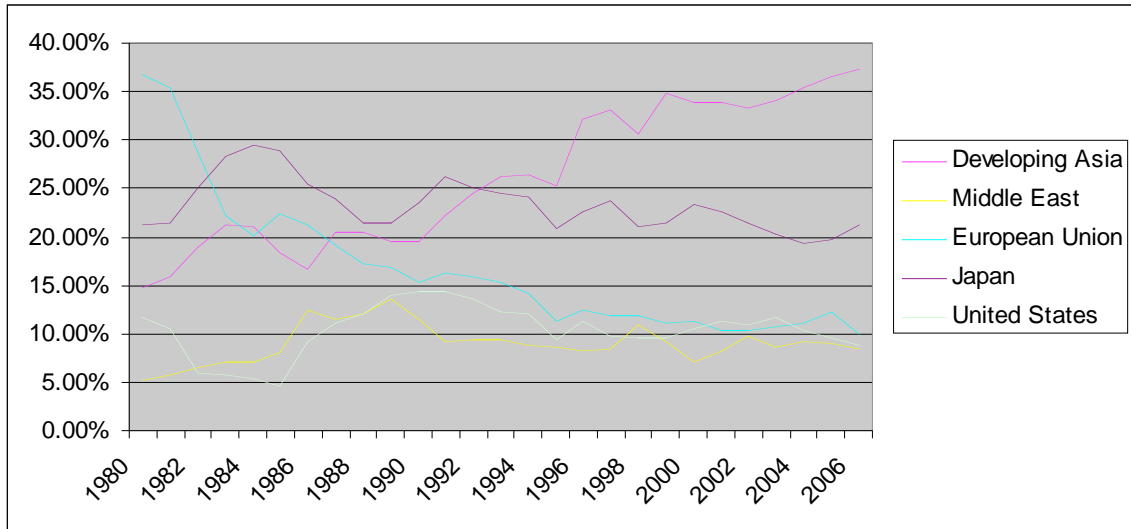
#### The GCC's worldwide trade

The most remarkable trend reflected in graphs 2 and 3 however is that of developing Asia emerging as the main trade partner of the GCC. It has become by far the largest importer of GCC goods, reflecting its hunger for Gulf oil, but also other kinds of industrial feedstock the GCC is increasingly able to provide. The US and Japan, by comparison, are still importing GCC oil on levels comparable to that of 30 years ago, but their role as exporters to the GCC has declined.

The EU's share in imports from the GCC has declined strongly, as it has increasingly been covering its (technically specific) crude oil needs from other producing regions. At the same time, it has been able to defend its status as largest exporter to the GCC.

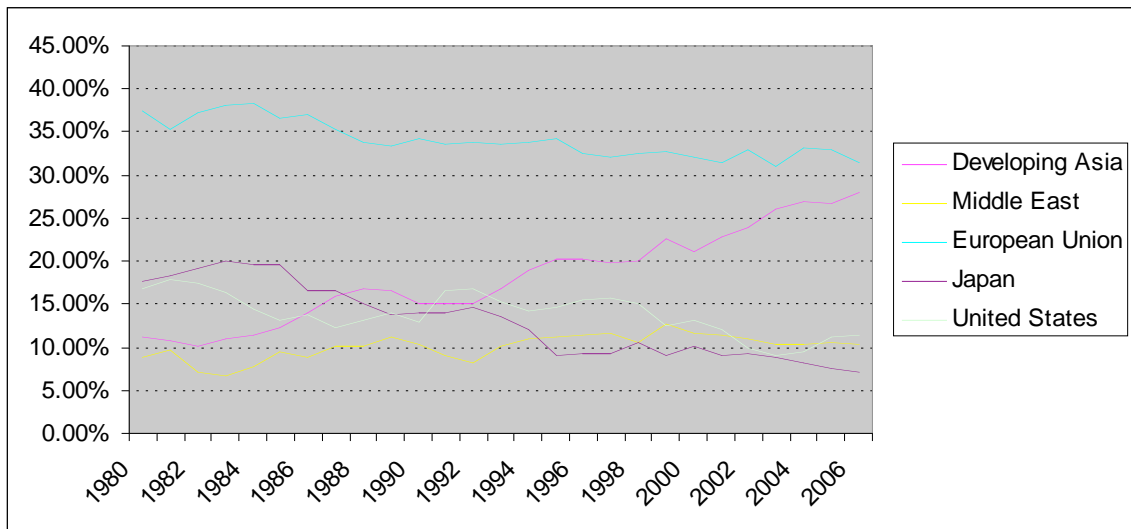


**Graph 2: GCC exports by region of destination**



Source: based on IMF DOTS database

**Graph 3: GCC imports by region of origin**



Source: based on IMF DOTS database

Developing Asia is likely to take over this title in a few years: The large-scale complementarity between Gulf raw materials and Asian industry will lead to a new geo-economic axis, based on global industries in which Europe has lost its competitive edge such as aluminum, petrochemicals and basic manufacturing.

EU exports to the Gulf however are already now dominated by machinery and transport equipment, a market in which Europe continues to enjoy competitive advantages. The Gulf's demand for sophisticated equipment will continue. As the volume of GCC imports has grown two and a half times between 2000 and 2006, the stagnation of the EU's share in graph 3 above hides a massive increase in absolute terms. The GCC is Europe's sixth largest trade partner. It is of much larger significance than the rest of the Middle East – notwithstanding the privileged bilateral trade relationships of Spain, France and Italy in North Africa.

GCC governments have repeatedly complained about the uneven balance of trade between EU and Gulf. With high oil prices and – in the long term – a higher share of the GCC states in global oil exports, this quasi-mercantilist complaint is likely to lose force. The concern with trade inequality will also recede as bilateral investment relationships increase in importance:

### GCC capital allocation on world markets

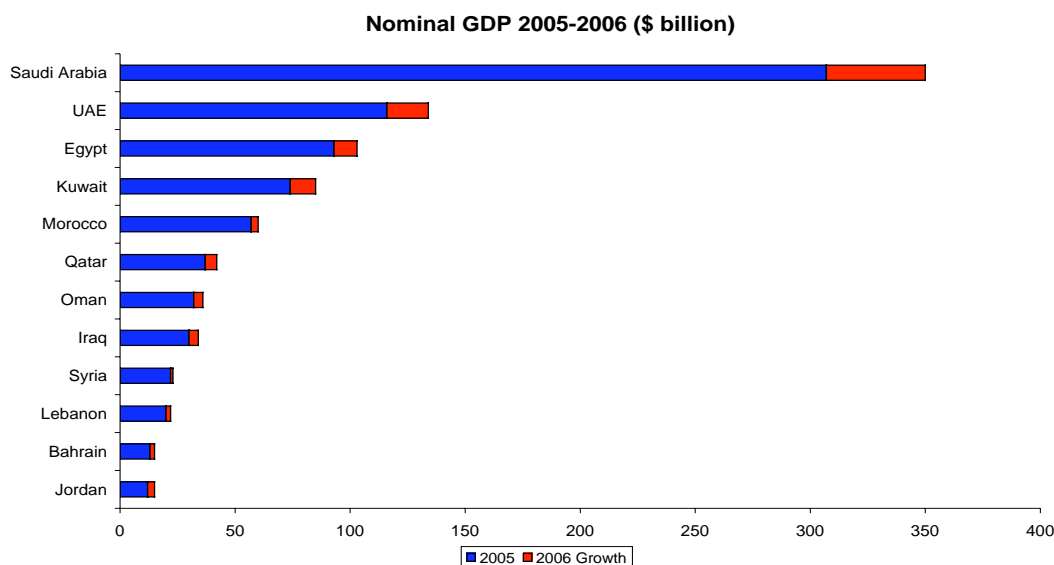
The allocation of GCC surpluses has become the big prize in the international world of finance, as GCC investors have become much more discerning in their investment decisions. Their portfolios are being actively diversified. Of the 542 billion \$ of surplus mentioned above, about 300 billion \$ went to the US, 100 billion to Europe and 60 billion to Asia. The US have still dominated to date due to the dollar linkage of GCC currencies and oil trade, yet other players have staked out a considerably larger share. As importantly, investment is more diversified in type, including increasing amounts of foreign direct investment that involves active management of the acquired assets.

In Europe, public and private GCC investors have picked up considerable assets in ports facilities, heavy industry, car manufacturing, banks, tourism and real estate. The total stock of Gulf investments in Europe is estimated at more than 400 billion \$, and is steadily increasing. This puts the GCC among the largest players on European markets. In the mid-term, central banks in the Gulf are likely to considerably increase their holdings of Euros, in particular if more currencies get decoupled from the ailing dollar as recently happened in the Kuwaiti case and now could be imminent in the UAE case. EU and GCC have reached a degree of financial interdependence which most European policy-makers are not aware of.

### **The Gulf's changing position in the regional political economy**

Many EU policy-makers seem to be similarly unaware of the GCC's emerging role the pivot of the regional political economy.<sup>3</sup> The GCC has been the economic heavyweight of the region for decades (see graph 4), but recently it has also emerged as the driving force of regional economy integration and cross-border exchange.

**Graph 4: Some Middle East GDPs compared**



Source: SAMBA Financial Group

### Trade within the region

As graphs 2 and 3 above have shown, the GCC's trade with the rest of the Middle East has remained on a rather low level, improving only moderately since the last oil boom. The low share however is not least explained with the high share of oil in total GCC trade: taking out oil, intra-regional trade amounts to up to one fifth of total Middle East trade, which is considerable and indicates a higher degree of economic integration than usually credited to the Middle East in the eyes of Western analysts. Again, the GCC plays the dominant role in

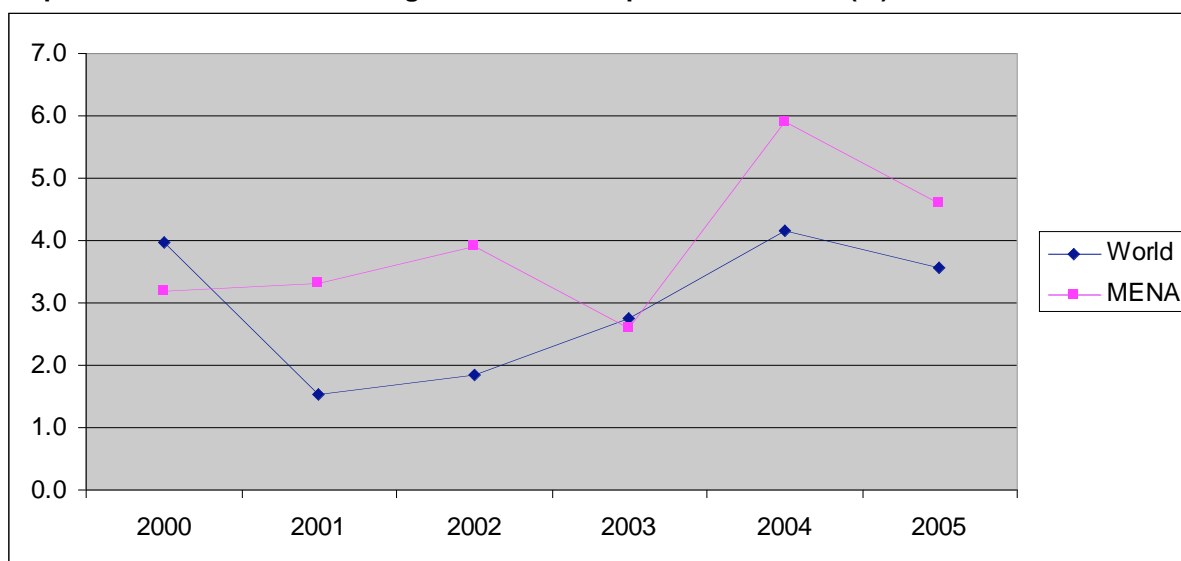
<sup>3</sup> For more details cf. Steffen Hertog, The GCC and Arab economic integration: a new paradigm, *Middle East Policy*, 1/2007.

this context: While the Maghreb and Mashreq have respective shares of about 7% and 30% in total intra-Arab exports, the share of the GCC is more than 60%. In trade within the Middle East – one of the EU’s Euromed policy’s past concerns, although with characteristic disregard of the Gulf – the GCC leads by far.

GCC FDI in the wider MENA region

More importantly, and even less well-known, the Gulf has emerged as the dominant driver of cross-border investment in the Middle East. Of the above-mentioned 542 billion \$ GCC surplus, some 60 billion \$ are estimated to have stayed in the non-GCC Middle East to be recycled there. Considering the small size of most of the MENA economies, this is a very considerable amount, and it likely has contributed to the impressive growth rates that non-oil states have achieved in recent years.

**Graph 5: World and MENA GDP growth rates compared since 2000 (%)**

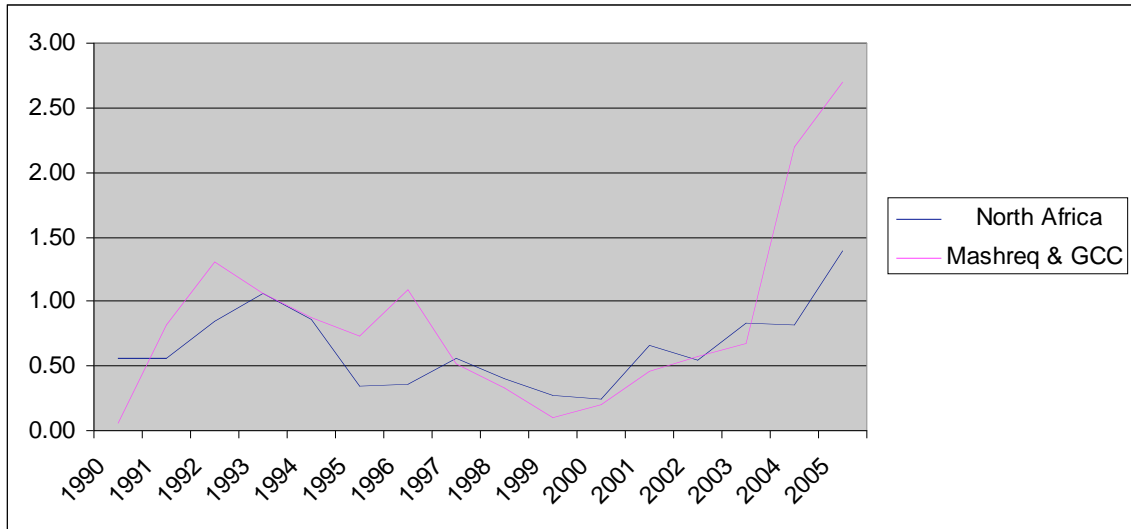


Source: World Bank Development Indicators

The Arab world’s share in global foreign direct investment has grown considerably during the last five years, as is detailed in graph 6. Regional recycling of GCC funds has played a considerable role in this. Considerable GCC portfolio investment has gone into the stock markets of Jordan and Egypt, but GCC investors have also started or bought up numerous companies in both Levant and North Africa. Target sectors include tourism, real estate, banking, heavy industry, telecoms and other utilities. An emerging private equity industry in the Gulf offers additional channels of cross-border investment. Managerial capacities are much higher in today’s Gulf than they were a few decades ago. Combined with a gradual investment liberalization in the rest of the region, this makes for a qualitatively new level of economic integration.

GCC money has also gone into “difficult” countries such as Djibouti, Syria, Lebanon or Yemen, underlining the comparative advantage that a shared culture can give to daring investors. The bottom line is that GCC investment has been playing a considerable role in boosting the economic fortunes of a region often neglected by international investors. This process is very much in the EU’s interest. GCC investors will also be at the forefront of Iraqi development once a minimal level of security is achieved there – probably a long time before many other investors outside of the oil sector will set foot there.

**Graph 6: The Arab world's share in global foreign direct investment**



Source: calculated according to UNCTAD

This FDI integration process is not driven by government-to-government initiatives, but rather by private sector investment decisions – mostly decisions taken in the Gulf by an increasingly independent and vigorous business class. This is a crucial insight on which to base all future EU attempts to promote economic integration in the Mediterranean and the wider Middle East: FDI is the most important motor of integration nowadays, and it is initiated mostly by the Gulf's private sector or, at a minimum, public companies operating on a commercial basis. The 2005 Bertelsmann report on EU-GCC relations has already pointed out the Gulf bourgeoisie's crucial role as stakeholder and reform partner for EU policies. Developments since then have only served to underline its growing importance as force of regional integration and modernization.

### **The changing FDI environment in the Gulf**

#### Regulatory changes

GCC countries themselves have taken significant steps in liberalizing their economies, attracting considerable investments from both the GCC itself and the rest of the world. Cross-border investment within the GCC has grown rapidly in recent years, and GCC governments are involved in a competition for offering the best incentives and smoothest regulatory environments (for detailed FDI statistics see annex). They are regional leaders in this process. Although not all have been as successful as Dubai in this, the overall trend of liberalization is unmistakable even in laggards such as Kuwait or Saudi Arabia. Governments offer 100% foreign ownership in increasing numbers of economic sectors and/or geographic areas, allow foreign stock ownership and have streamlined licensing operations. Previously non-existent or irrelevant sectors such as tourism, insurance and media are suddenly attracting money.

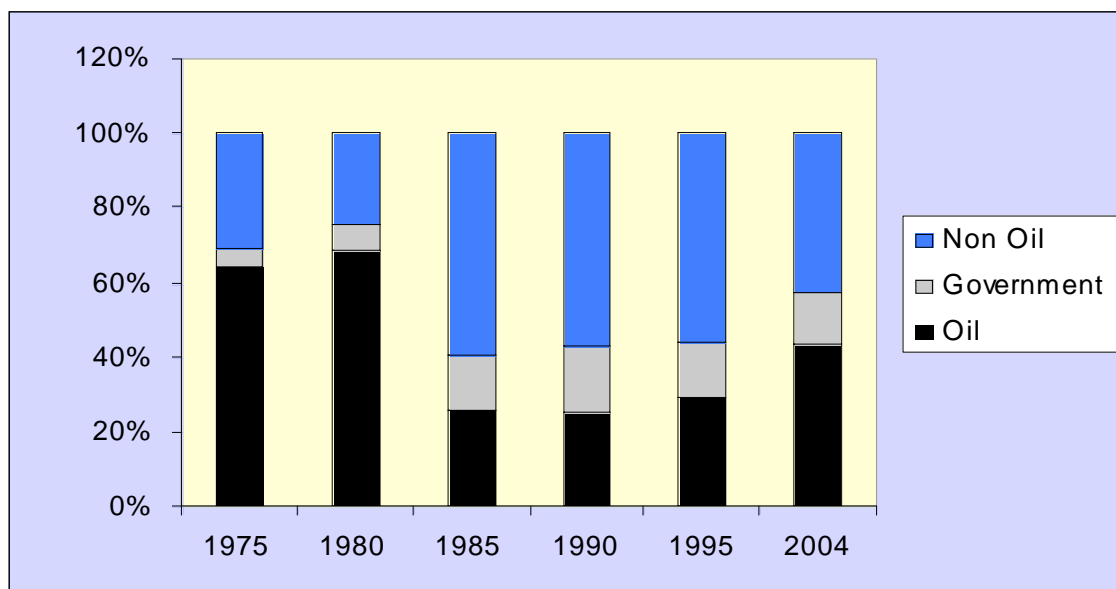
**Table 1: Ease of “Doing Business” in the Middle East in 2007, according to World Bank**

Economy	Ease of Doing Business Rank
Saudi Arabia	1
Israel	2
Kuwait	3
Oman	4
United Arab Emirates	5
Jordan	6
Lebanon	7
Tunisia	8
Yemen	9
West Bank and Gaza	10
Algeria	11
Egypt	12
Morocco	13
Iran	14
Syria	15
Iraq	16
Djibouti	17

Changing economic structures: private sectors as driver of development

As graph 7 shows, the GCC economies have matured a great deal since the last boom. Despite high oil prices, non-oil sectors continue to play a considerable role in GDP. As importantly, the non-oil share in GDP is based on serving private demand rather than state demand, making businesses less dependent on state procurement and contracting policies. During the current boom, GDP growth increased *before* state expenditure expanded, indicating the leading role of private investment in sustaining economic expansion.

**Graph 7: GCC economic structures over time**

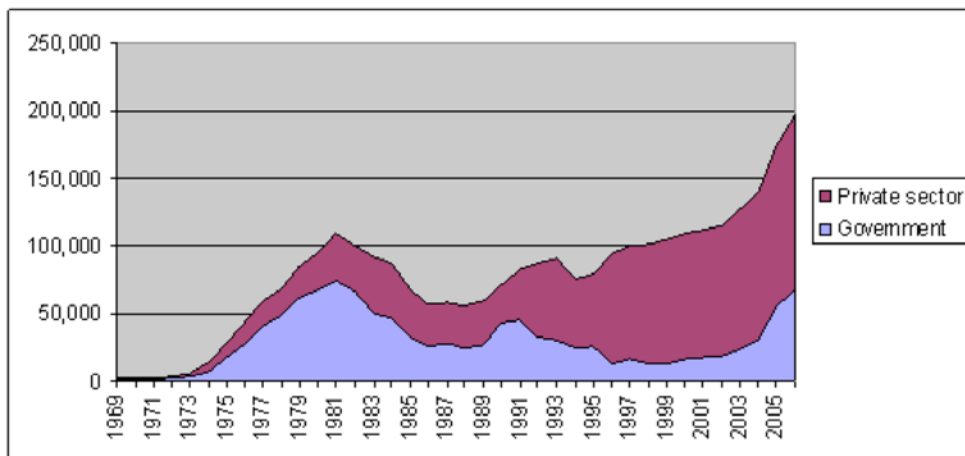


Source: Dubai Financial Market

In GCC economies, the share of private investment in total capital formation nowadays tends to be higher than that of governments (see graph 8). This underlines how deep the pockets of the Gulf business class are, and belies the clichés of underdevelopment and utter state dependence still circulating in the West. It furthermore underlines the potentially much larger

importance of local business actors as partners for the EU in its trade and investment negotiations.

**Graph 8: Saudi gross fixed capital formation (million SR)**

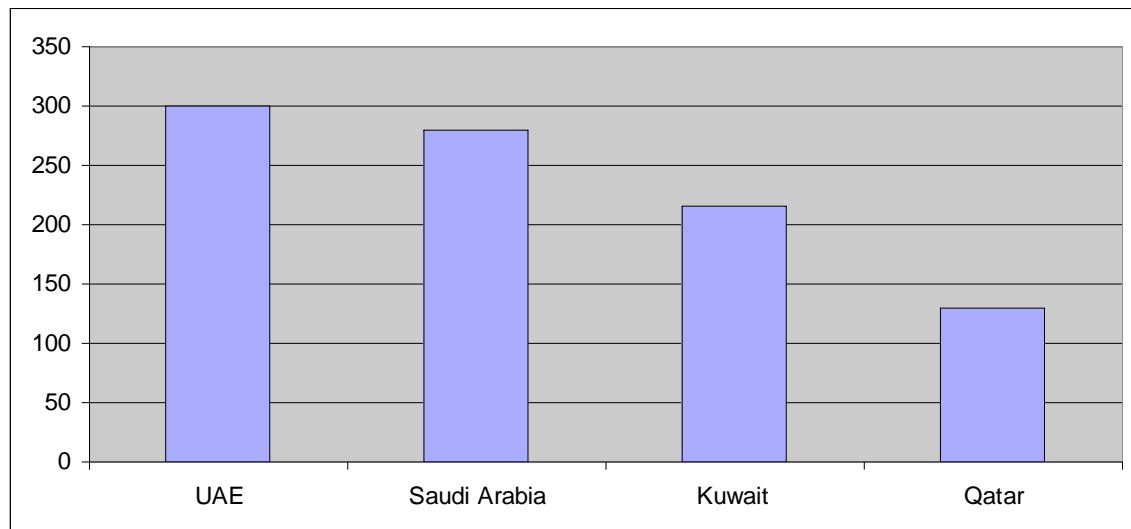


Source: Saudi Arabian Monetary Authority

After a number of lean years, GCC governments have recently started to invest heavily in expanding local infrastructure and initiating new development projects, often in partnership with local business. Although this has in several cases created bottlenecks, the general impression is that projects are better planned and executed than during the last boom, and overall expenditure is well within the limits of fiscal prudence.

Yet the numbers involved are mind-boggling. The total volume of projects underway in the GCC between 2007 and 2012 is estimated at 1.3 trillion \$. Although local contractors play a larger role than before, the opportunities for advanced European contracting and service firms probably are globally unrivaled.

**Graph 9: Estimated volume of infrastructure projects by country, billion \$**



Source: Lehman Brothers

### Sectors and projects

The new investment drive is spread over many more sectors than 30 years ago, with a much stronger role of private actors and more scope for foreign players:

- Dubai, but also Bahrain and Qatar are seeing increasing investment in *tourism* infrastructure, often by groups which are also active in other Middle Eastern countries. Foreign partners or franchises play a prominent role.
- A much more sophisticated *energy sector* offers new investment opportunities in mid-stream (transport), downstream (refining and petrochemicals), and, most recently, also alternative energy.
- As the employability of local populations has become an increasing concern, Gulf countries have started to liberalize their once state-dominated *education* sectors. Private groups have been setting up ever increasing numbers of schools, training institutes and universities. International providers play an important role especially in higher education. Although a crucial opportunity for building long-term networks, the EU has been lagging behind both US and Asian institutions in this field.
- As the efficiency of state-run medical sectors is mediocre in most Gulf countries, governments have opened increasing investment opportunities in the *health* sector – in the case of some smaller states tied to a strategy of attracting health tourists. Again, both local and international groups have been investing.
- Qatar and even more so Abu Dhabi have initiated research projects in *environmental technologies*. The GCC is likely to emerge as regional leader in this field – one in which European players have unrivaled expertise that could be marketed more aggressively.
- Gulf stock market regulators have been developing markets for *new financial instruments* to offer new channels of regional capital recycling. Some of the projects are undertaken in partnership with international exchanges. Dubai has introduced a new crude oil contract which could set an important precedent relevant for European oil markets.

Several of the new sectoral policies are bound to impact social developments in the GCC countries: A more open and more privatized education system will change both outlook and stratification of the Gulf's young generation. A larger role of business in public services will impact its social and political self-image. Increased international tourism could put strains on the coherence of local societies. Privatization of public services will need to be managed in a way that avoids the creation of a two-tier system in which only the affluent have access to quality services.

In administering all these new sectors, the GCC governments have demonstrated various levels of regulatory capacity. Although they can often draw on high quality consultancy, the complexity of the policies and the speed of change put strain on the young state apparatuses. They often suffer from lingering bureaucratic capacity problems: Administrative transparency and accountability can vary greatly from institution to institution. Bureaucracies are often not capable of consistently enforcing standards and gather information. Certification of providers in education and health can be deficient, as can the monitoring of private actors in most other sectors. Standardization of rules and procedures across borders is often incomplete.

### **The EU-GCC free trade agreement**

In many of these areas, the EU-GCC free trade agreement (FTA) currently under negotiation could open new opportunities for technical cooperation and assistance. The FTA will contribute to further the Gulf's global integration and open new opportunities for EU businesses. It will also help to open sectors which are not only economically significant but will play an important role in the long-term social and political transformation of the GCC. In a

time in which global economic blocs are vying for access to the Gulf, the FTA is of strategic political and economic significance. International consultants have warned that the EU has been losing access relative to both US and Asian countries which are more advanced in their trade negotiations. The recent delay in FTA negotiations is bad news for the GCC, but even more so for the EU.

EU and GCC concluded a cooperation agreement in 1989 which provided for annual meetings of the EU and GCC foreign ministers and laid the basis for FTA negotiations. The agreement already envisaged cooperation in a broad variety of fields, including energy, industry, trade and services, agriculture, fisheries, investment, science, technology and the environment. Many of these policy areas have been left derelict for many years. With the new dynamism of reform and economic opening in the Gulf, new opportunities are opening up to act on the agreement's promise. The FTA is one, but not the only, channel to do so.

After years of halting progress or stalemate, the FTA negotiations were relaunched in 2002 and broadened in scope, including services, investment and public procurement issues. Since then, substantial progress has been made in various policy areas, but several deadlines have passed without a conclusion to the negotiations. The most recent target was to conclude the agreement before year-end 2007, but unfortunately this deadline has slipped once again. It is unclear how much diplomatic momentum is left after the intense negotiations of the last year seem to have petered out.

The general political prospects for a settlement however seem to be better this time around, as more high-level attention has been given to the FTA. After long dithering, the EU seems to have compromised on rules of origin issues (which determine when a good can be considered as produced in the GCC), on alleged gas price subsidies in the GCC, as well as on GCC petrochemicals and aluminum exports to Europe – sectors which European industrialists had wanted to protect from more competitive GCC producers.

Yet, a number of sticking points seem to persist, including EU investors' access to GCC services and investment, notably banking, telecoms and infrastructure. Apparently the EU is also pushing for an opening of the Gulf ports services market, while the GCC is demanding entry to the market for fuel distribution in Europe. EU trade commissioner Peter Mandelson has reportedly said that ownership limits for foreign investors in the Gulf are the main pending problem – an issue that looms large also in the general economic reform debates in various GCC countries.

There are several administrative issues that have held up a swift conclusion of the agreement. This would be the first region-to-region free trade agreement, giving it large symbolic significance – not least in the otherwise so fragmented Arab world. Yet the two-layer structure of authority in both EU and GCC has led to snags and misunderstandings: On the EU side, the Commission leads the technical negotiations on the FTA, while the Council and presidency lead on political aspects such as non-proliferation and human rights clauses. This has led to some confusion on the GCC side, indicating that the complex division of labour and authority within the EU has to be communicated better.

Conversely, the GCC secretariat is a rather weak player which by itself cannot commit to any substantive concessions. That means that negotiations are usually led by senior bureaucrats from the various GCC countries, which can make it difficult to bundle common interests and positions. As problematic, even when an agreement on a specific issue is reached on the political level, the sluggish GCC bureaucracies often fail to implement the details – either due to lack of political pressure or lack of administrative capacity. The EU side will have to show some patience with GCC administrations, while pushing for capacity building and clear benchmarks of progress. It could potentially play a large role as facilitator of both.

There has been some concern about the EU's inclusion of human rights and other political issues in the negotiations – based on the perception that these were introduced post hoc, whereas in fact they are, by statute, part of any EU trade negotiations. Again, a clearer communication of institutional frameworks and purposes on the EU side could be helpful.



The EU-GCC FTA will set an important precedent of region-to-region cooperation and offers a chance for the EU to reposition itself in the Gulf in a period of rapid growth and geo-economic reorientation. Despite all frustration, the willingness to engage with the GCC as a collective actor is an important endorsement of regional integration efforts and signals the Gulf governments that their political projects are taken seriously. It will buy the EU credibility and give it a role in the regional integration process. The US by contrast has taken much flak in the Gulf for negotiating bilateral FTAs with individual Gulf countries that undercut the GCC and its customs union. The EU currently refuses to accept any conditions that do not match those offered to the US in its FTA agreements, which is in principle a reasonable position, but one that might have to be softened in some specific areas.

The FTA is of signal importance for EU-GCC cooperation, but it is not only important policy area. It is a means to certain ends – building up the EU's political profile in this pivotal region, deepening EU investments there, and giving the EU a role in local economic and political transformation processes – and arguably there are other, as important means to pursue these ends. Hold-ups on the FTA front must not be allowed to hamper other forms of cooperation.

### **Comparative advantages of the EU in cooperation with the GCC**

The EU has a lot to offer in helping the Gulf countries face the challenges of reform even short of the FTA framework. Compared with both Asia and US, it has the richest experience with managing and assisting regulatory reform in a variety of political systems, in bureaucracy-building and in harmonizing regulations across borders. Similarly, it has the broadest record of aiding political and judicial reform. None of these experiences can be transposed one to one on the Gulf, and they certainly cannot be imposed – the EU lacks leverage and the Gulf reform process currently is a buyer's market in which many players want to get involved. Yet the EU enjoys comparative advantages in certain sectors that no other power bloc can offer and that should be marketed much more aggressively. Europe has a wide toolkit for transformational assistance that can be deployed flexibly to build trust and gain influence on Gulf reforms in a non-confrontational way.

While US and EU policies towards Gulf reform do not have to diverge, in the current international climate the UE is much less distrusted than the US, meaning that it should take the lead on certain forms of cooperation. Awareness of these possibilities needs to be raised both in the Gulf and in Europe. In the Gulf, moreover, the EU and its governments have to convey more clearly which kind of entity the EU is – i.e. where its specific capacities lie, what it can but also what it cannot do. Expectations towards Brussels are sometimes incongruent with the EU's policy mandate and capacity, and the multi-level governance of the EU is often misunderstood.

### **Principles and policies for the EU in the Gulf**

Based on the above assessment of EU-GCC relations and political and economic evolution in the Gulf, the following section will discuss a number of policy proposals for EU decision-makers. Before these are presented in detail, however, I map out a number of underlying principles on which policies should be based. A coherent understanding of why the Gulf matters and what the specific role of the EU can be is arguably what has been lacking in EU policies towards the Gulf.

#### Principles:

- It is time for a big, public statement of EU policies towards the Gulf to give a new impetus and clear direction to EU policies, coupled with clear and measurable benchmarks of progress. All European countries need to be publicly obligated to a common European approach towards the Gulf.
- The GCC is becoming the hub of the MENA region and the EU should leverage it as such in its Middle East policies. The Gulf offers a precedent of sub-regional integration in an otherwise fragmented region and due to its economic muscle has a

vested interest in peaceful cooperation. It will prove difficult to engage other Middle Eastern states separately from the Gulf – certainly on economic terms.

- The EU should stick with cooperation on the GCC level unless this proves impossible. Deepened bilateral cooperation within individual countries can be offered *within* the EU-GCC framework along the model of differentiated integration (as has been foreshadowed in the 2004 strategy document, which suggested that the EU would consider ‘bilateral political engagement’ with individual Gulf states).
- The EU must clearly recognize and leverage the comparative advantages it has compared to US and Asia, notably on regulatory and institutional reform. Scope and nature of competition with Asia in particular are not well understood in Europe.
- EU policy-makers need to understand the limited political leverage they have over the GCC: there is no EU accession prospect that can be waved as a carrot, the Gulf does not require any financial aid, and in the economic realm it often operates eye-to-eye with European players. This is a different playing field from both Eastern Europe and the Southern Mediterranean.
- In its assistance for reform, the EU can however leverage the prevailing interest in governance, reform, and benchmarking in the Gulf – while understanding the underlying political interests and the limits they impose.
- The EU should encourage political and social reform vocally, but avoid backlashes – in lieu of a one-size-fits-all approach, it needs to support *local* reform drives that have genuine social traction. In this context, the drivers and limitations of top-down and bottom-up reform projects need to be clearly differentiated.
- The EU needs to make clear what it *cannot* do – e.g. it cannot play a leading role on hard security issues and it cannot function as a geo-strategic counterweight to the US.

#### EU policies in the political and economic realms

Building on these principles, I propose a number of policies the EU and its governments should pursue towards the Gulf. As attention spans are short and decision-makers often overburdened, I distinguish *essential* and *important* policies. The former are crucial for putting EU-GCC relations on a new track, while the latter are of substantial importance but will not by themselves usher in the qualitative change of the relationship I advocate here.

Several of the policies have already been proposed in previous policy papers, but here they are more consistently aligned with the above principles and ordered according to priority. The foundations of many of the policies advocated here already exist in principle. Recognizing that the Gulf offers qualitatively new chances of cooperation, we now need the political will to act on them.

#### *Resources*

- Essential: The EU needs to devote *more resources* to the GCC. By virtue of Middle Eastern history, politics and economics, the Gulf *is* part of the EU’s Arab neighborhood. There cannot be a Mediterranean policy without taking the Gulf, the hub of the region, into regard. The opening of an EU delegation in Riyadh is a good first step, but more needs to be done: The EU should open a representative office in Dubai and possibly Kuwait. Resources and expertise devoted to the Gulf in Brussels – currently close to non-existent – need to be substantially increased. Similarly, the new Commission budget line that allows cooperation with high-income countries should be substantially increased. Even then, policies towards the Gulf will be much cheaper than towards aid-dependent countries of the Southern Mediterranean.
- Important: As indicated in previous papers, the EU still sorely lacks expertise on Gulf matters. Building up knowledge of the region comparable to what EU countries and

academic establishments have on North Africa or Eastern Europe requires the creation of research institutes and resource pools for research projects.

#### *General cooperation*

- Essential: The EU should start a more comprehensive, open dialogue with the GCC on how it can assist the organization and its members in their efforts at multi-sectoral integration. Drawing on its unique experience in Eastern Europe, it should also offer assistance with the differentiated integration of Yemen. EU states are already substantially involved in aiding Yemen economically. The proposal of a EU-Yemen partnership in the 2002 policy paper is still pertinent.
- Important: Instruments of 'decentralized cooperation' (extant in principle since 1995) should be revived on the basis of co-financing. Thanks to recent liberalization steps, the Gulf today offers considerably better opportunities to cooperate on the levels of business, media, and higher education than it did only a few years ago.
- Important: Through cooperation with the Gulf private sectors in particular the EU could wield influence over reform processes. The EU and its chambers of commerce can offer technical assistance to GCC business associations and can promote increased exchange, secondments of functionaries and managers to business meetings. The October 2007 agreement between the Federation of GCC Chambers of Commerce and Eurochambres is a useful first step, but should be complemented also by bilateral agreements with the better-organized national chambers.

#### *Political and security issues*

- Important: Together with Russia and the US, the EU should work towards making a "Gulf Conference for Security and Cooperation" reality, e.g. through establishing a permanent security dialogue. A less politicized player than the US, the EU could give crucial international credibility to such an undertaking and offer some of its resources for any "grand bargains" that might be struck. The actual negotiations between GCC and its neighbours will have to be primarily local however.
- Important: In the context of NATO policies such as the Istanbul Cooperation Initiative's GCC track, the EU has to recognize limits and the fact that the US will remain the supreme player for many years to come. NATO in fact has little to offer to the Gulf states which will brook no intervention in their civilian-military affairs and do not see what the organization adds to the US' security presence. It is more important for the EU to focus on its core competencies.
- Important: At the same time, there is large potential in cooperation on policing, intelligence and counter-terrorism between EU and GCC authorities, not least taking into account the EU's gradually expanding capacities in judicial and police matters. Saudi Arabia still is a very important ideological hub for global Islamic radicalism, and its authorities today are much more interested in controlling their Islamic sector, as they have stopped turning blind eye to international linkages. Institutional mechanisms for information-sharing and secondments of security personnel should be considered. The GCC might also welcome EU expertise and technical assistance on cross-border security integration, which has loomed large in the region in recent years.
- Important: Europe needs to recognize the crucial role the GCC is likely to play in any Israeli-Arab settlement. With Egypt's influence declining, Saudi Arabia in particular has become the most important "moderate" Arab state and reasonably credible interlocutor with Palestine that Western powers will need. Europe must not allow the GCC to make progress on other areas of cooperation conditional on the Palestinian issue, yet needs to engage the Gulf when addressing Palestine.
- Important: As indicated in the 2005 policy paper, the EU should offer avenues of cooperation on constitutional, election and governance issues, where it enjoys a

distinct comparative advantage. Some aspects of institutional reform are less politically sensitive than others, and some GCC countries more advanced than others – opportunities to create an EU presence in this realm through technical and consultancy missions and secondments have multiplied in recent years. Not least due to the emergence of Asia as non-interventionist cooperation partner for the GCC, Europe cannot exert direct political pressure towards reforms, but due to the diversity and richness of its own experience it can exert some soft power (ideally in coordination with, but technically separate from, the US).

- Important: The EU should reinvigorate its attempts at civil society cooperation with GCC professional syndicates, parliaments, educational bodies, media institutions, women's bodies, charities etc. Although it has in the past been difficult to find access points for such cooperation, recent steps of liberalization have greatly enhanced opportunities in at least some of the GCC states. Such cooperation needs to be based on two principles: a) it must be mutual, not patronizing, and b) actual stakeholders in society must be engaged. There is a danger of playing a part in a regime-endorsed theatre, and it needs to be carefully established whether a given project or organization actually has any of the grassroots elements it claims. Civil society capacity-building, even if it starts with relatively apolitical bodies, is important to lock in reforms and to build constituencies for further steps of liberalization.

#### *Education*

- There is large scope for cooperation in the educational sector, which is of strategic importance both for EU-GCC cooperation and for long-term reform processes in the GCC. It is one of the few politically relevant fields of cooperation which are not a no-go area due to sensitivities of GCC political elites, and it is one in which demand for upgrading is huge and resources ample. New opportunities have opened up for the EU to position itself and build human-to-human networks that can define the future relationship:
  - Essential: GCC governments and the GCC itself still need to build capacity in the fields of licensing, accreditation, cross-border standardization and quality monitoring. In all of these, there is unrivaled expertise in Europe. As outlined in previous papers, Europe can draw on its national technical cooperation agencies and on NGOs active in this field.
  - Important: The EU should support the setting up of well-regulated European university campuses in the Gulf. As outlined in the 2005 policy paper, at least one substantial European university should be established in each Gulf country. Despite some British outlets in the UAE, a Sorbonne campus in Abu Dhabi and recent efforts to establish a German medical campus, US and Asia have been ahead of Europe in building relationships in this new area. The Commission should organize a competition among European universities for new campuses in the Gulf.
  - Important: The EU should deepen academic cooperation and exchange. The recently announced student exchanges are a good first step, but cooperation needs to happen on *all* levels of study and research. Joint research projects and twinning arrangements need to be initiated. Many Gulf and European academics are keen on such arrangements, yet do not have an institutional framework to draw on.
  - Important: Understanding of the Gulf in the EU and vice versa need to be promoted. There are currently very few Gulf studies activities in Europe. Gulf studies programs in the EU and European studies programs in the GCC should be initiated.

#### *Trade, investment and regulation*

- Essential: The EU should step up its offerings of technical assistance to the GCC secretariat. The latter urgently needs to build its technical capacities, and Europe is

the obvious partner in this process – provided a cadre of EU specialists is built up who have sufficient Gulf expertise. Technical assistance can help in pushing the GCC towards more substantial integration. The EU-GCC FTA is one, but not the only, instrument in furthering this. The recent creation of a GCC certification agency to supervise country-level inspection authorities could offer a great opportunity for the EU to help the GCC put more flesh on its bones. Progress on the GCC customs union, the recently announced common market as well as the monetary union will be difficult to achieve without external assistance on technical matters.

- Essential: Technical cooperation should also be offered to individual states to improve follow-up and implementation capacities. Mechanisms of reporting and benchmarking need to be established both in the EU-GCC framework and within the GCC. There is considerable scope for – and interest in – secondments and technical missions. Assistance on legal reform, competition policies, sectoral regulation, and civil service governance all can contribute to bringing good governance to the Gulf while remaining below the threshold of politically unacceptable interference.
- Essential: The EU-GCC FTA should be integrated with the Euromediterranean agreements. This would contribute to fostering regional integration in the Middle East and prevent a “hub-and-spoke” system from emerging which would put Europe at the center of economic exchange and fragment economic exchange within the region.
- Important: Human rights and governance issues should not be dropped from the FTA negotiations. Standards and principles should be informally coordinated with the US, while avoiding an open common front which will be counterproductive. There is increasing pressure for certain types of reforms from within Gulf societies: Labor rights issues e.g. are a very serious concern to which civil society groups in the more advanced Gulf countries devote considerable interest. Europe needs to be aware of the limited political leverage it has and hence mostly use soft instruments of change as advocated in this paper. Yet it must not compromise on its standards.
- Important: The EU-GCC energy dialogue needs to be deepened further. There are several potentially important issues of cooperation not yet broached, including oil pricing mechanisms, the option of commonly managed stockpiles, as well as Gulf-Europe pipelines. The initiative for a technical centre on energy issues in Riyadh should be vigorously pursued. A joint board to promote common energy projects should be envisaged. The Belgium-based Energy Charter currently plans accession talks with GCC countries – an initiative that deserves high-level backing. With growing European dependency on Russian energy, building up long-term relationships in these sectors should be a strategic priority for the EU.
- Essential: Closely related, the EU should deepen its environmental cooperation with the GCC. Renewables and fuel standards are emerging as a big long-term concern in the more advanced Gulf countries – fields in which Europe possesses unrivaled expertise. With the recent international mood swing in favor of aggressive climate policies, some GCC policy-makers have become seriously interested in carbon capture techniques. A common EU-GCC pilot project in this area, e.g. through the shared provision of venture capital, could have a huge impact. Qatar and Saudi Arabia are trying to position themselves as hubs of advanced energy technology; considering the current scale of project development in the Gulf, this means a potentially very large change for Europe to get involved in a growth sector.
- Important: At a time of large surplus capital, Europe should also work towards closer integration of its own and GCC financial markets. The latter are still in need of capacity building and are keen to cooperate closely with international exchanges. Technical assistance to work towards cross-listings should be one way of getting Gulf capital to Europe and vice versa. Activities of European regulators in the Gulf should be coordinated on the European level. The EU can share the experience accumulated with its own financial services action plan since the 1990s. The great

local interest in corporate governance can be tapped to help in improving corporate standards in the Gulf.

- Important: The EU should create an institutional mechanism of cooperation on currency issues and the allocation of sovereign reserves. The Eurozone is potentially threatened by the further devaluation of the dollar which could be engendered by a revaluation and/or decoupling of Gulf currencies that are currently pegged to the dollar. All players involved share an interest in gradual as opposed to sudden readjustments and no one is interested in too weak a dollar, not least as so many GCC assets are still held in the dollar zone. Central banks and sovereign wealth funds should agree on basic rules of information exchange, coordination and transparency.
- Important: Gulf foreign direct investment in Europe should be encouraged, including in the field of heavy industry. This will help to alleviate GCC complaints of unequal trade, and – more importantly – give the Gulf a stake in European production, which is likely to suffer badly from international competition if it is not integrated with a region that can support it with cheap feedstock such as the Gulf. It will help to build trust and make the GCC more receptive to European investment.

## Annex: FDI inflows to MENA from 1970 to 2005

	1970	1980	1990	2000	2004	2005	2005 in million \$
<b>ECONOMY</b>							
<i>Northern Africa</i>	3.25%	0.28%	0.55%	0.25%	0.83%	1.39%	12,738
Algeria	0.60%	0.63%	0.00%	0.03%	0.12%	0.12%	1,081
Egypt	0.01%	0.99%	0.36%	0.09%	0.30%	0.59%	5,376
Libya	2.36%	-1.97%	0.08%	0.01%	-0.05%	0.03%	261
Morocco	0.15%	0.16%	0.08%	0.03%	0.15%	0.32%	2,933
Tunisia	0.12%	0.45%	0.04%	0.06%	0.09%	0.09%	782
<i>Mashreq</i>		0.04%	0.02%	0.13%	0.37%	0.48%	4,405
Iraq	-0.01%	0.00%	0.00%	0.00%	0.01%	0.03%	300
Jordan		0.06%	0.02%	0.06%	0.09%	0.17%	1,532
Lebanon		-0.02%	0.00%	0.07%	0.27%	0.28%	2,573
<b>Gulf</b>		<b>-6.16%</b>	<b>0.06%</b>	<b>0.03%</b>	<b>1.77%</b>	<b>2.20%</b>	<b>20,111</b>
Bahrain		-0.76%	-0.09%	0.03%	0.12%	0.11%	1,049
Kuwait	0.19%	0.00%	0.00%	0.00%	0.00%	0.03%	250
Oman	0.02%	0.18%	0.06%	0.01%	0.03%	0.08%	715
Qatar	0.04%	0.02%	0.00%	0.02%	0.17%	0.16%	1,469
Saudi Arabia	0.05%	-5.78%	0.15%	0.01%	0.27%	0.51%	4,628
United Arab Emirates	0.06%	0.18%	-0.06%	-0.04%	1.18%	1.31%	12,000
World	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	916,277
Developed economies	71.28%	86.07%	82.16%	81.30%	57.82%	60.67%	555,927
Developing economies	28.72%	13.88%	17.80%	18.06%	36.61%	35.00%	320,670
Developing economies Excluding China	28.72%	13.78%	16.07%	15.17%	28.07%	27.09%	248,231
Least Dev. Countries	1.15%	0.97%	0.29%	0.29%	1.23%	1.06%	9,680
World FDI in \$	13,417	55,272	201,614	1,409,568	710,755	916,277	

Source: UNCTAD