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The GCC and Arab economic integration: a new paradigm

Steffen Hertog

Introduction

Two developments are currently changing the face of the Arab world. The first is the catastrophe in Iraq and the rebalancing of forces it entails. The outcome of this for the Arab world is still unclear, but its balance sheet is unlikely to be positive. The second, less salient development, is the second oil boom, which is generating a new regional political economy. The contours of this new regional system have been emerging in a much clearer fashion. Yet, in the shadow of Iraq, little ink has been spilled on the fundamental economic changes in the region. This article is a first attempt to describe and systematize what is happening.

In a nutshell, the boom has been driving a new, unprecedented phase of economic integration in the Arab region. The term "Arab economic integration" is evocative of countless inter-governmental cooperation projects – often grandiose, almost always futile. Current developments have little to do with multilateral trade diplomacy, however. Rather, the new phase of integration is characterized by three secular shifts:

- Business is playing a more important role than government,
- Foreign direct investment (FDI) is more important than trade, and
- The Gulf is the pivotal player.

In the following, I will analyze these shifts in detail. The article will start with a brief summary of inter-governmental attempts to foster economic integration, followed by an in-depth discussion of changing patterns of trade and FDI in the region. After some observations on the policies necessary to sustain and deepen integration, it will conclude by analyzing the role of the GCC monarchies in the emerging regional political economy.

A (very) brief history of Arab economic integration

As most other developing countries, the majority of Arab states have seen several decades of "import substitution" policies, saddling them with a legacy of high tariffs, heavy state intervention in production and, in many cases, uncompetitive industries. Due to the reluctance of governments to lose control over national industrial policy and fear of losing tariff income, regional attempts of economic integration have yielded modest results. Various regional and sub-regional agreements since the 1950s have aimed at liberalization of trade, capital, and labour flows, but hardly saw consistent follow-up and implementation.

States have been reluctant to expose local industries to competition from often very similar industries in neighbouring countries or to yield any discretion over trade policy through binding regional agreements, not to speak of regional institutions. Multilateral economic agreements were usually concluded in a haphazard fashion and in reaction to regional political developments. They have mostly focused on tariff reduction, not addressing regional trade in services (e.g. contracting, financial and transport services) or cross-border investments.

The most recent region-wide initiative, the 1997 Executive Program for Arab Free Trade that was signed by 17 of 22 member states of the Arab League, is no exception to this pattern. The Greater Arab Free Trade Area (GAFTA) accord stipulates an annual reduction of tariffs by 10%, resulting eventually in full liberalization of intra-Arab trade by 2007. Although narrow in scope, this would be a considerable achievement. Many tariffs have indeed been reduced. GAFTA has run into a number of specific problems, however. Due to similar production structures, governments have requested too many exceptions in exactly the areas of manufacturing in which intra-Arab trade is likely to take place. "Rules of origin" which define a good as regionally produced (and hence eligible for tariff exemption) remain unclear. The Arab League lacks follow-up capacity to put pressure on its members to implement their agreements.

Beyond tariffs, intra-Arab exporters have had to cope with sometimes unpredictable and heavy non-tariff customs charges. This is closely related to the broader issue of non-tariff trade barriers, which remain considerable in most Arab countries and which have not yet been comprehensively addressed on a regional level. Intrusive and time-consuming goods inspection regimes, unnecessary or unusual product standards and documentation requirements tend to lift transaction costs in Arab trade above global averages. Exceptions like Dubai with its swift customs bureaucracy have not inspired comprehensive change elsewhere. Some GAFTA members are not yet in the WTO, further opening the door for non-tariff trade barriers.

Sub-regional economic integration also has a very mixed record: The Arab Maghreb Union is politically dormant, as are a number of other agreements in North Africa and Mashreq. The Gulf Cooperation Council (GCC) alone has had a discernible degree of success in terms of trade integration, creating labour and capital mobility, and setting common standards in various areas of regulation. In several areas such as investment, stock market participation, and government procurement, at least some of the GCC governments have extended national privileges to nationals of other GCC countries.

On the political and administrative level, several fundamental problems of GCC integration remain unsolved, however: The 2003 customs union is still not fully implemented, as GCC members request exceptions and bilateral agreements of the US with individual GCC states undermine the coherence of its external tariff regime. The GCC monetary union has been seriously called into question by Oman's recent announcement to opt out and by the reluctance of heads of state to agree on official convergence criteria. Political tensions between Saudi Arabia and its neighbours, particularly Qatar, could throw a spanner into the works of "deepening" the GCC.

The new economic dynamism in MENA

The stagnation on the political level of regional integration stands in stark contrast to the dynamism of the regional economy during the last six years of augmented oil prices. Table 1 below gives some basic aggregate figures on economic developments in Middle East and North Africa since 2000.

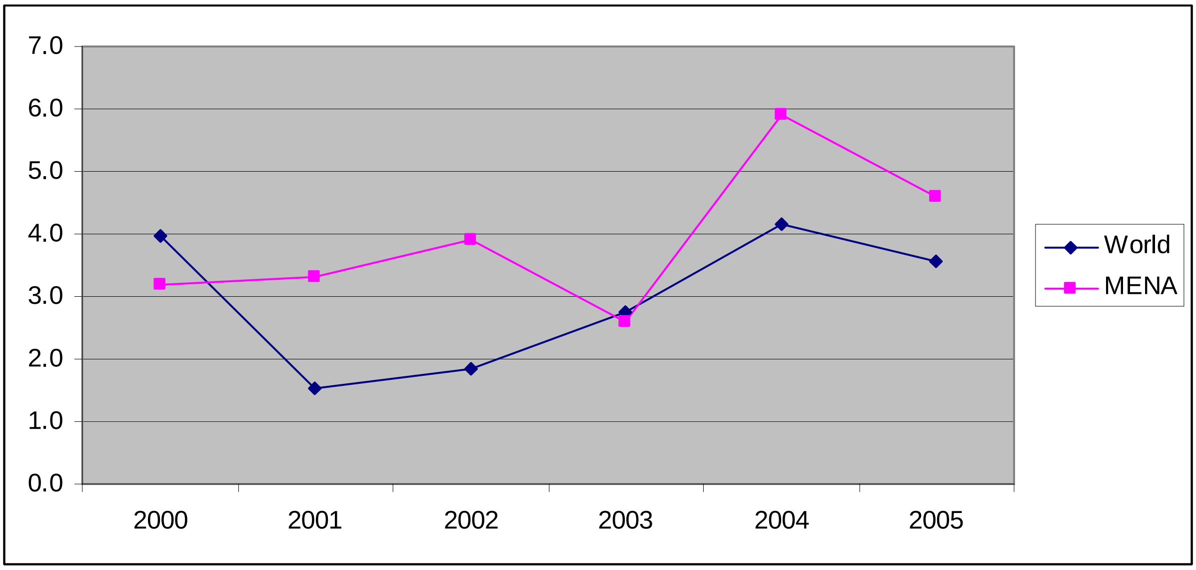
Table 1: Overview of MENA economic development – some aggregate figures

	1960	1970	1980	2000	2001	2002	2003	2004	2005	Share in world total
Current account balance (% of GDP)	..	..	1.3	4.9	1.5	1.1	2.1	1.5		..
External debt, total (DOD, million US$)	..	4 822	64 482	145 225	142 993	151 383	161 162	163 934	162 494	..
GDP (million US$)	..	..	..	447 482	449 621	439 469	483 413	547 496	632 570	1.43%
GDP growth (annual %)	..	..	0.4	3.2	3.3	3.9	2.6	5.9	4.6	
Merchandise exports (million US$)	2 919	8 766	90 244	124 324	107 694	113 161	131 720	170 600	221 252	2.13%
Total reserves (includes gold, million US$)	1 565	3 735	49 046	65 316	76 946	90 055	119 189	140 020	176 606	3.83%

Source: World Bank Development Indicators

GDP growth rates between 3 and 6% and quickly growing foreign reserves make the economies of the Arab world look much more hopeful than during the gloomy 1990s. Both aggregate reserves and annual exports now are larger than aggregate international debt. Balances of payment of most states – including non-oil exporters – have been positive. Expansion is set to continue: The IMF estimates real GDP growth in the Middle East at 5.8% and 5.4% in 2006 and 2007 respectively. The Arab world currently goes through the second oil boom, as oil prices have reached levels comparable to the 1981 price peak. As important, they are likely to remain above at least 40 US$ for several years due to unprecedented capacity constraints in the upstream sector of the international oil market.

Graph 1: World and MENA GDP growth rates compared since 2000 (%)



Source: World Bank Development Indicators

The boom appears to be more sustained and considerably better managed than the first one in the 1970s and early 1980s. Especially the governments on the Arabian Peninsula exhibit better management capacities and a much more cautious fiscal approach than a quarter of a decade ago. Less money is wasted, projects are more targeted, and more reserves are built up and managed in more sophisticated and diversified ways. All this augurs well for stable and sustained economic expansion, improvements in public services and the systematic removal of infrastructural bottlenecks.

The most important difference to the last boom however is arguably the role that private business plays in sustaining economic growth and in converting the psychological and, lately, fiscal boost of augmented oil prices into diversified growth. Large Arab companies – especially those based in the Gulf – have embarked on a rapid investment and expansion drive, with private sector growth regularly surpassing the growth of the government sectors. Private managerial expertise is much broader than 20 years ago, and private capital resources are huge thanks to decades of rent accumulation. Private wealth in the Middle East has been estimated at 1.5 trillion US$.

Moreover, although expansionary budgets are welcome, large parts of the Gulf private sectors are much more independent from state contracts than they used to be, catering to private demand and contributing the majority share to national capital formation.[i] Importantly, the current economic boom in the Gulf started *before* governments started their oil-based fiscal expansion, being driven by private investment.[ii]

Gradual trade integration

The greater sophistication and diversification of Arab business has contributed to a modest, but discernible improvement in regional trade integration (see table 2). Most Arab exports have traditionally gone to importers outside of the region. Intra-Arab trade has roughly doubled its share in the overall trade of Arab states during the last two decades, however. Remarkably, the recent export boom has led to more than a tripling of intra-Arab trade between 2000 and 2005.

At the same time, its share in overall trade still hovers around only 10%. In Asia, by comparison, intra-regional trade is about 40% of total trade. More than half of Arab trade tends to consist of the global commodity of oil, however, which means that the low figures are somewhat misleading. About a fifth of the total MENA non-oil trade is intra-regional, which is a more respectable score, comparable to that of regional groupings such as Mercosur or ASEAN in Latin America and Southeast Asia respectively. Needless to say, business plays a much larger role in non-oil trade than in oil trade.

Table 2: Middle East exports by region of destination (US$ '000)

	1980		2000		2005	
Middle East	9.125.560	4,8%	15.428.300	5,8%	47.734.700	8,9%
Asia	23.643.200	12,5%	74.368.300	27,8%	157.684.000	29,5%
China (P.R.: Mainland)	298.964	0,2%	9.323.480	3,5%	29.262.900	5,5%
Developing Countries	45.945.600	24,3%	107.179.000	40,0%	244.568.000	45,8%
European Union	72.862.300	38,5%	56.858.700	21,2%	101.209.000	18,9%
United States	27.247.200	14,4%	36.388.600	13,6%	63.092.200	11,8%
World	189.246.000	100,0%	267.680.000	100,0%	534.437.000	100,0%

Source: calculated from IMF Directions of Trade data base

Table 3: Middle East imports by region of origin (US$ '000)

	1980		2000		2005	
Middle East	7.314.840	7,9%	14.888.500	8,6%	48.174.700	12,3%
Asia	7.867.590	8,5%	29.493.500	16,9%	87.276.000	22,2%
China,P.R.: Mainland	853.536	0,9%	5.856.650	3,4%	26.751.000	6,8%
Developing Countries	21.410.600	23,2%	60.493.200	34,7%	185.313.000	47,2%
European Union	38.612.800	41,8%	63.860.400	36,7%	132.932.000	33,9%
United States	12.065.500	13,1%	21.532.000	12,4%	36.682.600	9,3%
World	92.439.000	100,0%	174.118.000	100,0%	392.628.000	100,0%

Source: calculated from IMF Directions of Trade data base

Although the Arab world has not seen industrial development on the scale of newly industrializing countries in Asia or Latin America, intra-regional trade is considerably more diversified than it was 20 years ago.[iii] Mid-level manufacturing has grown in importance, and diversification and upgrading has taken place in sectors such as steel and aluminium, machinery, plastics, and food processing.

More sophisticated industrial goods however by and large remain off-limits. Value added often is limited, much manufacturing only consists of final assembly, and export competitiveness is frequently lacking. Industrial structures of neighbouring countries are often very similar, making for limited sub-regional complementarity.

With the partial exceptions of Egypt, Tunisia, Morocco and the UAE, the importance of intra-industry trade in overall trade is still rather low, which indicates the absence of advanced production structures and a smooth regional division of labour. Sophisticated exports – i.e. medium- and high-technology exports – only accounted for 16% of the region's total exports in 2003, up from 10.7% in 1995.[iv]

While industrial structures are relatively similar in most cases, directions of trade differ greatly from country to country, indicating different levels of integration into the region and its sub-regions. Table 4 contains the export volumes of a number of important Arab countries broken down by region of destination. Smaller economies such as Jordan, Syria, and Lebanon tend to have a higher share of regional as compared to global exports. Political economists would expect this to undermine the political drive towards trade integration, as larger and more powerful players like Saudi Arabia can be expected to have a lesser economic interest in it.

In absolute terms, Saudi Arabia has by far the largest exports into the region, despite their small share in the kingdom's total exports. Conversely, six Arab countries send more than a fifth of their regional exports to Saudi Arabia, further underlining its pivotal role in the region. With the partial exception of Tunisia, North African countries are hardly integrated with the rest of the Arab world, warranting their analysis as a separate block. The Maghreb has a share of only 6.8% among total intra-Arab exports, whereas the shares of GCC and Mashreq countries are 60.6% and 29.5% respectively.

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[i] Cf. Giacomo Luciani, 'Saudi Arabian business: from private sector to national bourgeoisie', in Paul Aarts, Gerd Nonneman (eds.), *Saudi Arabia in the balance: political economy, society, foreign affairs* (London: Hurst 2005), pp. 144-181.

[ii] SAMBA Financial Group, *The Saudi Economy at Mid-Year 2005*, pp. 18f.

[iii] This is true regarding both measures of export diversification according to Standard International Trade Classification (SITC) and to the Herfindahl-Hirschman Index applied to traded goods.

[iv] Oxford Analytica, *Intra-regional trade to expand slowly*, 19 April 2006.

Table 4: Main international export destinations of select Arab countries (2005, in '000 US$)
(dominant shares above 30% are highlighted)

		Exporting country										
		Algeria	**Egypt**	**Jordan**	**Kuwait**	**Lebanon**	**Libya**	**Morocco**	**Saudi Arabia**	**Syria**	**Tunisia**	**UAE**
Export Destination	**Asia**	739.513	1.186.950	538.415	18.361.400	52.839	950.274	1.278.020	54.992.100	449.272	213.245	30.296.300
	(share in total)	1,7%	7,8%	13,7%	52,3%	2,4%	3,3%	9,1%	34,3%	3,1%	2,2%	32,3%
	Arab countries(*)	933.179	2.752.230	1.532.664	1.373.875	1.273.942	1.042.769	372.700	15.341.447	7.824.727	840.356	7.082.208
	(share in total)	2,2%	18,2%	39,1%	3,9%	57,8%	3,6%	2,7%	9,6%	64,2%	8,5%	7,6%
	EU	23.431.200	5.826.680	215.316	3.655.450	243.188	21.922.500	10.308.600	24.729.200	3.288.340	7.780.050	10.349.900
	(share in total)	54,4%	38,5%	5,5%	10,4%	11,0%	76,1%	73,6%	15,4%	22,9%	78,7%	11,0%
	United States	9.849.730	2.019.090	1.148.680	4.194.730	82.909	1.506.450	431.273	26.332.700	319.545	220.455	1.401.450
	(share in total)	22,9%	13,4%	29,3%	11,9%	3,8%	5,2%	3,1%	16,4%	2,2%	2,2%	1,5%
	World	43.081.300	15.121.000	3.915.830	35.128.000	2.204.350	28.806.600	14.003.800	160.310.000	12.193.100	9.879.850	93.778.300

Source: calculated from IMF Directions of Trade data base

(*) This includes Algeria, Bahrain, Djibouti, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, Qatar, Saudi Arabia, Somalia, Sudan, Syria, Tunisia, UAE, and Yemen. Although the Comoros are member of the Arab League, they were excluded due to their geographical position outside of the Middle East. The IMF Directions of Trade data base contains no data for the Palestinian territories.

Trade is moreover strongly clustered within sub-regions: 58.0% of the intra-Arab exports of the Gulf Cooperation Council (GCC) countries go to other GCC countries, and 57.2% of Maghreb trade is with other Maghreb countries. Mashreq countries have the most diversified intra-Arab export structures, with only one third of Mashreq Arab trade being with other Mashreq countries.

Econometricians disagree on whether regional trade is too low, i.e. whether the potential for regional exchange is underexploited due to tariff and other obstacles. Depending on the model applied, current levels of trade are interpreted as just right or too low by up to 100% of current volumes. Considering the still considerable non-tariff trade barriers in the Arab world, there is likely to be some further scope for trade integration, especially between the sub-regional blocs. At the same time, the modest share of the MENA region in global GDP – currently around 1.5% – and its intermediate level of technological development make the evolution of a high-powered trading bloc akin to the EU unlikely.

However, looking beyond industrial structures and trade shares at the more fundamental level of factor endowments, the Arab world arguably is a textbook candidate for economic integration: Whereas some countries are richly endowed with the factors of labor and arable land, others are capital-abundant. Different countries are rich in different natural resources; not only oil, but also gas and various minerals. Assets are complementary, and the Mediterranean is ideally situated to facilitate exchange. Bringing together the comparative advantages and assets of different players should result in a large scale positive-sum game.

The real story: explosive investment integration

The complementarity of assets has arguably been played out in recent years on an unprecedented scale. This has however happened less so in the realm of traded goods than in that of foreign direct investment: FDI has been at the core of regional economic integration since 2000. It has accelerated much more massively than trade, and is cross-cutting sub-regions in a way that commerce has never managed.

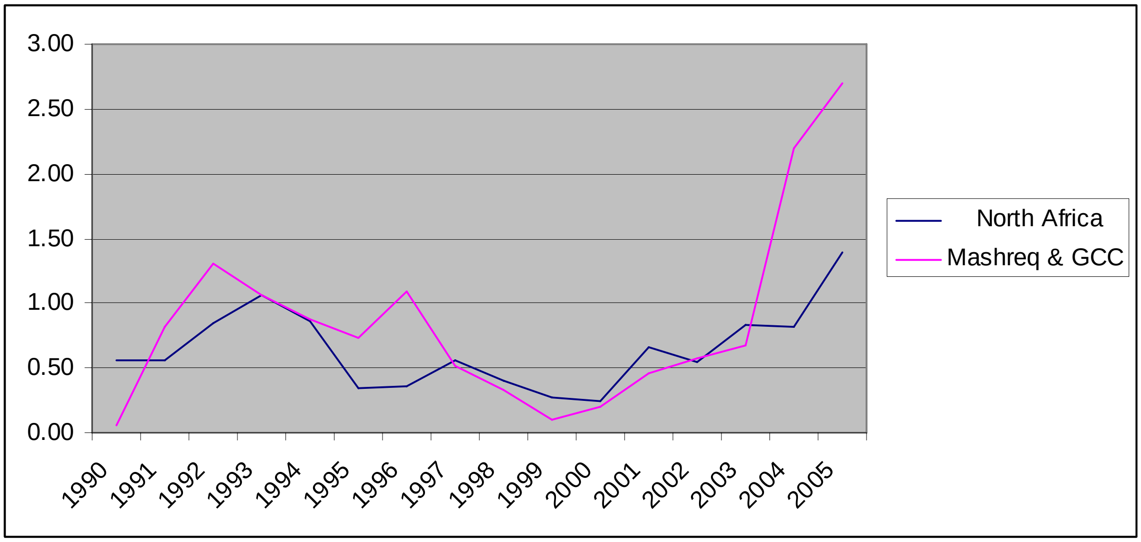
Table 5 shows that FDI levels in the Middle East are still modest by global comparison, but have increased very rapidly: The region's share in global FDI inflows has grown from 0.4% in 2000 to 4.1% in 2005. 2006 figures are not available, but are likely to be even higher.

Table 5: Annual FDI inflows of MENA states, % of world total

ECONOMY	1970	1980	1990	2000	2004	2005	2005 in million US$
Northern Africa	*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
Libyan Arab Jamahiriya	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
Mashreq and Gulf	*0.46%*	*-6.05%*	*0.07%*	*0.17%*	*2.20%*	*2.70%*	*24,750*
Bahrain		-0.76%	-0.09%	0.03%	0.12%	0.11%	1,049
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
Kuwait	0.19%	0.00%	0.00%	0.00%	0.00%	0.03%	250
Lebanon		-0.02%	0.00%	0.07%	0.27%	0.28%	2,573
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
Syrian Arab Republic	0.00%	0.00%	0.04%	0.02%	0.04%	0.05%	500
United Arab Emirates	0.06%	0.18%	-0.06%	-0.04%	1.18%	1.31%	12,000
Yemen	0.09%	0.06%	-0.06%	0.00%	0.02%	-0.03%	-266
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 Developed Countries	1.15%	0.97%	0.29%	0.29%	1.23%	1.06%	9,680
World FDI in US$	13,417	55,272	201,614	1,409,568	710,755	916,277	

Source: based on UNCTAD data

Graph 2: Share of Arab countries in world FDI since 1990 (%)



Increased FDI reflects increased local and international confidence in Arab economies in the course of the recent oil boom and the way it is being managed – different from the last boom, which led to a rapid expansion of imports and the service sectors, but an outflow of capital, as the 1980 column in table 5 shows. The last three years have brought heightened international interest in the Gulf economies in particular, as extra-regional institutional investors and industrial players are slowly moving into markets that have seen a progressive erosion of national privileges and investment restrictions since the late 1990s.

During the last decade, one third of FDI in the region was intra-Arab, and although no precise figures are available, the share has quite probably grown further in 2005 and 2006 – which helps to explain, among other things, why the economies of non-oil states have also benefited from the boom.

In FDI, the Arab world has seen stronger bottom-up integration than in trade, as private Arab investors have displayed a growing predilection for regional projects. With large capital reserves, growing surpluses and scepticism of Western investment locations after 9/11, the gradually liberalizing region has gained new attractiveness for Gulf investors. Their asset allocation by and large is much more sophisticated than during the 1970s boom, as many of them have transformed from rentiers to entrepreneurs and take active interest in the projects they invest in. The geopolitical atmosphere has newly rekindled an interest in Arab and Islamic markets, and liberalization and privatization policies in various neighbouring countries are opening opportunities which were not available two decades ago.

This is not to say that regional investors do not face considerable hurdles in plowing their capital back into the region. Although gradually liberalizing, the governments of the Arab world have not changed overnight. Entrepreneurs have to face bureaucratic opacity, complex and outdated regulations, intransparent licensing policies, judiciaries moving at a glacial pace and, frequently, outright corruption. Setting up projects can be time-consuming and subject to uncalled for bureaucratic interventions. That so many investors decide to brave this environment underlines their dedication and resources.

Where does the money go? The following overview draws on a comprehensive database of regional investment projects assembled over the last two years.

FDI in the Mashreq

First of all, an existing tradition of Gulf investment in the Mashreq has been considerably deepened in recent years, covering a plethora of sectors:

Industrial projects. Gulf investors have been particularly active in the relatively advanced Egyptian manufacturing sector. Big names active there include the Saudi Al-Zamil group and the Kuwaiti Khorafi group. Saudi Savola Group purchased the Egyptian Fertilizers Company for 800 million US$ last December and is building a large sugar refinery. Other projects currently in the pipe in Egypt include a Kuwaiti-Saudi refinery for 1 billion US$ and a steel plant by the Saudi Tuwairiqi group. Kuwaiti investors have also initiated a 230 million US$ cement project in Jordan, and Qatar has been considering a refinery project in Lebanon.

Tourism and real estate projects: This is the sector with the largest capital commitments. Regional real estate leader Emaar from Dubai is developing the 4 billion US$ Cairo Hills commercial and recreation community as well as the 1.7 billion US$ Marassi tourist resort for in Egypt. Dubai-based Al Futtaim Group has announced investments of 3.5 billion US$ to build a new residential area on 1750 hectares of New Cairo, Cairo Festival City. Damac Holding Group, also of the UAE, has announced a residential and tourism project on Egypt's Red Sea coast which is supposed to grow to up to 16.3 billion US$.

In Jordan, the 1 billion US$ Royal Metropolis project is also financed mostly through Gulf investment companies. Saudi Oger and Jordanian real estate company Mawared are executing another 1 billion US$ urban regeneration project in Amman, in which Kuwait Projects Company (KIPCO) has a 400 million US$ share. Emaar Jordan, along with a group of regional and Jordanian investors, has formed The Dead Sea Company that will develop a luxury mixed-use realty project for 500 million US$.

In Lebanon, Gulf investors have reportedly invested a total of 3.5 billion US$ in local real estate, constituting 40% of total realty investments; large players there include Abu Dhabi Investment House, Dubai's Habtoor Group, Dubai Islamic Bank as well as private Saudi investors.

Even "difficult" Syria is seeing the development of large Gulf-financed tourism ventures, with Emaar planning a 4 billion US$ project. The Aref Group of Kuwait has started a 2 billion US$ development to create a new finance and business district in Damascus. Saudi Prince Waleed is majority shareholder in the new Four Seasons hotel in central Damascus; Majid Al-Futtaim from the UAE and Saudi Bin Laden Group are planning further projects. Together with Turkey, Saudi Arabia and Kuwait reportedly are the largest foreign investors in Syria.

Telecoms. This is a sector in which Gulf multinational companies such as Kuwait's MTC and the UAE's Etisalat have rapidly spread across the region in recent years. An Etisalat-led consortium bought the third Egyptian mobile phone license for 2.9 billion US$ last summer. At the same time, Bahraini Batelco acquired a 96% stake in Jordan's mobile firm Umniah for 415 million US$. In September, Kuwait's Wataniya won the second Palestinian mobile phone license.

Finance. Banking is an area in which the Gulf business classes have gathered particularly deep experience since the 1970s, whereas banking sectors in most other Arab countries have atrophied under state control. The last year has seen numerous smaller acquisitions and new ventures. In April, Kuwait's Global Investment House acquired a 22 per cent stake in the Jordan-based bank Societe Generale De Banque – Jordanie. In September, Dubai-based Abraaj Capital acquired 25% of Egypt's EFG-Hermes investment bank.

Gulf investors have also been the most prominent actors in the newly liberalizing Syrian financial sector, where numerous smaller banks and insurance companies have been called into being. Participants include the Saudi Dallah Al Baraka group, UAE's Emirates Bank International, Qatar National Bank, Qatar International Islamic Bank, Commercial Bank of Kuwait and Al-Shall Company and Investment Dar of Kuwait. Several Gulf investors have also moved into the Iraqi banking sector, including Bahrain's United Gulf Bank, Ahli United Bank, and Kuwait's Iraq Holding.

FDI in the Maghreb

Hardly smaller in scale, Gulf investment in Maghreb countries has emerged as a new intra-regional phenomenon. It is of far greater importance than the still small trade between Maghreb and other Arab states.

Tourism and real estate projects. Again leading the pack, the UAE's Emaar has started half a dozen large tourism and realty ventures in Morocco. Together with Dubai International Properties, a subsidiary of Dubai Holdings, it has committed more than 19 billion US$ of investment over the next 10 years. Bahrain's Gulf Finance House is developing the 1.4 billion US$ Gateway to Morocco tourism and residential project, while property firm Qatari Diar aims to build a resort with hotels, holiday homes and a golf course near Tangier for 335 million US$. Bahrain-based RealCapita and Morocco's Jet Asset Management have formed a joint venture that plans to spend 400 million US$ on social housing projects in Morocco over four years.

Last April, Emaar Properties also announced plans to develop the 1.9 billion US$ "Al-Qussor" project on Tunisia's eastern coastline. Similar large-scale tourism projects have recently been envisaged for Libya and Algeria, countries which are often considered as too unpredictable and bureaucratic for Western investors. Sharjah-based Tameer has announced plans to undertake a combined residential, commercial and tourist project in Libya with a total volume of up to 20 billion US$. Emaar has entered a joint venture to set up a development zone in Libya and has been negotiating large-scale deals with the Algerian government.

Telecoms. A consortium of Dubai's Tecom and Dubai Investment won a tender for shares in Tunisie Telecom last year. The group paid 2.25 billion US$ for a 35% stake in the company, which holds a fixed-line monopoly and competes against Tunisiana for mobile customers – a joint venture of Kuwait's Wataniya and Egypt's Orascom. Wataniya is also present in

Algeria, where it runs the mobile phone service Nedjma. Further telecoms investments are bound to happen in coming years.

Gulf investment in Maghreb finance and industry is smaller-scale, but nonetheless actively developing, with a special focus on Algeria. Saudi magnate Saleh Kamel's Baraka bank is active there, and Bahrain's Al Salam Bank has acquired a licence to launch an Islamic bank with a paid up capital of 100 million US$. Abu Dhabi's Mubadala Development Company is engaged in a build, own and operate (BOO) project together with Canadian SNC-Lavalin for a 1200 MW power plant in western Algeria. In March 2006, Saudi pipe producer Amiantit announced manufacturing joint ventures in Algeria and Morocco.

FDI in the Arab periphery

Gulf investors have not shied away from harsher environments on the Arab periphery such as Sudan or Djibouti. In these places, they tend to dominate non-oil FDI.

Sudan. Investors from Kuwait, Saudi Arabia and the UAE – again including Emaar – have launched several projects in Sudan. Kuwaiti investors have initiated a 70 million US$ project to upgrade the Nile port of Juba in Southern Sudan and a 40 million US$ project for a luxury hotel in the same town. Much larger Sudanese real estate projects have been announced with the involvement of large Saudi business players such as Juma Al-Juma, the Alireza and Jamjoum families. Details remain unclear, however.

Whereas real estate is still in its infancy, Gulf investors already have a firm foothold in the Sudanese telecommunications sector: Kuwait's MTC has assumed full control of leading Sudanese mobile operator Mobitel in February 2006, paying 1.33 billion US$ for the 61% of the company which it did not already control. The UAE's Etisalat holds a license for a second fixed-line network and a stake in former monopolist Sudatel. Gulf money has also gone into shares in several Sudanese banks and into the IPO of Al Salam Bank Sudan, which was organized in 2004.

Djibouti. Dubai has also taken the lead in investing in Djibouti, which harbours ambitions to become a local trading hub for Northeast Africa. In February 2006, Dubai's DP World inaugurated the Doraleh Oil Terminal project, a 240,000 metric tonne facility which it will manage for Djibouti's government. DP World also intends to build a new container terminal in Doraleh for 300 million US$.

Altogether, Dubai is estimated to be working on projects worth 800 million US$ in Djibouti, including a free zone and hotel facilities. The intention patently is to make Djibouti a mini-hub for the surrounding sub-region, corresponding to Dubai's own model.

Further vehicles of investment integration

Capital is also recycled within the region through non-FDI channels, i.e. various forms of portfolio investment. These include a wide variety of usually Gulf-based investment funds active in infrastructure, energy, utilities or real estate projects, often benefiting from the region's governments' increasing willingness to draw on private capital to finance public functions. Recent years have also seen an emerging buyout and private equity industry in the region as well as smaller-scale venture capital funds.

Portfolio investment opportunities have also been broadened by the increasing breadth of regional stock markets. In early 2006, non-Jordanian investment was estimated to make up about 45% of Jordan's stock market capitalisation, with Gulf capital playing a leading role. Similarly, some 30% of the investment on the Egyptian stock market was estimated to be Gulf money, half of it Saudi. These shares have been fluctuating, and non-Gulf stock markets were affected by the slow-motion crash that GCC capital markets have seen since late 2005.

Nevertheless, the injection of Gulf capital has created new opportunities for start-ups and the creation of companies which operate on a regional level. Local entrepreneurs can tap Gulf capital through offering their companies to public subscription. Even Syria is planning to open a stock market this year. Arab bourses suffer from typical emerging market ailments, but the very presence of for cross-border stocks investment is a substantial step ahead, while the emergence of institutional investors is likely to gradually improve governance.

The Gulf and its networks

With projects in the billion-dollar range, some of the enormous overseas capital resources of the Gulf bourgeoisie – estimated at 800 billion US$ or more – have clearly been unlocked in recent years. The repatriation of even small share of this wealth can make a big difference to regional capital formation.

The new pattern of capital recycling reflects a larger regional shift in business capacities: Most of the largest Arab investment consortia and companies are now located in the Gulf, even if they often have a considerable share of non-Gulf Arabs in their management. Among a 2006 Forbes Arabia list of the 50 best performing companies in the Arab world, there were 22 Saudi companies and 11 UAE companies alone. Although some regional champions are also emerging outside of the GCC, notably Egypt's Orascom Telecom, these tend to be the exception.

Many of the new large-scale investment projects are set up as investment enclaves with limited linkages to the local economy, and intra-Aran investment arguably is too dominated by real estate projects. However, there is undeniable tourism potential in most Arab countries, not least as rich (and increasingly richer) Arabs are more and more looking for tourism opportunities and second residences in Arab Muslim countries as opposed to the West. From a local perspective, regional rent recycling is vastly preferable to just parking money in Western bonds and investment funds.

And although capital flows from GCC to other Arab countries are largely one-way, they are welcome thanks to their domestic employment effects and the fact that they do not bring along as strong economic displacement effects as trade. Some Gulf attempts to take over publicly owned industries have led to political backlashes in the host countries, e.g. when Saudi conglomerate Savola intended to buy state-owned sugar mills in Morocco. Investments in new ventures – the clear majority of projects – do not face such problems however, even if some locals may secretly grumble over overweening Gulf magnates.

There is a speculative element in some of the realty ventures, and the scale of some of them might be overestimated. Surplus Gulf capital will grow further and continue to look for regional outlets, however; and even if only half of the envisaged investment gets realized, it will make a very substantial contribution to the smaller economies of the non-oil states. Although some projects probably will not get off the ground and others might not turn out to be profitable, the region is unlikely to see white elephants on the scale of the 1970s or 1980s.

Private companies and independently managed, profit-oriented public companies dominate cross-border investment, resulting in projects which are based on economic rather than on symbolic or political criteria as often was the case with government-driven undertakings in the past. As far as public investment agencies play a role in regional capital recycling, they also act more strongly on economic criteria. This is not to say that politics plays no role in investment decisions of public companies or investment agencies, but it does so only after minimal profitability estimates have been made.

Cross-border investment leads to a significant deepening of networks among regional business and government elites. Gulf investors can draw on their local skills as Arabs, their knowledge of regional business and bureaucratic cultures, and on personal networks of the large non-Gulf Arab communities in the GCC: although the number of Arab workers in the Gulf has decreased over the decades, Arabs continue to be strongly present in managerial strata there. All this allows Gulf companies to operate in relatively hostile investment environments in the Arab world in which large Western companies do not tread as easily. Conversely, Mashreq businesspeople have been investing in GCC countries which offer a more liberal investment climate than their home countries, and to which they have personal links built up in the 1970s and 1980s.

Arab governments outside of the Gulf have been actively soliciting FDI from the GCC. New bilateral investment offices are opened in the Gulf, large conferences for Gulf investors held, and privatization initiatives are announced with a specific view to attracting Gulf capital. Several of the big Emaar deals were negotiated with the involvement of senior political figures in Maghreb and Mashreq.

A healthy competition for Gulf capital has started – a process in which business tends to drive politics rather than the other way round. Within the GCC in particular, a virtuous competition for better FDI governance is taking off. Qatar and Bahrain are acutely aware of Dubai's attractiveness as business hub with a smooth administrative environment, and are trying to create their own special zones and administrations to attract or at least retain capital. Even the generally immobile Saudi government is now promoting new "economic cities" following the Dubai model of investment enclaves. Cross-border capital flows and FDI within the GCC itself have been growing strongly in recent years.

In trade and more so investment terms, the Arab world today is best understood as a system that is increasingly centred around the Arabian Peninsula. The Mashreq countries have a tradition of relatively intense trading relations with the Gulf and have deepened their existing role as investment destination for Gulf capital. The Maghreb remains peripheral to Arab trade, but has recently emerged as an important investment location for Gulf money. Private investment has taken over official aid as main component of cross-border capital flows.

A policy perspective

Though economics has overtaken politics in processes of Arab economic integration, the latter has political externalities. For one, cross-border capital flows increase the interdependence of Arab countries to a higher degree than trade ever could. With assets spread across the region, the costs of diplomatic, economic or military conflict increase. This is a good reason for external players to support regional economic integration. And although the integration process is playing out more strongly in favor of the Gulf, the FDI recipients also have a clear interest in attracting and retaining capital – if only because they are capital-poor and prefer to diversify away from exclusive dependence on Western FDI.

Albeit Arab governments cannot micro-manage economic integration, they can do a lot more to facilitate it. In this context, it will be crucial to give inter-governmental cooperation in the region a new focus. What has to be tackled is not mainly trade tariffs, it is administrative reform and regulatory convergence. All too often, investors are still held back by opaque rules and institutions – especially smaller ones who have less political weight to throw around, but whose aggregate capital resources are as impressive as those of the large conglomerates.

FDI requires policies that transcend traditional trade rules of cross-border exchange and deal most of all with domestic regulatory structures. Arab economic integration should not least become a program for targeted bureaucratic reform and standardization. This is a tall order, but the returns in terms of reducing transaction costs and utilizing regional complementarities in terms of factor endowments are enormous. Issues that would need to be tackled include the standardization of investment regulations, dispute settlement and accounting procedures, streamlined and non-discriminatory licensing, principles of mutual recognition, regional standards, and a predictable legal environment for foreign actors. This will also help in moving the Arab world towards compliance with the WTO's General Agreement on Trade in Services (GATS).

Even in trade, addressing non-tariff, institutional barriers has been shown to yield higher economic returns than sheer tariff reduction.[v] Growth effects of service and FDI integration are more difficult to model than those of trade integration, but are likely to be much more substantial. "Dynamic gains" through competition effects, technological upgrades, economies of scale etc. are likely to be especially high in FDI and services.[vi] The scale of current investment, which is happening despite considerable obstacles, indicates the potential of further liberalization.

Every regime is politically constrained in its reform efforts. It is all the more important to create regional awareness of how important certain types of administrative reforms are, and to set clear benchmarks to evaluate change, e.g. through a new regional FDI agreement. International standards are often available in the form of specific WTO protocols, which could in a phase of transition be applied only regionally or sub-regionally. Reforms need to be broken down institution by institution in order to build coalitions for change and avoid cross-cutting bureaucratic obstruction. Regional reporting requirements and supervision arrangements, possibly organized through a beefed-up Arab League secretariat, could help to enable follow-up and increase peer pressure. Private sectors should be included in regional policy deliberation. Although reforms by and large have to be negotiated domestically, a regional "hook" could greatly help to focus the process, make it less threatening and make the rewards appear more tangible.

Outlook: the GCC's pivotal role

The paradigm of state-directed economic integration has become obsolete in the Arab world; states can at best be facilitators. Concurrently, the Gulf has become the pivot of the regional political economy, as it harbors the most capable and capital-rich private sectors. The larger political consequences of all this for the region are not yet clear. The trends analyzed here are important enough, however, to warrant some speculation.

With its emerging role as dominant economic hub of the region, the GCC arguably is a potential anchor of stability in the Arab world: Relatively weak in military terms, it has a vested interest in political calm, as it can then play out its economic muscle. At a time at which American hegemony has become of questionable value even to its "moderate" allies, the GCC might be willing to play a more assertive role based on its economic resources.

Needless to say, no amount of Gulf capital can buy stability if facing a mess of epic proportions as in Iraq (although Gulf money has been helping significantly in shoring up the economy of the war-wrecked country). Still, the "soft power" of Gulf capital is not an academic point: As more and more GCC money is channeled into Syria for example, Gulf political influence there is bound to increase. A regime in rather dire economic straits, Syria will be increasingly reluctant to alienate Gulf governments – which are not capable of micro-managing the investment decisions of their business classes, but can certainly use their moral suasion to indicate which investment destination is not palatable. Similarly, Gulf FDI imparts considerable soft power in Lebanon, where it will play an important role in reconstruction.

This is not to say that economics always trump politics. The more ideological regional politics becomes, the less the Gulf can play out its economic power. Nonetheless, at least in inter-state relations, the dynamics have shifted: As a full clash with Israel has become increasingly unthinkable, and no Arab regime has mounted a military challenge to any of its neighbors since Saddam's Gulf war, military power is of declining utility in today's Arab world. In the absence of a full-scale clash with Iran, economic power will increasingly come to the fore in defining intra-Arab relations. And this power largely emerges from the Gulf, through its business classes and their rapidly increasing regional investment.

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[v] Denise Eby Konan, *Alternative Paths to Prosperity: Economic Integration Among Arab Countries* (University of Hawaii 2002).

[vi] Free trade in the Euromed area – combining EU and Arab countries – is expected to yield static gains of around 2% of GDP, whereas dynamic effects of deep integration including services and FDI are estimated between 4 and 20% depending on the depth of integration. For a survey of econometric studies cf. SIA-EMFTA Consortium, *Sustainability Impacts of the Euro-Mediterranean Free Trade Area* (University of Manchester et al 2006).