

# Gulf Monitor



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Economic Diversification and  
Knowledge Economy



Gulf Issues a Predominant Theme  
at G8 Meeting



Looking Ahead: Saudi Arabia's Economy



The Curse of Oil and  
the Disintegration of Iraq



Analyzing the Military Posture  
of US and Iranian Troops in the Gulf Region



Overlooked and Understated:  
EU-GCC Economic Cooperation

June 2007, Vol. 1, No. 4

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Editor-in-Chief: Abdulaziz Sager  
 Editor: Christian Koch  
 Assistant Editor: Radhika Menon  
 Concept & Design: Susan Nteife  
 Cover Photo: Model of King Abdullah  
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Gulf Research Center  
 P.O. Box 80758  
 187 Oud Metha Tower, 11th Floor  
 303 Sheikh Rashid Road  
 Dubai, United Arab Emirates  
 Tel.: +971 4 324 7770  
 Fax: +971 4 324 7771  
 Email: info@grc.ae  
 Website: www.grc.ae

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# Gulf Issues a Predominant Theme at G8 Meeting

**Dr. Christian Koch**

As the world's leading industrialized countries gathered in Heiligendamm, Germany, for the annual meeting of the Group of Eight (G8) that comprises Canada, France, Germany, Italy, Japan, Russia, the United Kingdom and the United States (with the European Commission also represented), issues related to the Gulf region featured prominently on the summit agenda. The Foreign Ministers' meeting which was held on May 30, 2007 as a preparation for the summit meeting which was held from June 6 to 8, included on its list the issues of Iran, Kosovo, the Middle East, Sudan/Darfur and Afghanistan; four of these five items are of direct interest to the Gulf region for developments in those areas can have an impact in the region. As such, it is important to look at how these items should have been handled at the G8 meeting and how the outcome fell short.

## The Broader G8 Framework

Germany placed this year's meeting under the slogan of "Growth and Responsibility" defined as promoting economic growth and applying similar standards to make globalization more equitable. Included in this approach is the idea of a strengthened dialogue with so-called "major emerging economies" although under this broad heading, one tends to find the usual suspects like India, China, Brazil and South Africa. No mention is made of the Arab Gulf region which in recent years has witnessed some of the strongest economic growth rates in the world and where the continued influx

of oil revenues will ensure that rapid development occurs not only on the economic, but also on the social front.

In addition, the summit focused closely on issues such as strengthening ties with Africa and working out a development program for African nations, climate change, energy security, and shaping the social dimensions of globalization. On many of these

fronts, the Arab Gulf states have a significant role to play. Already, many of the current budgets of the Gulf Cooperation Council (GCC) states focus more on infrastructure development and improvement of the social sectors such as health and education than in the past. These states have shown an increasing awareness of both the risks and opportunities that globalization affords, and are taking

*Climate change and energy security were among the main topics at the 2007 G8 summit meeting in Germany*





steps to both improve the conditions whereby one can take advantage of a rapidly changing global environment while, at the same time, attempting to mitigate risks wherever possible.

To what degree the Gulf and the Middle East as a whole is a focal point for global risk and corresponding mitigation strategies was highlighted by the recent Middle East@Risk report which was issued in conjunction with the annual Middle East summit of the World Economic Forum (WEF) and developed in collaboration with the Gulf Research Center (GRC). Here two of the risks which were also part of the G8 discussions – energy security and climate change – were

identified as having particular relevance for the Middle East and ones in which the Gulf region more specifically has a key role to play. In terms of energy supply disruptions, it would not be the energy-consuming nations that would bear the consequences but such disruptions would undermine the economic foundation at the heart of the current growth and development in the region. Beyond that and in the longer term, given a continued high price environment for energy products as demand continues to outstrip supply, the danger is that at least as far as emerging economies are concerned, one could face a situation of unsustainability of secure energy supplies, thereby increasing overall competi-

tion and the possibility of so-called resource conflicts.

Thus, within the context of future supplies, the Middle East – and in particular the Gulf region – represents the main source of supply of hydrocarbon energy both at the present time and for the foreseeable future. The Gulf today holds 61.7 percent of the world's proven reserves of oil and contributes 30.5 percent to worldwide production. Of the current largest producers of oil, five of the six countries are Gulf States. In addition to oil reserves, Saudi Arabia, Abu Dhabi, and Kuwait account for around 50 percent of the production of the Organization of Petroleum Exporting Countries (OPEC). While OPEC currently accounts for 41.7 percent of production, it also accounts for a whopping 75.2 percent of official worldwide reserves.

### Focusing on the Middle East and the Gulf

The above risk factors concerning energy security would not be of great concern were it not for the fact that the Gulf region is also one of the most unstable regions of the world from a geopolitical and geostrategic perspective. Thus, it needs to be mentioned here that the issues of regional security and political stability cannot be de-linked from questions of energy production and supply. For the G8 summit, this means that the issues on the agenda are of paramount importance for the continued stability and security of the Gulf region, and as such the kind of statements that the summit prepared and released about those issues would be keenly studied. This includes especially the more prominent risk areas of Iran, Iraq and terrorism as well as that of energy security.



With regard to Iran, very little has changed in the regional climate since the last G8 summit in St. Petersburg, and the Gulf continues to be confronted with the possibility of an armed conflict that would drag the region into another senseless cycle of violence. As far as the Arab Gulf states are concerned, unless a solution is found to the militarization of the Iranian nuclear program, the Middle East and the Gulf could find themselves engaged in a competitive race to harness nuclear energy with the clear possibility that this could spill over into a more wide-ranging arms race. Not only would this further threaten the regional security environment, but indirectly the spending on these programs would divert income from economic development projects and slow growth prospects.

With Iran being one of the main topics of the preceding Foreign Ministers' meeting, the G8 summit was challenged to produce a unified stand on the Iranian nuclear issue that would do two things. First, it should have sent a tough message to Tehran that the current UN Security Council resolutions demanding Iran cease its uranium enrichment must be respected and fulfilled. Second, it should have also kept the door open for continued dialogue and negotiations whereby the dispute over the nuclear program can be resolved through peaceful means. The delicate challenge to keep the debate within the diplomatic context and avoid a further deterioration in the current climate and consequent risk of a military confrontation, however, was not handled at all.

Within the framework of the debate over the utility of nuclear power and the associated dangers of nuclear proliferation, the G8 summit could, for example, have come out clearly in support of the project of the Gulf

Research Center, initiated in December 2004, for the establishment of a Gulf Weapons of Mass Destruction Free Zone (GWMDZF) based on the concept of a sub-regional to regional approach to freeing the entire Middle East of WMD. The GWMDZF project opens the door to a possible resolution specifically as it represents an initiative from the region that has gained in legitimacy and acceptance. Equally important would have been the reiteration that the EU-3 proposal from June 2006 remains an offer on the table and that this proposal extends to Iran a number of concrete and tangible benefits while leaving open the door towards the development of a peaceful and civilian nuclear program. Much of the utility of this offer has been lost in the acrimony of the current debate. The G8 summit would have been the right moment to re-emphasize the proposal under the limelight of the world's media.

On Iraq, it is obvious that there are no clear cut answers which can resolve the absolute quagmire that the country currently finds itself in. Nevertheless, the summit should have been aware that developments in Iraq have the potential for negative

fallout throughout the Gulf region and that such consequence must be understood outside of the realm of US action inside Iraq. Without a noticeable improvement in the security situation in Iraq, which is highly unlikely, the calls for some form of US troop withdrawal will gain momentum. A US withdrawal, however, carries with it a number of uncertain consequences beginning with the disintegration of Iraq and the split of the country into three parts. Were this to happen, the possible independence of the Kurdish north would bring about active Turkish intervention while Iran would use the event to spread Shi'a radicalism throughout the region, including in Saudi Arabia's Eastern Province and in Lebanon. Another possibility is the establishment of a radical Islamic state in Iraq as the internal political process disintegrates. Given such a dire outlook, the G8 summit should have come out with a clear statement of support of new initiatives including those emanating from the region and suggesting even a moderate level of success. Saudi Arabia is one country that has at least tried to mitigate sectarian tensions. To such efforts, the summit could have played closer attention.

*Political reform in the Middle Eastern states was not on the top of the agenda at the G8 summit in Germany as in previous summits*





On terrorism, the recent suicide bombing and killing of three German soldiers in Afghanistan showed that terrorist networks are well aware of international developments. The attack was clearly linked to the G8 summit and was meant to put the issue of Afghanistan, and Germany's participation in the stabilization campaign on the summit agenda. The G8 foreign ministers' meeting stressed the cooperation between Afghanistan and Pakistan as a means to particularly improve border security, thereby resolving the refugee problem and developing the border region. But beyond that, and in the context of terrorism specifically, it was necessary for summit participants to understand, and as the Middle East @Risk report of the WEF and the GRC clearly states, "the Middle East region as a whole suffers from international terrorism on multiple levels: as a direct victim of attacks, as a perceived centre of instability (reducing foreign investment appetites) and as a perceived source of terrorism in terms of personnel, training and ideological background (reducing opportunities for knowledge transfer and personnel exchange

with Western countries). A number of Middle East regimes are specific targets of Al-Qaeda as the 'near enemy.'" The war on terror has not produced acceptable results, in fact, it has worsened the environment under which terrorism thrives. This is an assessment that the G8 summit failed to acknowledge.

Finally, the issue of energy security has been on the agenda for more than a year since featuring prominently during the St. Petersburg summit in 2006. The concern about adequate and stable energy supply routes, the fears about possible disruption to that supply, and concerns over the rising price in the energy sector, have all contributed to making energy security a permanent topic of debate. The importance placed on this issue has taken on such momentum that not only did it again feature as a topic of the summit meeting, but German Foreign Minister Steinmeier also underlined his intention to hold a special conference solely on the energy security issue in December 2007. In line with suggestions, besides the G8 foreign ministers, the foreign ministers of Brazil, Mexico, India, China and South Africa were also invited to attend. That the Arab Gulf states were not considered in this debate or mentioned as being possibly invited is problematic to be sure. As stated above, the energy security equation cannot be resolved without the most important energy region in the world. During their recent ministerial meeting, the EU and the GCC agreed to an intensified energy dialogue. With several of the Arab Gulf states also expressing an interest in investing in the development of renewable energies, this is a point of departure that the G8 should consider and take advantage of.

One topic that received less attention, although there was some mention in some of the statements and communiqués that were released, was the issue of democracy and reform in the Middle East. With the numerous challenges that the region faces, the issue of actively pushing for democratic reform has been taken off the priority list although the debate continues in several G8 countries whether this is a prudent approach. That the item is not completely removed is exemplified by the fact that the G8 Foreign Ministers will meet again in November under the Broader Middle East and North Africa Initiative (BMENA) to discuss the strengthening of development and reform in the Near and Middle East. In the meantime, it would have been a forward step if the summit had acknowledged that political reform is in fact occurring in the region and that foreign involvement is at best a supporting, but not a determining factor in this process.

Under its current presidency, Germany has underlined that the Gulf region is of strategic importance for all of Europe not only from an energy security perspective but also in light of the need for a new regional security architecture. The G8 summit offered an opportunity to lay the groundwork for such an approach which undoubtedly is desperately needed. An even better starting point would have been a signal to build on the cooperation and partnership with the Arab Gulf states to improve the chances for such a process to actually move forward. That, however, remains a missing link.

*Dr. Christian Koch is Director of International Studies at the Gulf Research Center.*



# The Curse of Oil and the Disintegration of Iraq

**Dr. Mustafa Alani**

Civil wars such as in Sudan, Nigeria, and other parts of the world often have a strong economic dimension. The fighting and spilling of blood are not always motivated by nationalist feelings or aspirations, or by the desire to protect human, ethnic, religious, or cultural rights of certain minorities. History has proven that civil war leaders and warlords are among the worst violators of human rights, and many of them are no better than criminals or dictators working for self promotion, personal wealth and glory.

land; the economic dimension was, and remains, a major underlying factor in internal and external conflicts.

During the last four years, news about the escalating violence in Iraq has dominated media headlines across the world. Media reports have been full of the news of violence in the by now well-known hotspots like Baghdad, Falluja, Rumady, and Diyala. However, there is very little news about the violence endured by Iraqi people living in other regions

main city in the south. Nevertheless, there is a common link between the two cities as they are both considered 'jewels in the crown' in the country's oil production sector. Indeed, for the last three years, the two cities have experienced a virtual civil war. With the country sliding gradually toward chaos and possible disintegration, the crucial question is: who is going to control the country's oil wealth? Although Iraq, until now, is able to function as a 'state', albeit with a weak central government, the battle for

*Iraqi Oil Minister Hussein Al-Shahristani (C) and Iraqi First Deputy Parliament Head Khaled Al-Attiya (2R) attend a conference in Dubai, in April 2007, on a controversial oil draft law which opens Iraq's oil sector to foreign investors*



Thus the fight is not always for what is visible above the ground, or what is publicly claimed as justification for the civil war, but in certain cases for what is hidden from view. If we exclude the genuine and rightful struggles for the right of self-determination, in most other cases of civil wars it is rare that people will fight and die for worthless

and cities of the country. The daily violent struggle in the two oil-rich cities of Kirkuk and Basra has a special meaning for Iraqi people and is of significance for the state. Kirkuk and Basra have no geographical link between them, they are separated by hundreds of miles; one is a main city in the north of Iraq, the other is the

the control of the country's oil wealth is already in progress, if not in an advanced stage.

In Kirkuk, the two Kurdish parties, with the support of the armed militia "the Peshmarga" and the participation of many Kurdish security services and party cadres, are working very



hard to secure the city and the entire Kirkuk province, and establish control over the oil resources of the province. The Kurdish leadership has realized that the present situation in Iraq offers them a historic and probably unrepeatable window of opportunity to impose Kurdish control over the oil-rich city of Kirkuk and secure economic viability for a future Kurdish political entity, eventually leading to the declaration of the first Kurdish independent state. The strategy to bring Kirkuk under Kurdish control is based on taking full advantage of the chaotic situation prevailing in Iraq. The Kurds today appear as the strongest, the most organized political group on the Iraqi political scene. They understand that neither the Iraqi government nor the US will be able to pressurize them. To secure control over Kirkuk, the two Kurdish parties adopted a multi-stage strategy. First, they pushed their militias to impose control over the city and take over most of the key positions in the provincial administration. At the same time, they initiated a campaign of 'ethnic cleansing' to force the non-Kurdish population of the city (Arabs and Turkmen) to move out. They were able to impose Article 140 in the new Iraqi constitution which calls for the "normalization" of the situation in the province. Coupled with other practical measures already implemented on the ground by the Kurdish leadership, they may well be on their way to secure the "Kurdization" of Kirkuk and its oil wealth.

In Basra, the situation is slightly different. The bloody fight for the control of the city and its enormous oil wealth has been going on for the last four years, yet remains unsettled. There is an ongoing Shi'a-Shi'a conflict between a number of rival Shi'a militias, and organized

criminal groups dominate the city's political and security scene. Basra has been effectively out of the central government's control since the invasion of the country, and it is unlikely that government's authority can be restored in the near future. The Baghdad government is paralyzed, and unable or unwilling

partial or complete separation of Basra from the rest of the state. A de facto separation is now in existence which means that Basra and its oil wealth are at the mercy of ambitious and ruthless local warlords who have no consideration for or attachment to the country or its national interests.

*Massive fire at an oil well after it was attacked by insurgents using an improvised-explosive device outside the northern town of Kirkuk on May 24, 2007*



to stop the sectarian "cleansing" in Basra, or the ongoing fight for control of the province and its resources. The rival Shi'a political groups, small and big – many depending on support coming from across the international borders – are working hard to secure some formula that could guarantee a

In view of the current developments in both major oil cities, it seems that the vicious hyenas have started their feast, even before the death of the prey.

*Dr. Mustafa Alani is Senior Advisor and Program Director, Security and Terrorism Department at the Gulf Research Center.*

# Analyzing the Military Posture of US and Iranian Troops in the Gulf Region

**Musa Hamad Al-Qallab**

The likelihood of a military confrontation in the Gulf region remains a subject of much discussion especially in light of the presence of many US naval vessels in Gulf territorial waters, the Gulf of Oman and the Arabian Sea. In concert with the operations in Afghanistan and the Horn of Africa, the maneuver area of these US naval vessels extends across the Indian Ocean to the eastern coast of Africa. As such, they move through a wide area that gives them ample space for greater mobility and maneuvering. This will also enable them to remain outside the zone of Iranian missiles for the longest possible period.

Unlike the US Navy, the Iranian Navy moves within the restricted space of Iranian territorial waters. Iranian naval forces thus remain within the range of the more advanced

US missiles. They move with great caution to avoid any unnecessary friction with US warships in the vicinity as this could spark a new deadly war in the Gulf region.

Various scenarios could trigger a possible military confrontation between the US and Iran. Given the fact that the political discussions have at this stage not broken the deadlock over the Iranian nuclear program, the military option to resolve the crisis remains very much a possibility. Both US President Bush as well as Secretary of State Rice have made it clear that a resort to military means cannot be removed from the equation at this stage. This, in turn, has caused the Iranian leadership to threaten various degrees of retaliation should Washington proceed with any attack plans. As such, it is useful to look more closely at the military posture

and combat readiness of the US and Iranian armed forces in the Gulf and to assess their capabilities in light of such contingency.

The main part of the current US military build-up in the Gulf is

**A US war against Iran to overthrow the Iranian regime would vastly differ from the case where the US intention is limited to the mere destruction of Iranian strategic weapons**

constituted by the US Navy, formed in battle groups consisting of aircraft carriers, destroyers, gunship boats, submarines and logistic ships. This is in addition to other naval and air resources that could be used for

*The United States backed up its threat of new UN sanctions to punish Iran's nuclear drive with the positioning of three different strike groups in Gulf waters, May 2007*





possible strikes against naval targets or even ground and air assets within Iran. Meanwhile, the US concentration of ground forces remains away from the battle zone and is quite limited in size, with the exception of the US army and marines in Iraq and some other US pre-positioned military sites in the Gulf region.

On the other hand, Iran has deployed sizable ground forces on all vital approaches leading to the main strategic targets, including sensitive nuclear facilities, industrial sites and headquarters of main military formations. The ground forces include the air defense elements required to provide local air defense for those strategic targets and other land, air and military commands in which they have been placed.

The Iranian air force is bigger in size than its naval counterpart. Their combat capabilities, however, are modest in comparison with the superior US air force in terms of both quality and quantity. The same could be said about the Iranian navy which owns a fleet of less advanced naval warships, armed boats and

a few small size submarines. This does not exclude the possibility of Iranian naval vessels waging swift or sporadic attacks against US naval assets should an opportunity arise. But this should be the extent to their power. The Iranian air defense forces, meanwhile, do have a better chance of hitting attacking US aircraft, despite the US supremacy in areas of electronic warfare, jamming, neutralization of enemy air defenses, in-flight refueling of aircraft, and air and space reconnaissance and communications.

The Iranian land forces and the Iranian Revolutionary Guard Corps, which is responsible for the deployment and employment of strategic missile brigades with full combat capabilities before suffering any strategic or tactical aerial bombardment from the enemy, would in all likelihood have no real chance of engaging the US army or Marines forces except for the very initial stage of the fighting. Such a situation would only come about at the beginning of a campaign, i.e. when US elite forces and/or airborne paratrooper forces engage in commando operations

before the actual outbreak of hostilities or further down the line when US armed forces actually enter and begin to control some of the areas inside Iran. In such scenarios, the US air force will seek to deny Iranian land forces the chance to use any of its weapons against US forces. Iranian Revolutionary Guard Corps will in any case do their best to fire any long range or ballistic missiles they have at the outbreak of operations before they become vulnerable to possible strikes from the US side.

In the event of a battle, it is expected that both sides would use their effective combat elements in a fast, precise and efficient manner in order to cause maximum casualties to the other side's forces. Clearly, there is no tactical, strategic or logistical parity between the two foes. The military balance clearly favors the US side. While it is generally assumed that conflict would be the result of an initial American attack, Iran, having determined that the US is about to launch a strike and bring about regime change inside Iran, could decide to achieve a tactical surprise by launching a pre-emptive attack on the US forces.

*Missile testing is a regular feature of Iranian military maneuvers (File photo from August 2006)*



To be sure, a US war against Iran to overthrow the Iranian regime would vastly differ from the case where the US intention is limited to the mere destruction of Iranian strategic weapons. In the first case, Washington would wage an all-out war against Iran to destroy the public resources of the state, including the military, political and media facilities. This would be done by intensive bombing from the sea and air, using US smart missile capabilities to weaken Iranian combat resolve, demoralize the regime and force it to surrender. The US would avoid deploying army and other ground forces in Iranian territory, except for a limited number of US special forces employed to carry out attacks against selected targets. The US would also refrain from causing any permanent damage to major economic facilities, such as infrastructure, and water and electricity systems. By avoiding damage to public utilities, it would allow for a smoother transition for the Iranian people in the post-war period, reducing any sense of alienation or hostility towards the US. The US must make use of the lessons from its experience of the 2003 invasion and occupation of

Iraq. Thus, it is quite improbable that the US would resort to direct military occupation of Iran. Besides its experience in Iraq, the US would also be deterred by the huge size of Iran – almost four times the size of Iraq – and its difficult terrain, in addition to its large population (three times the population of Iraq).

If US intentions were limited to the destruction of Iranian nuclear facilities, the scenario would be different. In this

**A question mark remains over the use of weapons of mass destruction (WMDs), especially chemical and biological weapons**

case, the destruction could involve most of the economic resources and the infrastructure, in addition to the main facilities of Iranian armed forces. The aim here would be to cause maximum economic and security difficulties for the Iranian regime. The most hoped for outcome would be to turn the Iranian population against its own government and thereby bring about regime change as an additional bonus.

In either case, Iran would target its missile and conventional weapons against US forces in order to maximize casualties on this front. It would also try to protect its forces from swift destruction thereby allowing it to provide resistance as the conflict drags on. It is rather unlikely that Iran would carry out attacks against any military, economic or residential targets in the GCC states. This is due to several reasons including the limited number of ballistic and tactical missiles available to Iranian forces, the overwhelming air and naval supremacy of US forces all over the operations theatre, Iranian deficiency in the field of spare parts and logistics, the expected weaknesses in command and control of Iranian formations during the post-war stages, and the extensive use of advanced US air defense systems against ballistic and cruise missiles, such as the new Patriot Advanced Capability (PAC-3). What Iran might seek in using its missile capabilities is to attack US military bases inside Iraq. On Israel, Iran would probably avoid launching any long-range attacks against Israeli targets due to difficulties related to precision, and the impact and possible retaliation by Israel, which could in turn change the course of the war. The only scenario where Iran could carry out an attack against Israel is when and if the latter participated directly in a possible US war against Iran.

A question mark remains over the use of weapons of mass destruction (WMDs), especially chemical and biological weapons. Whether this option is viable and to what degree would very much depend on the initial direction of the combat operations.

*Brigadier (Retd.) Musa Hamad Al-Qallab is Defense Program Manager at the Gulf Research Center.*

*US and Allied Forces in Iraq and the Gulf*

Nationality and location of forces	2006
US forces in Iraq	121,600
Other coalition forces in Iraq including British forces	9,500 British personnel 16,360 personnel from 28 nations Total: 25,860
US forces in the UAE	1,300
US forces in Bahrain	3,000
US forces in Saudi Arabia	300 (Instructors)
US forces in Oman	270
British forces in Oman	132
US forces in Qatar	6,540
US forces in Kuwait	25,250
British forces in Kuwait	Elements of the British army
German forces in Kuwait	50
Total	184,302



# Economic Diversification and Knowledge Economy

Dr. N. Janardhan

The creation of the Mohammed bin Rashid Al-Maktoum Foundation with an endowment of \$10 billion is aimed at “contributing to the development of a knowledge-based society, by supporting and empowering young minds and focusing on research, education and investment in the infrastructure of knowledge.”

This is indeed a whiff of fresh air to the Arab world, but it is important to remember the adage that “a few flow-ers don’t make a garden.”

The acknowledgment by the UAE Vice-President, Prime Minister and Ruler of Dubai that “there is a wide

knowledge gap between us and the developed world in the West and in Asia,” is a good start. Equally laudable is his assertion that “our only choice is to bridge this gap as quickly as possible, because our age is defined by knowledge.” However, the most difficult part of the process lies in drawing up a strategy and implementing it.

It is hard to challenge the fact that the oil wealth in the region lies side by side with social backwardness. The only other region in the world with an income level lower than the Arab world is Sub-Saharan Africa. Arab countries have the world’s largest

proportion of young people – 38 percent under the age of 14. Even more alarming is the fact that more than 25 percent of the world’s un-employed youth between 15 and 24 years are in this region. Between 2002 and 2025, with Saudi Arabia’s popula-tion expected to double to 48.5 million, Egypt’s likely to grow from 73 to 103 million, and Iraq’s, from 24 to over 40 million, unemployment and its impact should indeed be a priority concern.

According to the 1999 World Devel-opment Report, “For countries in the vanguard of the world economy, the balance between knowledge and re-sources has shifted so far towards the

*Shaikh Mohammed Bin Rashid Al-Maktoum, Vice President and Prime Minister of the UAE and Ruler of Dubai, announcing the creation of a 10-billion-dollar fund to promote education in Arab countries at the World Economic Forum summit in Jordan on May 19, 2007*



former that knowledge has become perhaps the most important factor determining the standard of living – more than land, tools, and labor. Today's technologically advanced economies are truly knowledge based."

That premise rests on breaking away from the neo-classical economics model, which recognized only two factors of production – labor and capital – for over two centuries. Instead, New Growth theorists stress on a third dynamic – technology, where knowledge is seen as increasing the return on investment.

Taking a cue from this and realizing the need to diversify their oil-reliant revenues, some Gulf Cooperation Council (GCC) countries are attempting to tread the "knowledge economy" route – "one in which the generation and exploitation of knowledge play the predominant part in the creation of wealth," where human capital is the chief source of economic value, and education and training the main tools.

With respect to economic diversification, more than \$1 trillion is estimated to be involved in infrastructure and real estate projects in the GCC, with more than half of these projects already under way, translating into one of the largest construction booms in the world. The Saudi government is planning to privatize 20 state-owned corporations and institutions. The new economic cities in Rabigh, Hail, Madinah and Jizan, as well as the new industrial city in Jubail, are expected to attract over \$100 billion in investments and create about a million new jobs.

Dubai is a good example of the post-oil age in the Gulf – some statistics suggest that oil contributes to only about four per cent of the GDP, down from 50 per cent in 1975. While Plan Abu Dhabi 2030 has just been an-

nounced, it is estimated that declared projects and those under development are worth about \$400 billion. The emirate is positioning itself as a manufacturing hub with plans under way for aluminum smelters, as well as aerospace components and shipbuilding ventures. And, Qatar has earmarked \$130 billion for investments in the next six years, with about 50 percent of it going into the non-oil sectors.

Just as the GCC countries are attracting investments, they are also on a buying spree abroad. Financial institutions and government investment arms are diversifying across asset classes and regions – recent

**Higher education . . . is not just an academic exercise. It is a source of economic opportunity, industrial innovation and social progress**

estimates put Saudi Arabia's foreign assets at \$250 billion, Kuwait's has grown from \$60 billion in 1995 to over \$200 billion, and the UAE's is estimated at more than \$500 billion.

It is obvious that the GCC countries have learnt a lesson after squandering oil wealth during the 1970s. Thus, for the first time, high oil price is accompanied by economic diversification. Economic reform is also encouraging private sector growth, which in turn is providing competitive and underprivileged nationals with opportunities to take up challenging jobs, rather than rely just on the public sector.

However, while the diversification plan appears to be chugging along smoothly, the road towards creating a knowledge economy is very bumpy. While the GCC countries have the required

financial resources and leadership, it is important to ensure continuity in the core management of every enterprise that is put up, which requires a proactive national workforce.

The GCC countries suffer from a deficient educational system, particularly lacking in providing an adequate foundation for human resource development. As a consequence, this strategic and wealthy region has failed to generate a capable indigenous workforce that can keep pace with the advanced skills and technological capabilities required. Instead, the region is dependent on foreign technologies and labor.

Since the academic-industry linkage is a major force in the knowledge economy, the newfound understanding in the region is that the learning community will facilitate a rich environment of ideas, creativity and expertise that will stimulate strategic growth for companies.

Though incomparable, the hope is that expanding Western- and Asian-styled universities in the UAE, Qatar and Kuwait might end up doing what Stanford University did for Silicon Valley – provide the right human resources. Perhaps the attempt is also to draw a leaf out of Japan's modern history, which shows the benefits of investing heavily in people.

However, the GCC countries must hasten the process of exploring the interaction between technological change and human capital if diversification has to sustain. Here, it is worth emulating the Singapore model for a start.

Attributing part of the city-state's success to education in the English medium, the architect of modern Singapore Lee Kwan Yew recently told a group of young Arab and Asian leaders: "What we did was to switch



the education from native languages to English and keep native languages as a second language. It was a very difficult thing to do, emotionally. If it was done by legislation, we would have had riots. Instead we let the market decide who got the better jobs. Parents then began to shift their children into English language schools with the mother tongue as the second language. Forty years later, we are connected with the world because the modern world is in English.”

At the same time, the next phase of development in the region must focus on bridging the gap between research and application. The youth must be empowered with tools required to face the challenges of the new economy. Crucial factors that could help meet these requirements are e-learning and e-education.

The incidence and transfer of knowledge within the Gulf society could benefit from institutional support, such as the just-announced foundation, which will act as an added incentive to public spending on education and training, providing grants for research and development, and enhancing information systems. Research partnerships between higher education and public industries and private businesses could boost the region's economies and return value to the societies.

In doing all this, it is important to constantly remember that higher education and research in today's world is not just an academic exercise. It is a source of economic opportunity, industrial innovation and social progress.

*Dr. N. Janardhan is Program Manager of Gulf-Asia Relations and the Editor of 'Gulf in the Media' at the Gulf Research Center.*

*Estimates indicate that GCC states will be spending more than a trillion US dollars over the next decade to modernize and update their education systems*



# Looking Ahead: Saudi Arabia's Economy

Dr. John Sfakianakis

## Macroeconomic Landscape

Saudi Arabia's economy will continue to grow at a healthy pace despite the deceleration it will witness yet again this year. The nominal GDP is estimated to decline from SR 1,304.6 bn (\$347 bn) in 2006 to SR 1,275 bn (\$340 bn) in 2007, a 2.2 percent reduction. Real GDP will reach 3.7 percent on the back of anticipated minimal oil output increases in 2007. A 3.7 percent real GDP growth is not negligible. Placed in a regional context, the economy's real GDP growth forecast for 2007 will be double the size of Bahrain's economy. If Saudi Arabia increases its oil output, real GDP will rise above our forecast. It is estimated that an increase in the Kingdom's oil production of 5 percent will see an increase of around 1.8 percent in real GDP.

Real GDP growth for 2006 was below the forecast expectations of 5.1 percent. The decline in real GDP can be attributed to a fall in Saudi oil production. Real non-oil private sector growth was 6.3 percent, down from 6.5 percent in 2005, effectively a drop of 3.2 percent. A substantial 19.2 percent fall in wholesale, retail, restaurants and hotels in 2006 was witnessed as was a 33.3 percent fall in activity in the insurance, real estate, business service and finance sectors. It is believed that these declines illustrate reduced consumer spending associated with the stock market collapse. From the market's high (20,966) in February 2006 to the market's low (6,767) at the end

of January 2007, the market had shed around 68 percent of its index value. The 'wealth effect' that caused a consumer frenzy in 2005 made many consumers feel more spending cautious in 2006. The volatility of the stock market does not offer consolation to consumers. The market between February and mid-March rose by more than 28 percent and during the last eight

trading days of March had lost more than 15 percent of its value. Certainly, the macroeconomic effects associated with such a severe reversal in most equity markets was absent from Saudi Arabia, with no inter-related currency or banking crisis of any sort.

Economic history shows that the main factor that has pushed

*Artist's impression of King Abdullah Economic City, a 26.6-billion-dollar project to build a residential and commercial complex near the Red Sea port city of Jeddah. The project is "the single largest private sector investment" in Saudi Arabia and is expected to create 500,000 new jobs*





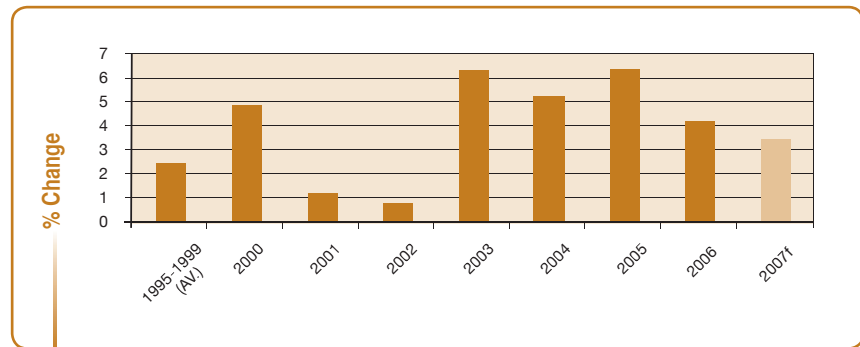
stock market crashes into deep recessions in the past was financial weakness. Virtually every severe recession in US history before World War II involved banking panics and severe financial distress. This was also the case for the UK in the first two-thirds of the 19th century. Despite the market collapse, the Saudi economy is not entering into a recession. Moreover, had the Saudi economy slowed down, as it had throughout the 1990s due to a substantial fall in oil prices, the stock market correction would have been more deeply felt and would have lasted longer.

Empirical evidence (1959-2002) from G7 countries suggests that on

average one crash occurred every 13 years, lasted for 2.5 years, and was associated with GDP losses of about 4 percent. In the case of the US and the UK, more than half the crashes were associated with recessions, five in the UK and nine in the US. Linkages between equity and housing prices are of great

significance, as equity wealth leads in most cases to increased demand for housing, pushing housing prices up. Evidence from the G7 sample shows that half of all housing price falls partly overlapped with equity price crashes, while only one-third of all equity price declines overlapped with housing price collapses.

Figure 1: Real GDP Growth, 1999-2007f (Source: SAMA & SABB Estimates)



Housing price decreases in the same group of countries (1970-2002) were less frequent than equity crashes, one every 20 years, but lasted for five years with a GDP loss of around 8 percent. Besides this is the fact that a housing collapse creates a sharper fall in consumption and real private gross fixed capital formation in machinery and equipment.

Growth in 2007 will be derived from the non-oil private sector as well as government spending. Corporate growth will be strong on the back of a very respectable year. Net income was up by 19.1 percent in 2006, albeit down from the 40.1 percent seen in 2005. Leading this growth will be the construction sector, as fixed capital expenditure continues to grow and the government continues to build large infrastructure projects. It is estimated that there is more than SR 225bn (\$60 bn) worth of construction projects underway in the Kingdom and that as construction demand continues to increase an obvious beneficiary will be the cement sector.

## Inflation

Inflation is one of the most important economic indicators of the level of well-being of an economy. We estimate inflation currently in Saudi Arabia to be at 3.5 percent and rising. Long-term persistence of inflation above real GDP can act as a growth reversal, and gradually erode real per capita GDP. However, it is believed that the economy does not face structural inflationary problems and, as a result, long-term price pressures will probably subside. Inflation is not a Saudi phenomenon but GCC-wide. Inflation in the UAE, particularly Dubai, as well as Qatar is in double digits.

Even if consumer price indices demonstrate a rise in inflation in all GCC countries, the measurement methods underestimate the rate of inflation. A rise in rents over the past year and a half and supply bottlenecks associated with the regional boom are pushing up prices. The regional inflation divergence is related to differences in capacity, supply and demand dynamics as well as the pace of growth. Although the role of "imported inflation" cannot be discounted, the recent spike in prices in Saudi Arabia can be attributed to domestic factors more so than currency volatility. Also, currency volatility (making imports more

expensive) does not translate into automatic price rises by importers. Agents, in agreement with their parent companies, can share the cost of higher imports due to currency volatility so as not to pass along an entire price rise to the consumer.

Food prices are on the rise. According to the Central Department of Statistics on a year-to-year (Q3 2006) basis, the price of fresh fruits rose by nearly 7.9 percent. Reports in the local press and our survey show that the price of fresh fruits has jumped by more than 50-80 percent. Similarly, during the same period of time, the price of fresh vegetables rose by more than 21-40 percent whereas wholesalers have raised prices by between 70 percent and 100 percent over the past year.

Demand for labor is clearly on the increase in Saudi Arabia. As the requirement rises due to the many projects being undertaken throughout the Kingdom, supply is limited due to Saudization restrictions.

Rents have also gone up over the past few months in Saudi Arabia reflecting the demand for housing and commercial, mainly office, space in the main urban centers such as Riyadh, Jeddah, Dammam and Al Khobar. Prior to recent rental hikes, rents remained well subdued for many years. However,

rents in Saudi Arabia are lower than in any other country in the GCC. Compared to the rest of the region, Riyadh is still a very affordable city.

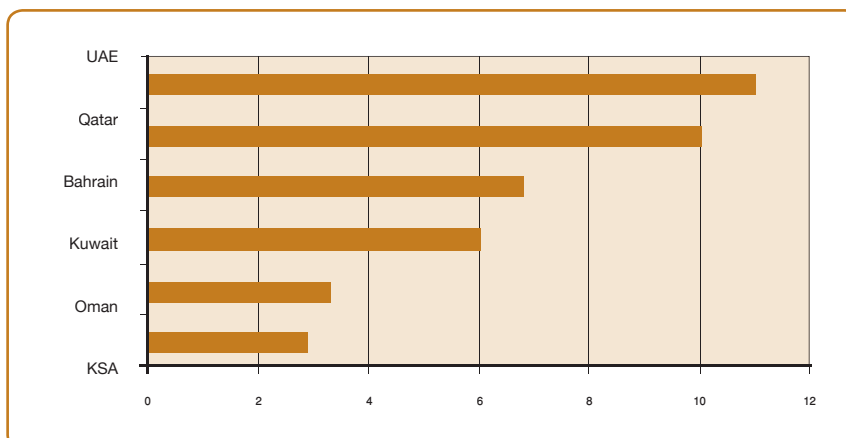
## Blame It on the Euro

Most people living in Saudi Arabia would point the finger at imported inflation (mainly from the Euro zone)

**... the economy does not face structural inflationary problems and, as a result, long-term price pressures will probably subside. Inflation is not a Saudi phenomenon but GCC-wide. Inflation in the UAE, particularly Dubai, as well as Qatar is in double digits**

as the main culprit behind the rise in inflation. Retailers blame the Euro specifically as the cause for recent price rises but, although the Euro has appreciated by around 12.5 percent during the past year, prices have risen by more than 40 percent in many retail outlets. Undoubtedly, imported inflation has been a contributor to upward price pressures in the past. As it happens, the Euro is a clear case in point as, since its introduction in 2002 to the end of 2005, it had gained 32.3 percent against the US Dollar. During the same period, Saudi Arabia's average inflation rate was a meager 0.46 percent. Specifically, between January 2002 and January 2003, the Euro appreciated by 21.2 percent whereas inflation grew by 0.2 percent during the same year (see graph). Inflation in 2003 reached 0.61 percent, but between February 2003 and January 2004, the Euro appreciated by 16.7 percent. As the Euro appreciated the following year by another 7.7 percent, inflation fell to 0.3 percent. In 2005,

Figure 2: GCC Inflation - 2006



the Euro fell by 14.3 percent but inflation was on the rise, reaching 0.71 percent by year end. One can also claim that imported inflation was low due to low import volumes. However, import growth rose strongly averaging 18.5 percent between 2002 and 2005. So other dynamics have been at play that are not attributable to currency fluctuations. Had the culprit for inflation been imported inflation, then inflation rates in many of the GCC states should have moved in tandem but they did not. It is thus the view that imported inflation has not been the main culprit of the price hikes we have witnessed over the past year. If the US Dollar weakens further, then one could see additional price pressures as importers decide to pass along the higher cost of imported goods to the consumer.

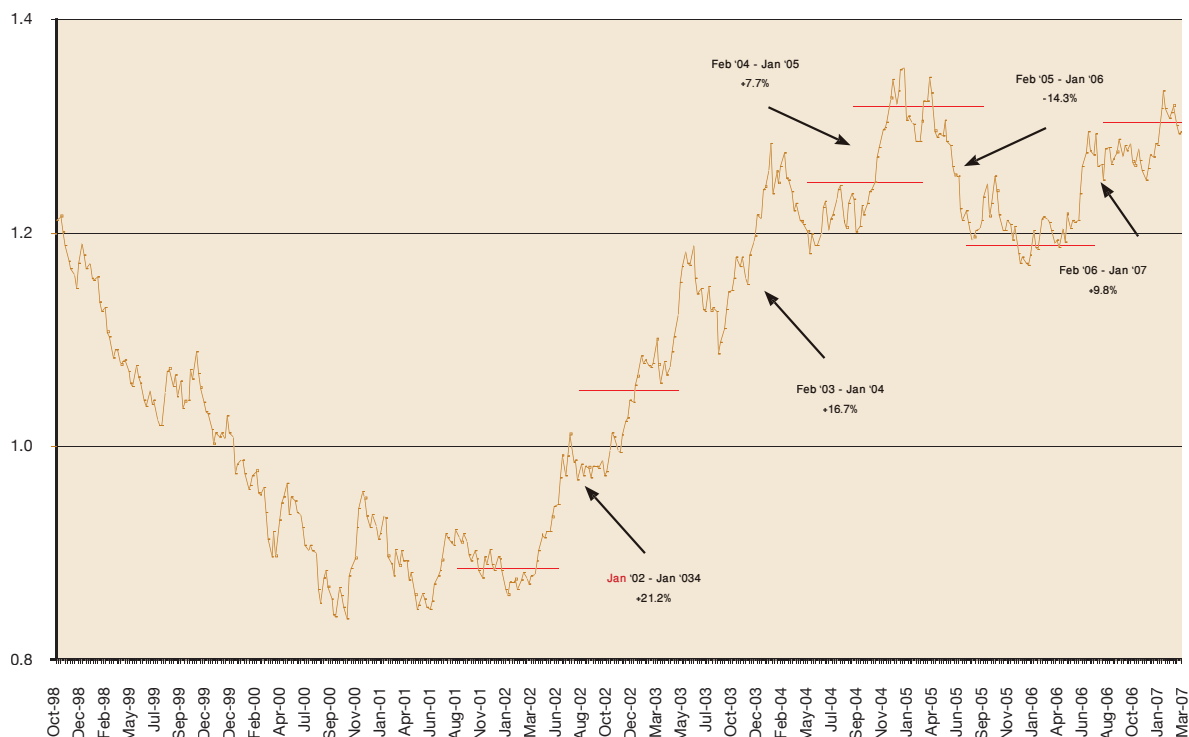
International newswires often state that about half the Kingdom's imports are priced in the Euro and the Yen but we do not think this is the case.

Around 25 percent of the Kingdom's imports originate from the Euro zone and around 9 percent originate from Japan, according to the latest available statistics (2005). Around 50 percent of the Kingdom's imports are priced in US dollars. Not all of the Toyotas driven in the Kingdom are imported from Japan. The best selling car in Saudi Arabia, the Toyota Camry, is manufactured in Australia, as is the Chevrolet Lumina, and the well-known Crown Victoria is manufactured in Canada. By the same token, US-made automobiles should be flooding the Saudi market and market share should be expanding. US automobiles have become more price competitive not so much due to the weakening dollar but mainly due to the restructuring of the US automobile manufacturers. So the terms of trade are somewhat different from what people seem to believe. Also, imports from the GCC hover around 10 percent on average and there is no currency

fluctuation since almost all GCC currencies are pegged to the dollar. However, in today's marketplace in Saudi Arabia, one finds a lot of talk about a weakening dollar and, as a consequence, a rise in the cost of imports. Retailers would often justify the rise in the price of their products, often above 40 percent, to the weakening US dollar which, on average, has fluctuated and year-on-year lost around 12.5 percent. Only since the end of February has the Yen appreciated in value by around 3 percent but during the past year its value has appreciated by not more than 0.9 percent. The way one can justify the unusually high price rises is to suggest retail greed but then again greed is part of the free and competitive market. As long as consumers are willing to buy, retailers will continue to derive the benefit.

*Dr. John Sfakianakis is Chief Economist, The Saudi British Bank (SABB).*

Figure 3: EUR-USD - Oct-'98 - March-'07





# Overlooked and Understated: EU-GCC Economic Cooperation

**Dr. Eckart Woertz**

When it comes to media reputation, the EU is in an unenviable situation. While the financial press tends to portray the US as the ever-dynamic stronghold of free market capitalism and Asian countries as aspiring new representatives of limitless growth, it often has only thinly disguised contempt for “sick man” Europe, which is allegedly trapped in a downward spiral of unfavorable demographics and bureaucratic stasis. Obvious shortcomings notwithstanding, the EU is probably doing better than these one-sided portrayals suggest; it continues to be the most important supplier of imports to the GCC, and its capital markets constitute an increasingly popular destination for Gulf investors. Reason enough to take a closer look at the reality and potential of EU-GCC economic cooperation.

Underpinned by relatively strong currencies, the EU now represents the largest economic bloc in the world in terms of GDP, slightly ahead of the US and by far surpassing the accumulated figure for the most important Asian countries. At the same time, it does not show the same amount of external vulnerabilities as the other two regions. Its foreign trade position is relatively balanced, while the US depends heavily on foreign financing for its huge current account deficit and Asian countries rely heavily on this very deficit spending to spur their export-led growth models.

Figure 1: 10 Major GCC Import Partners 2005 (Source: Eurostat)

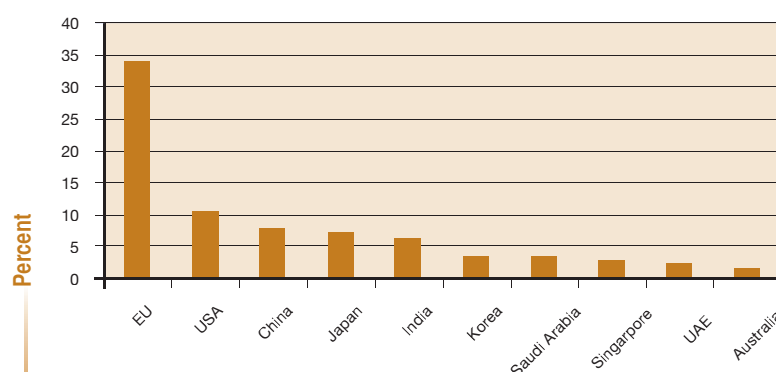


Figure 2: 10 Major GCC Export Partners 2005 (Source: Eurostat)

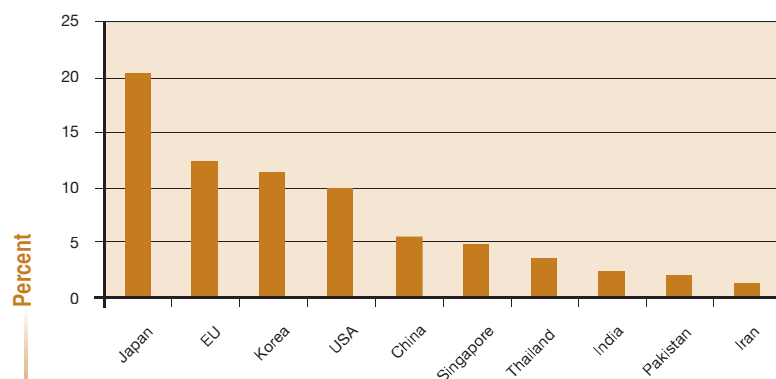


Table 1: World Economy in Perspective

\*Estimate

\*\*Hong Kong, Taiwan, Singapore, South Korea

(Source: IMF, World Economic Outlook Dataset, April 2007)

	GDP (billion \$)*	Population (in million)	Current Account
EU	14,527	487	-117.7
US	13,245	300	-857
Japan	4,367	128	170
China	2,630	1,315	239
NIC Asia**	1,566	83	87
GCC	718	36	176

## Trade

The EU is the only economic bloc in the world with which the GCC entertains a trade deficit; it is the most significant import partner of the GCC with one-third of all imports. This share, as well as the share of the US, has been declining though since 1980, while the share of Asia as a whole has more than doubled during the same time span.<sup>1</sup> Thus, one can speak of a relative decline of the EU and the US as import partners of the GCC. Still the importance of the EU in transport

equipment and development-related machinery makes it arguably a strategically very important partner along with the US, which maintains a strong presence in the supply of services and machinery to the oil sector. Asia's influence has risen tremendously and it increasingly exports more sophisticated goods, but unlike the US and the EU it does not represent a unified market with common institutions and coordinated policy approaches.

On the export side, Asian countries are dominant, as about two-thirds of GCC energy exports go to this region. Up to 90 percent of the individual GCC countries' overall exports consist of oil and gas, and not surprisingly, exports from the GCC to the EU are dominated by energy as well, although they also include a sizable share of machinery and chemicals and are more diversified than exports

to other world regions. In the 1970s, the EU relied much more on energy exports from the region; with the discovery of oil in the North Sea and increasing supplies from Africa and Russia, this reliance has diminished as compared to the past. But as oil production in the North Sea peaked in 1999 and as Western Europe feels a certain uneasiness about overt reliance on Russian supplies, the role of the GCC countries is likely to increase in the future.

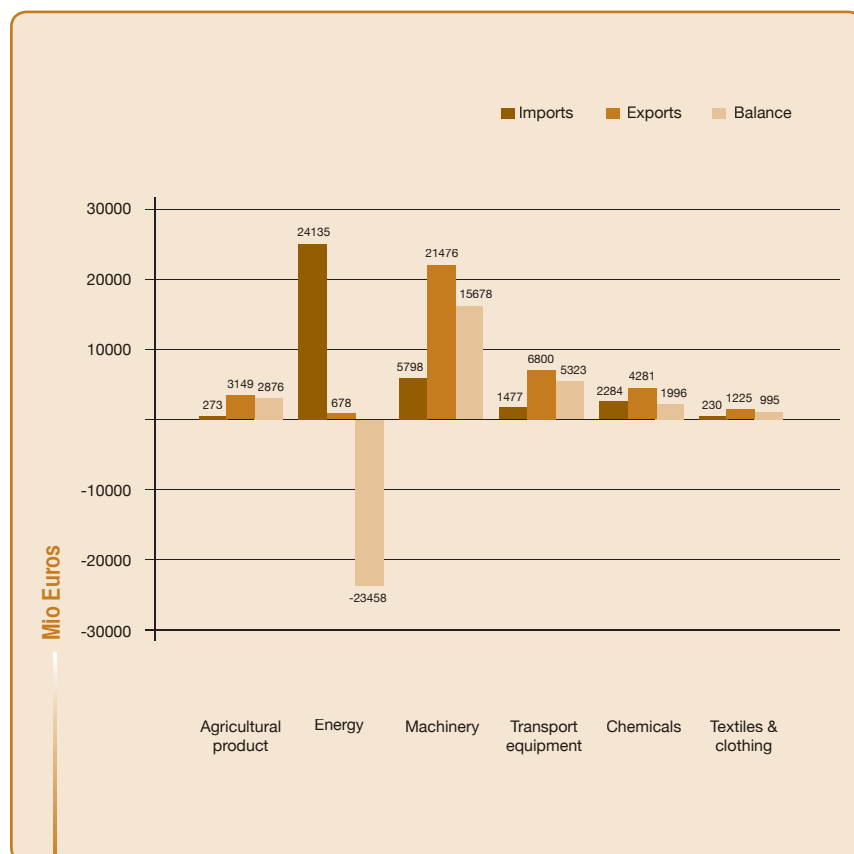
## Cross Border Investments and Financial Markets

Investments follow trade and with the rise in oil prices, the GCC countries have a lot of money to invest abroad. An increasing share of petrodollars has gone abroad, as local markets are not able to accommodate all this capital despite a boom in domestic investment activity. Currently, about half of the oil revenues is invested in international capital markets. Contrary to widespread media perception, Asia's role is still subdued; of the \$176 billion GCC current account surplus in 2006, we estimate that only \$10-15 billion went to other MENA countries and the same amount to Asia respectively, while a hefty \$150 billion was invested in Western securities markets.

Europe has become an important destination of portfolio and direct investments from the GCC and the only serious competitor for the still dominant dollar-based investments, which account for 65-70 percent of GCC foreign assets. The euro has now overtaken the dollar in terms of outstanding bank notes and market capitalization on internationally syndicated bond markets, and this year, the combined market

**The Asian FDI of GCC countries are on the rise ... but it is important to differentiate between announced deals and their actual closing**

Figure 3: EU25 Merchandise Trade with GCC by Product - 2005 in million Euros (Source: Eurostat)



<sup>1</sup> Steffen Hertog, "Renewing an Old Geo-economic Axis," GRC Gulf-Asia Research Bulletin, no.1, January 2007.

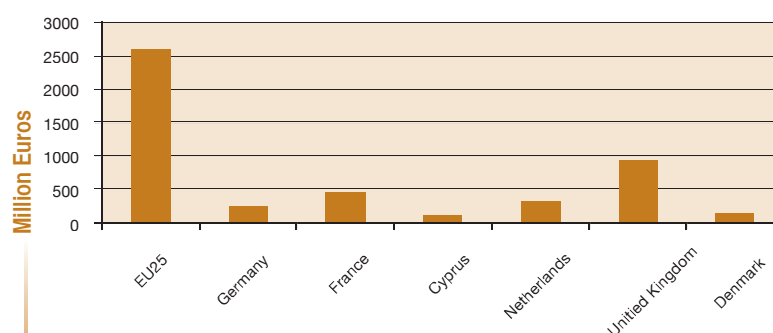
capitalization of European equity markets (including Eastern Europe and Russia) has been surpassing the ones of the US for the first time since 1914.<sup>2</sup> Furthermore, in 2006, London was a more popular destination for IPOs worldwide than New York. Of course the domestic bond market in the US is nearly three times larger than the internationally syndicated one and the dollar still reigns supreme in the dollar-priced commodities markets and the rapidly expanding derivatives markets. Thus, it would be wrong to speak of a flight out of the dollar, but the euro and other European currencies like the pound, Swedish or Norwegian kroner have established themselves as forces to be reckoned with on international capital markets alongside the still dominant dollar. In comparison, the often opaque Asian capital markets still show only modest market capitalizations to present themselves as real alternatives, and GCC

investments there have been done mainly in the form of FDI.

The Asian FDI of GCC countries are on the rise and have concentrated on energy, telecom and heavy industries- related large scale projects like refining. But it is important to differentiate between announced deals and their actual closing;

sometimes GCC countries have faced considerable bureaucratic hurdles. For example, Saudi petrochemical giant Sabic recently indicated that it may withdraw its plan to invest \$5 billion in China because of stalling negotiations. On the other hand, the US has presented itself as an increasingly hostile place for GCC FDI in the wake of 9/11 as the P&O

Figure 3: EU FDI flows to GCC Countries, Yemen and Iraq - 2005 (Source: Eurostat)



German Foreign Minister Steinmeier, his Saudi counterpart Prince Saud Al-Faisal, EU Trade Commissioner Peter Mandelson and GCC Secretary-General Abdul Rahman Al-Attiya at a meeting during the GCC conference in Riyadh, May 8, 2007. Steinmeier stated that the GCC and the EU would ink a free trade agreement by the end of the year





debacle of Dubai Ports World in America has shown.

At the same time, there have been a string of closed and well-diversified GCC investment deals in Europe like Kuwait-based MTC buying Dutch Celtel (\$3.4 billion), Sabic purchasing UK-based Huntsman Petrochemicals (\$700 million), Abu Dhabi-based Mubadala buying 5 percent of Ferrari (about \$2.8 billion) and Dubai International Capital buying 2 percent of DaimlerChrysler (about \$1 billion). Thus, the GCC has shown a clear disposition to invest in Europe, but it has frequently complained that some European companies still shy away from such moves and confine themselves to the role of mere trading partners. Apart from an outdated mindset which tends to reduce the Gulf to a politically unstable region without seeing its economic potential, possible impediments may lie in the extensive bureaucracy involved in opening or closing down a business, shortcomings in investor protection, and lack of qualified human resources as the competitiveness reports of the World Economic Forum and the International Finance Corporation have shown. On the other hand, EU FDI in the GCC has picked up again in 2005 after it went through a trough between 2002 and 2004.

## FTA and Politics

This leads to the political component of the equation. More soft-spoken than the unilateral US and more powerful than Asia, which has been confined to a mere economic role so far, the EU and its individual member countries have the potential to play an intermediate role in an unstable region, should they get their act together and find a more unified stance in foreign politics. After the GCC customs

union has been established, and progress in contentious issues like petrochemicals and aluminum has been made, the planned EU-GCC free trade agreement (FTA) has good chances of becoming the first FTA of the GCC as a whole with

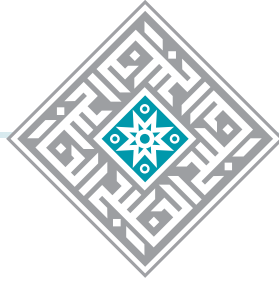
**The EU is . . . the most important supplier of imports to the GCC, and its capital markets constitute an increasingly popular destination for Gulf investors**

a major economic bloc. So far, GCC-wide FTAs only exist with Syria and Lebanon, besides the bilateral FTAs between Bahrain and Oman with the US; other FTA negotiations with Japan, China, India, Singapore, Turkey and the Mercosur are in the early stages. Thus, once an FTA is signed between the EU-GCC, important ingredients for a further deepening of EU-GCC economic ties will be in place.

*Dr. Eckart Woertz is Program Manager Economics at the Gulf Research Center.*

*The trade volume between the EU and the GCC has more than tripled since 2000 and has reached over 100 billion Euros*





# Gulf Research Center

K n o w l e d g e   f o r   A l l

Based in Dubai, UAE, the Gulf Research Center (GRC) began its activity in 2000 as a privately-funded, non-partisan think tank, education provider and consultancy specializing in the Gulf region. The GRC produces recognized research from a Gulf perspective, redressing the current imbalance in Gulf area studies, where regional opinions and interests are underrepresented.

The GRC believes that the Gulf Cooperation Council has transcended the initial reasons for its establishment, to become a fundamental right of its citizens in the development of the region. The GRC seeks to further this belief by being an institution of distinction and innovative research that advances different aspects of development to ultimately benefit the people of the region.

187 Oud Metha Tower, 11th floor  
303 Sheikh Rashid Road  
P.O. Box 80758, Dubai, UAE  
Tel. No.: +971 4 324 7770  
Fax No.: +971 4 324 7771  
E-mail: [info@grc.ae](mailto:info@grc.ae)  
Website: [www.grc.ae](http://www.grc.ae)