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High-level politics within the Gulf Cooperation Council (GCC) can be contentious at times.[1] Nonetheless, regional economic cooperation has continued to develop involving private cross-border trade and investment as well as, even if at a slower pace, technocratic cooperation on mundane regulatory issues. By many standards, GCC economic integration continues to be a success story. The public as well as high-level decision makers, however, have arguably focused on the wrong, highly visible but often too ambitious targets like monetary union. Even the much discussed customs union arguably is not as important for economic integration as less visible processes of gradual regulatory standardization and convergence that make cross-border investment easier – a process that has taken on a more important role than cross-border trade, which remains limited.

1. The GCC has had its share of political hiccups in recent years. Some of its flagship projects like the common currency or the political union appear to be stuck. In early 2014, an unusually open diplomatic conflict led to the withdrawal of three GCC ambassadors from Qatar – an even more drastic development than the withdrawal of the Saudi ambassador in the wake of the 2002 Saudi-Qatari spat.

Intra-GCC Trade and Its Limits

The GCC economies have been growing rapidly since oil prices started rising in the early 2000s. Yet, their macro-economic position in the world economy is still that of a secondary player: The total GDP of the region amounted to about $1.6 trillion in 2013 – less than that of Canada, and little more than half that of France. It is hence unsurprising that trade exchange with the rest of world remains much more important for the GCC than intra-regional trade: While the share of intra-GCC imports and exports has more than doubled since 1980, they still constitute only about 8 percent of total GCC trade today.

Trade is not only externally oriented because of the relatively small size of GCC markets relative to partner regions like Asia, Europe, or North America. There is also limited exchange of merchandise within the GCC because the region's economies are not particularly complementary: All have a similar factor endowment in terms of hydrocarbons resources, abundant capital, and relatively cheap but predominantly foreign labor in the private sector. They tend to produce similar goods also outside of the hydrocarbons sector, notably energy-intensive heavy industry products as well as assorted downstream goods.

The GCC lacks the more complex value chains that larger economic areas like the EU or ASEAN have developed. In these regions, companies from different countries jointly produce advanced products like cars, airplanes, or industrial machines; different economies contribute to different parts of the production process depending on their factor endowment, input prices, and technological capacities. Little such complementary use of comparative and competitive advantages happens in the GCC, or indeed the MENA region at large, where there is little intra-industry trade and most production happens within rather than across economies.

This is one reason why intra-regional trade is higher in ASEAN (where it constitutes more than a fifth of total trade) or Europe (where it constitutes more than half). Some of the lack of cross-border value chains is due to a lack of technological sophistication in manufacturing, which might be overcome with time. Bureaucratic and logistical obstacles to intra-regional trade in some cases also remain considerable; on several occasions, politics and administrative bottlenecks have slowed the flow of goods across borders between Saudi Arabia, UAE, Oman, and Qatar. Such issues might also be alleviated over time.

Yet, the similar factor endowments and price levels of the GCC make complex cross-border manufacturing an unlikely prospect even in the long run. If anything, it is more likely that multi-country value chains will emerge with neighboring economies with lower labor costs and capital deficits, such as Egypt or Jordan.

There is no reliable study on the macro-economic effect of trade integration in the GCC, but given current and likely future trade structures, it is obvious that the growth impact is likely to be relatively modest. The region's limited set of manufacturing activities that have achieved world scale – petrochemicals, aluminum, and to a lesser extent plastics – is outward oriented and depends on Asian demand rather than smaller regional markets.

A Regional Service Market

If potential for trade in merchandise is limited, should the GCC dial down its ambitions of regional economic integration? This would be a misguided conclusion. The GCC has focused on trade liberalization mostly because this is the traditional international recipe for regional economic integration. However, the world economy has been changing with international trade in services and cross-border investment rapidly gaining in importance. The GCC is no exception to these trends which, if anything, have been more pronounced there. Regimes of international economic integration outside of the GCC also increasingly focus on regulating trade in services and foreign direct investment – a shift that, however, has been slow to happen in the GCC, at least on the level of high politics.

Although there is a lack of reliable data, it is obvious that starting from a very low level in the early 2000s, trade in services between GCC countries has witnessed a tremendous boom. Regional and, in some cases, world champions have emerged in telecom, aviation, logistics, oil services, retail, tourism, and real estate as well as large-scale construction.

Including both private and government companies, the GCC's new service champions like Zain, Aramex, Agility, Al-Futtaim, or Emaar tend to have a much stronger regional focus than the region's (largely state-owned) manufacturing champions like SABIC or Industries Qatar. And while large state-owned airlines like Emirates, Qatar Airways, and Etihad pursue a global strategy, smaller but important private players like Air Arabia or Jazeera Airways provide predominantly regional services.

Important obstacles to cross-border service delivery continue to exist in important markets: Access to aviation markets continues to be restricted; Saudi Arabia has only recently started to open its important domestic aviation sector to competition from GCC neighbors. Access to retail banking markets also remains limited. But where cross-border service delivery has been allowed, it has flourished, drawing on genuine competitive advantages of individual companies.

For services more than for manufacturing markets, economies of scale in the GCC truly seem to matter. Proximity brings more advantages than in manufacturing, as the capability to tailor services to local needs and demands is more important, and it is not necessary to serve global markets to become a big player. Intra-GCC competition has greatly improved the choice and quality of services in the region, and the GCC service sector now arguably is more advanced than Gulf industry, with more brands that enjoy recognition even outside of the region despite their strong Gulf focus.

The UAE, particularly Dubai, has played a pivotal role in this process and continues to be the main hub of the regional service industry. Business models developed in Dubai have been successfully adopted by service exporters in neighboring markets, and Dubai itself has been an important recipient of GCC investment in its service sector.

An Integrated Investment Space

The flourishing of cross-border investment within the GCC in fact explains, to a great extent, the emergence of the unified GCC services market, which continues even as integration stalls on the political level.

Cross-border investment has been happening on a large scale in telecom, retail, real estate and tourism, health, and non-retail banking (as well as, to a lesser extent, manufacturing). It is gradually taking off in aviation. It has involved both state-owned enterprises and the private sector and has gained additional dynamism with the emergence of a regional private equity industry led by large players like Investcorp or Abraaj who have undertaken numerous mid-scale cross-border transactions covering a wide range of sectors.

Average annual inflows of foreign direct investment (FDI) into the GCC have amounted to about $30 billion since 2001, up from less than one billion during the 1990s and constituting the lion's share of total FDI in the Arab world. Critically, a third or more of the 30 billion has been intra-GCC FDI.

While there is a long tradition of Kuwaiti and Saudi FDI in Bahrain, the flows have become much more diverse during the last decade or so. The UAE with its free zones now has become the most important hub of smaller-scale investments. The authorities of different emirates issued 30,425 trade licenses to GCC nationals between 2000 and 2012, of which 43.2 percent were given to Saudi citizens.

Saudi Arabia, in turn, has become particularly attractive to investors from its GCC neighbors because of its large and growing market size and because it is relatively less accessible culturally and administratively to non-GCC investors, giving Gulf businesses a strategic edge. UAE-based real estate and tourism companies like Emaar, Damac or Rotana, for example, are increasingly present in Saudi Arabia. The Saudi market accounts for about half the order book and revenues of Dubai contractor Drake & Scull.

Other new links include Kuwaiti and UAE retailers in Saudi Arabia, Saudi and Kuwaiti media investments in the UAE, large-scale investments of Qatari real estate companies in Oman and large cross-border telecoms investments involving all GCC countries as either source or recipient.

Standardization and Convergence below the Radar Screen

Such increasingly integrated service markets have not emerged in a regulatory vacuum. Although apparently less of a priority on the political level, GCC administrations have made significant efforts to open up important sectors to foreign investment and unify regulatory standards. The GCC countries have worked on giving regional investors the same legal status as locals under the GCC common market, even if in practice these policies have experienced teething problems. Where the policies have worked, they have had a direct, positive impact for consumers. In Qatar, for example, traditionally a high-price country with limited domestic competition, car dealers now have to compete with sales agencies from neighboring countries, which has led to a reduction in prices.

Standardization has also happened with regard to product standards, metrology, or portability of social insurance benefits, which has allowed GCC citizens to work in neighboring countries more easily. Though many higher-profile integration policies such as an integrated airspace, joint financial markets, or monetary union remain stuck, there has been much unsung progress on lower-profile matters of liberalization and standardization.

Not all investment reform and regulatory convergence has happened under GCC auspices: In the Saudi case, for example, investment liberalization of core service markets happened in preparation for WTO accession in 2005. Many other steps of FDI liberalization across the GCC – such as the creation of free zones or the opening of retail and real estate sectors to foreign investors – have been general rather than GCC-specific.

In fact, much of the FDI opening and regulatory streamlining has been an outcome of intra-GCC competition rather than cooperation: With the UAE setting the standards of investment-friendly regulation, GCC governments have felt increasing pressure to make (and keep) their markets attractive as destinations for international and regional investors.

It has often been exactly the rivalry that leads to non-cooperation on the official level which has pushed governments to compete with each other for investors. The net effect of this ironically has been integration. The most important beneficiaries of investment liberalization, even if global in nature, have often been GCC businesses who could easily use their local expertise and infrastructure to expand into neighboring markets.

A Rationale for Future Economic Integration

The further integration of service markets and facilitation of cross-border investment should therefore be the main focus of future GCC economic integration efforts. It is not possible to make precise predictions of the macro-economic impact that such policies would have. Yet it is clear that structurally speaking, diversification and integration of service markets has been a critical step away from hydrocarbons dependence in the region – Dubai is a good example of a post-hydrocarbon economy which among all GCC markets is also the most integrated and involved in cross-border service delivery and FDI.

The tangible benefits that cross-border services and investments have delivered for GCC citizens are also obvious: better and cheaper mobile services, much better options for air transport, local and regional tourism, as well as more diverse and competitive retail sectors. Through service market integration, more than perhaps any other GCC-level economic policy, regional governments can build a popular constituency that supports further regional cooperation.

Compared to service and FDI integration, the benefits of the higher-profile monetary union project appear less significant: As most GCC currencies are already tied to the US dollar, the impact would mostly consist in reduced cross-border transaction costs – an important but by no means the only step towards further facilitating a common GCC market. Given the high political and symbolic stakes involved in the monetary project, investment in more mundane processes of standardization and sectoral opening are likely to have a better payoff.

This does not mean that GCC decision makers should give up on goals like a monetary union. They should also continue to pursue the (trade-oriented) customs union, where a recent agreement on revenue-sharing may pave the way for concrete progress. At the same time, however, more political capital should be devoted to the “nitty gritty” of common market integration, including the opening of critical sectors like aviation or banking, and further regulatory and administrative opening and convergence in retail, telecom, construction, tourism, and logistics.

Important initiatives are under way in areas as diverse as GCC-wide sharing of credit information and health records, the establishment of joint construction standards, and the regulation of telecom roaming prices. They are, for the most part, progressing only slowly as they receive limited high-level attention. While it is true that none of these initiatives are likely to make international headlines, their cumulative impact on regional integration can be much more profound than that of the GCC's traditional flagship projects.

"Nitty-gritty" integration requires perseverance and specialized administrative capabilities. For this, further administrative and policy planning capacity needs to be built both at the national and the GCC secretariat level, not only to coordinate and improve regulation, but also to generate better data on cross-border FDI and service flows. Policymakers should also consider commissioning regular surveys and focus groups probing the needs and complaints of cross-border investors so that regulation is focused on the issues that really matter, and private-led initiatives can continue to lead regional integration.

Once set in motion, more diffuse integration of standards and processes is less likely to become hostage to diplomatic conflicts over symbolic issues such as names and locations of new GCC institutions. More easily than monetary union, for example, diffuse integration allows for flexible cooperation under which some countries can move ahead with deeper standardization without creating political issues. On economic integration, perhaps the GCC should aim less for large, headline-grabbing initiatives and dare to be a little more boring.

About the Author

Steffen Hertog is an associate professor of comparative politics at the London School of Economics. His research interests include Gulf and Middle East politics and economics as well as the political economy of the developing world more broadly. He has published in journals such as World Politics, Review of International Political Economy, Comparative Studies in Society and History, and International Journal of Middle East Studies. His book about Saudi state-building, "Princes, Brokers and Bureaucrats: Oil and State in Saudi Arabia" was published by Cornell University Press in 2010. He has worked with the World Bank, OECD, GIZ and the European Commission on numerous projects relating to labor market, public sector reform, and trade issues in the GCC region.