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EU-GCC free trade agreement: Adjustments in a factors proportion model for the UAE

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ABSTRACT

The EU-GCC Free Trade Agreement would likely cause price changes across industries with subsequent effect on output and factor price adjustments. With higher levels of trade, the rising income will be redistributed among winner and loser industries and factors of production. This paper simulates the magnitude of these adjustments with a factors proportion model of production and trade for six different labor categories and capital in four sectors of the UAE economy. Results show a large impact on sector specific factors but for mobile factors, the shocks would be smaller suggesting a policy to increase factor mobility in the UAE.

1. Introduction

The Gulf Cooperation Council (GCC) countries (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates) are negotiating a free trade agreement (FTA) with the European Union (EU) stimulated by the increasing number of young workers entering the labor force and structural reforms to reduce their public sectors. The EU-GCC FTA will increase but redistribute national income with some industries enjoying increased export demand while others suffering from import competition.

The UAE economy is the second largest in the GCC after Saudi Arabia. The combined GDP of GCC countries is $ 646 billion. Saudi Arabia's GDP represents 42% of the GCC followed by the UAE with 27%. However, in terms of GDP per capita, Saudi Arabia ranks last with $ 13,600 while the UAE second with $ 26,610. Qatar has the highest GDP per capita in the GCC with $ 32,000, all these based on 2006 estimates.

According to the *Economist*, during 2002–2006, GCC countries exported a total $ 1.5 trillion, of which $ 1 trillion have been spent in imports. As reported by Table 1, in the period 2002–2006, UAE exports amounted to $ 469.7 billion or 31% of GCC exports, while imports totaled $ 307.3 billion or 30% of GCC imports. Further, Table 2 reports that over the same period an average of 30% of total UAE imports came from the Euro zone while 70% from other countries.

In the last 2 decades, the UAE has managed to diversify its economy with outward looking development moving it from the most oil dependant GCC country (90% of GDP in 1980) to the least (37% in 2006). The federal UAE government allows individual

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Table 1
United Arab Emirates. Exports/imports, 2002–2006 (in billion of USD).

	Total	2002	2003	2004	2005	2006
Exports	469.7	52.5	67.2	90.2	117.2	142.6
Imports	307.3	37.5	45.8	63.4	74.5	86.1

Source: IMF Country report No. 07/748.

emirates to develop specializations, namely energy and petrochemicals in Abu Dhabi, tourism and services in Dubai, light manufacturing in Sharjah, and heavy industry in Ras Al-Khaimah. UAE exports have evolved from oil, petrochemicals, fertilizers, cement, and aluminum to include electronics, light manufacturing, machinery, and transport equipment. The UAE has developed banking and tourism although other services such as telecommunications and insurance remain less developed and closed to foreign investment and competition. With free trade, tariffs on UAE exports of petrochemicals and aluminum to the EU would be eliminated, a significant achievement for the UAE on a contentious issue that had delayed the free trade pact for some time. The EU has demanded the GCC to open all the services sectors to foreign competition and while the GCC agrees in principle it is also seeking reciprocity from EU countries.

The GCC is a fully functioning custom union and most imports from non-GCC countries face a duty rate of 5%. However, over 400 tariff lines mainly food stuffs and industrial inputs carry a zero tariff. In this unorthodox custom union, member countries are allowed to nominate a list of "protected commodities" on which they charge a duty rate than ranges from 12% to 20%, thus there is no common external tariff (CET) among GCC countries for a substantial number of protected commodities. For example, Saudi Arabia has listed 839 protected commodities, the most of any GCC country member.

The present application of the factors proportion model of production and trade or the Heckscher–Ohlin–Lerner–Samuelson (HOLS) model simulates the effect of expected price changes on output and factor payments across four economic sectors of the UAE. The factors proportion model has become a standard model in the literature although more sophisticated models are now being used to analyze the impact of free trade. However, the limitation of data both in quantity and quality in the UAE and GCC countries (Al-Mansouri and Dziobek, 2006) makes it difficult to conduct the present study with a more sophisticated trade model. A major advantage of the factors proportion model is its minimal data requirement. Fortunately, there is enough data from 2003, the latest available, to calculate the factor payment matrix for the UAE in order to conduct a preliminary study of the potential impact of free trade between the EU and the GCC. The expectation is to identify important policy issues for the local economy. Only a very limited number of studies have been conducted on this topic and policy implications are scarce as in Sturm, Strasky, Adolf, and Peschel (2008), and Boughanmi (2008).

This paper also looks into the potential effect of labor immigration on wages and output. This is important and relevant for the UAE where about 90% of the labor force in the private sector is foreign.

The four economic sectors included in this study are:

Agriculture (A): fishing, dates and fruits, vegetables, meat, poultry and dairy products
Industry (I): crude oil, gas, petrochemicals, cement, and fertilizers.

Table 2
United Arab Emirates. Direction of trade, 2002–2006 (percentages).

Exports to	2002	2003	2004	2005	2006
United Kingdom	27.2	26.2	24.9	24.5	25.9
Belgium	1.0	1.0	1.6	2.1	1.6
Netherlands	0.3	0.5	1.1	3.2	0.7
Germany	0.4	0.5	0.5	0.5	0.6
France	1.1	1.2	1.0	1.1	1.6
Other countries	70.0	70.6	70.9	68.6	69.6
Total	100	100	100	100	100
Imports from	**2002**	**2003**	**2004**	**2005**	**2006**
Germany	7.1	8.0	6.5	5.9	6.2
United Kingdom	7.4	5.7	6.2	10.0	5.5
France	6.6	6.7	6.1	4.7	4.1
Italy	5.1	4.3	3.9	3.5	4.0
Netherlands	2.5	1.5	2.4	2.3	2.2
Belgium	1.6	0.0	1.7	1.7	1.7
Switzerland	3.6	3.4	1.3	1.2	1.3
Finland	0.7	1.0	1.8	1.6	1.0
Spain	1.2	1.1	0.9	0.8	0.9
Other countries	64.2	68.4	69.2	68.3	73.1
Total	100	100	100	100	100

Source: IMF Country report No. 07/348.