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Article

Further integration with the EU: Just one ingredient in the reform process

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The Mediterranean Region
A Special Report

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Summary

This paper provides a broad survey of the economic situation in nine Mediterranean Partner Countries, and assesses the impact of the Euro-Mediterranean association agreements. The starting point of the analysis is the observation that overall economic performance of the region has been relatively poor when measured as growth of income per capita. Several factors are likely to have contributed to this. Investment in physical and human capital has both been lower and less efficient than in more successful developing economies. In addition, inward-looking development strategies have been combined with extensive state ownership and overall involvement in the economies to produce a high degree of protection. This has hampered competition and limited the gains from trade, leading to low productivity growth.

In light of this experience, it is argued that the Euro-Mediterranean trade agreements are a necessary but not a sufficient element in bringing the region onto a more promising path of economic development. The freeing-up of trade with the EU needs to be accompanied by domestic economic reforms on a broad scale to facilitate needed structural transformation and to reduce the fiscal dependency on tariffs. Similarly, the Mediterranean countries need to remove trade barriers also between each other, so as to create a sufficiently large regional market to attract the foreign direct investment necessary to modernise their economies.

Further integration with the EU: Just one ingredient in the reform process

"There can be no greater error than to expect or
calculate upon real favours from nation to nation"
George Washington

1. Introduction

Too much inequality in a neighbourhood may result in socio-economic disruption. Indeed, there is a consensus within the European Union that increasing the standard of living in neighbouring countries in the Mediterranean is pivotal to prevent political instability in the area with the associated risk of large-scale economic migration to the EU. With EU unemployment still being substantial - especially in Southern Member States - and given the recent revival of extreme right parties across Europe, both the Council and the Commission have identified this area as a key external relations priority for the EU.

The EU's policy toward the Mediterranean region is governed by the Euro-Mediterranean Partnership, which was launched at the 1995 Barcelona Conference (hence called the Barcelona Process). The central idea is that further integration with the EU provides considerable potential to foster economic growth for small and rather closed economies such as those in the Mediterranean (here and elsewhere in this paper we use the term Mediterranean loosely to mean the 12 Partner countries located around the southern and eastern borders of the Mediterranean Sea (1)). The Partnership aims at establishing a Euro-Mediterranean free trade area by 2010 (Box 1 recalls in a general fashion different stages in the process of regional integration). To help this process the Union has promised a major financial contribution to support the modernising efforts in the region.

The Euro-Mediterranean free trade area is to be achieved mainly through "Euro-Mediterranean Association Agreements" between the EU and individual Mediterranean countries. Table 1 summarises the status of the Euro-Med Agreements. The process seems to have been slower than expected given that Agreements with only four partners - namely the Palestinian Authority, Tunisia, Morocco and Israel - have become effective since 1995 (2).

Institutional factors in the Mediterranean countries are likely to have contributed to the moderate pace of putting the Agreements into place. However, more fundamental concerns as to the merits of such Agreements for the Mediterranean countries appear to have played a role as well. It is this paper's thesis that the further integration of the Mediterranean countries with the EU in the framework of the Euro-Med Partnership will contribute to the development of the region. At the same time, we see significant scope for accelerating the development process. For one thing, a case can be made for trade liberalisation that goes beyond what is envisaged under the Agreements. For another, there remains considerable room for improvement outside the realm of trade policy.

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1) These are Morocco, Algeria, Tunisia (Maghreb); Egypt, Israel, Jordan, the Palestinian Authority, Lebanon, Syria (Mashrek); Turkey, Cyprus and Malta. Libya currently has observer status at certain meetings. Since Cyprus and Malta have started accession negotiations with the EU, they are omitted from this analysis. Turkey has also become a candidate for EU membership since the Barcelona Conference. In any case, most of the issues to be covered by the Euro-Med Agreements already apply to Turkey. Its Association Agreement with the EEC/EU came into force on November 1, 1964 and its Customs Union Agreement on December 31, 1995.

2) Egypt has finalised its agreement, which is expected to become operational in the near future.

Box 1. From shallow to deep regional integration

Preferential Trade Agreements (PTAs) reduce trade barriers between countries that are signatories to the Agreement. The reduction is not granted to non-PTA members and thus constitutes a deviation from the most-favoured-nation principle (MFN), which stipulates that a country's trade barriers - including their reduction - should apply in a non-discriminatory way to all other countries. Members of the PTA are free to choose their external trade policy that governs their trade with non-member countries.

The preferential reduction in trade barriers can be asymmetrical or reciprocal. In the former case, one country - or a group of countries - offers trade concessions to another country without requesting the same concessions. Under a reciprocal PTA, partner countries grant each other the same reduction in trade barriers.

Free Trade Agreements (FTAs) are PTAs that establish free trade between partner countries while still leaving it up to them to set external trade policies vis-à-vis non-members. As there is no external trade policy, a FTA can fulfil its purpose only if member countries follow rule of origin and contents rules. Both need to be applied to ensure that goods traded freely among members are really member countries' products and not goods that are merely transhipped - possibly with only token value added generated in the FTA area - through the country with lowest external trade protection.

In a **Customs Union**, FTA partners pursue a common external trade policy. This substantially reduces the "whose is whose" problem. A further deepening of integration is the objective of forming a **Common Economic Area** and a **Single Market**. The former adds the use of common rules and technical standards to the Customs Union and the latter tops that by completely dismantling all barriers to trade, the exchange of services, and to the movement of capital and labour.

The remainder of the paper is organised as follows. The next section starts off with a description of the economic situation in the Mediterranean region, and includes a closer look at three countries (Egypt, Turkey and Tunisia). Section 3 moves on to a review of the cooperation between these countries and the EU. The benefits and costs of the regional trade integration envisaged under the Agreements take centre stage. From this, section 4 draws some conclusions on the ways and means of putting the southern frontier of the EU on a more promising path of economic development.

Table 1. Status of Euro-Mediterranean Association Agreements

Partner	Conclusion of negotiations	Signature of agreement	Entry into force
Tunisia	June 1995	July 1995	March 1998
Israel	September 1995	November 1995	June 2000
Morocco	November 1995	February 1996	March 2000
Palestinian Authority	December 1996	February 1997	July 1997
Jordan	April 1997	November 1997	-
Egypt	January 2001	June 2001	-
Lebanon	in progress	-	-
Algeria	in progress	-	-
Syria	in progress	-	-

Source: European Commission, 2000b, and the EU DG External Relations web site:
http://europa.eu.int/comm/external_relations/med_mideast/euro_med_partnership/conf/marseilles/bp_5_yr_en.pdf

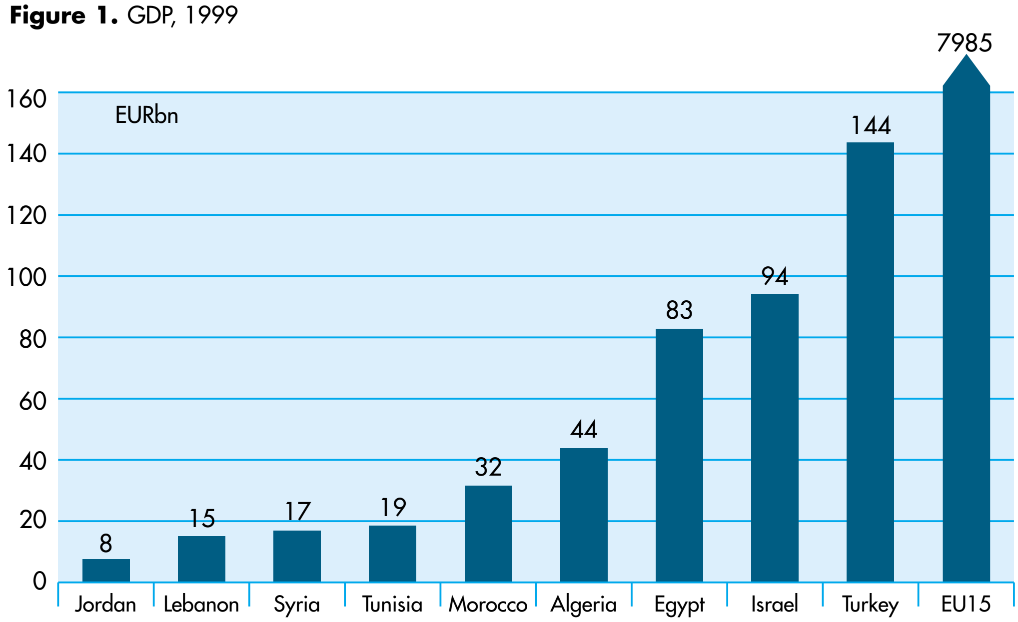
2. A brief overview of the Mediterranean region

2.1 Growth, human capital and investment

After decades of moderate economic performance and high population growth, the Mediterranean countries face low standards of living.

While the Mediterranean countries have a population that is equivalent to around 60 percent of the EU population, Figures 1 and 2 reveal that their economic size is considerably smaller. For instance, in 1999 the region's GDP reached just 6.5 percent of Europe's - it was, in fact, only slightly higher than that of Spain. Only three countries account for about three quarters of the regional product (namely, Turkey, 32 percent; Israel, 21 percent and Egypt, 18 percent), but it is only in Israel where this is due to much greater income per capita rather than population size (see Table 2) (3). Thus, after decades of moderate economic performance and high population growth, the Mediterranean countries still have comparatively low income levels. With the exception of Israel, Mediterranean standard of living - measured as income per capita in terms of purchasing power parities - stands at merely 10 percent of that in the Union.

Figure 1. GDP, 1999

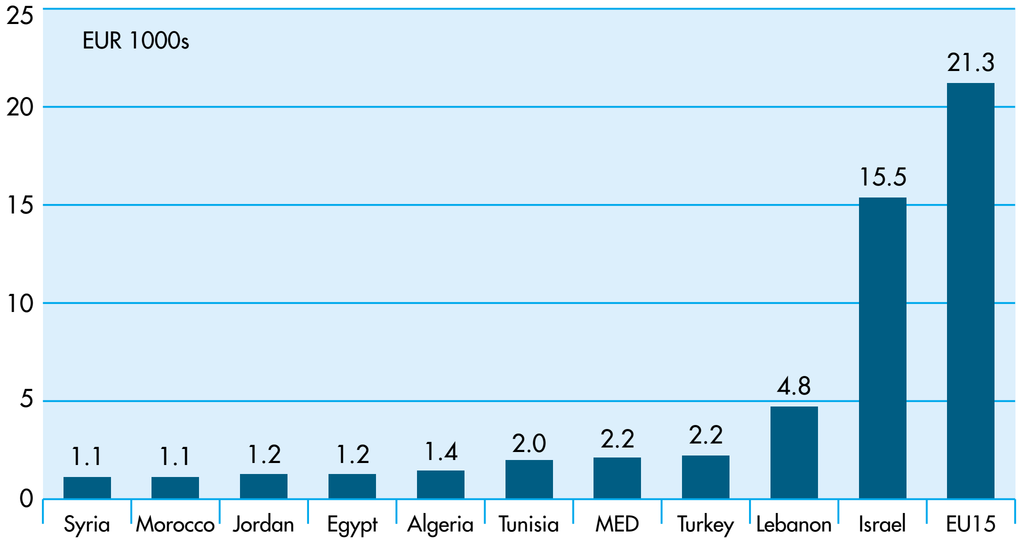


Source: IFS, Eurostat and World Development Indicators

Most of the economies suffer from a substantial handicap concerning human capital. In spite of an improvement since 1990, between one third and half of the labour force is illiterate in Algeria, Egypt, Morocco and Tunisia - and these countries account for almost 60 percent of the region's population. In middle-income countries, the average stood at 15 percent in 1997, and was of the order of 1 percent in the most advanced Central and Eastern European countries (see Table 3).

3) These tables and charts are based on a variety of sources, including IFS, Eurostat and the World Development Indicators. However, data for the region is often criticised for its unreliability. Syrian and Egyptian statistics are known to be particularly problematic. In Syria, for instance, there is a large difference (of roughly 4:1) between the official and unofficial - but widely used - market exchange rates. Using the official exchange rate would tend to overstate the size of the Syrian economy relative to other countries in the region. For comparative reasons we have therefore chosen instead to apply the market rate in this case.

Figure 2. GDP per capita, PPP, 1999



Source: IFS, Eurostat and World Development Indicators

Table 2. Size and growth of population, and real GDP growth

	People	Population growth		GDP average real growth	
		historical	forecast		
	1999	1995-99	1999-15	1980-90	1995-99
	Million	%	%	%	%
Algeria	30.8	2.3	1.7	2.7	0.8
Egypt	67.2	1.8	1.5	5.4	3.0
Israel	6.1	2.4	1.6	3.5	3.5
Jordan	6.5	3.1	2.3	2.5	1.3
Lebanon	3.2	1.9	1.2	..	7.3
Morocco	28.2	1.7	1.4	4.2	2.4
Syria	16.1	3.3	2.1	1.5	7.4
Tunisia	9.5	1.4	1.2	3.3	5.8
Turkey	64.4	1.5	1.2	5.4	0.4
EU	374.9	0.3	-0.1	2.2	2.5
MED	232.0	1.9	1.5	4.0	3.0

Source: IFS, Eurostat and World Development Indicators

Most of the economies suffer from a substantial handicap concerning their human capital.

With such low levels of schooling, indicators for knowledge generating activities in the region are bound to be low. Table 3 for instance, shows that, except for Israel, average expenditures on R&D stand at only about 0.3 percent of gross national product - compare this with the 1 percent of other middle-income countries. In Egypt, the number of scientists and engineers in the population reaches a quarter of the EU level, but for the region as a whole this figure still stands far behind that observed in Central and Eastern Europe.

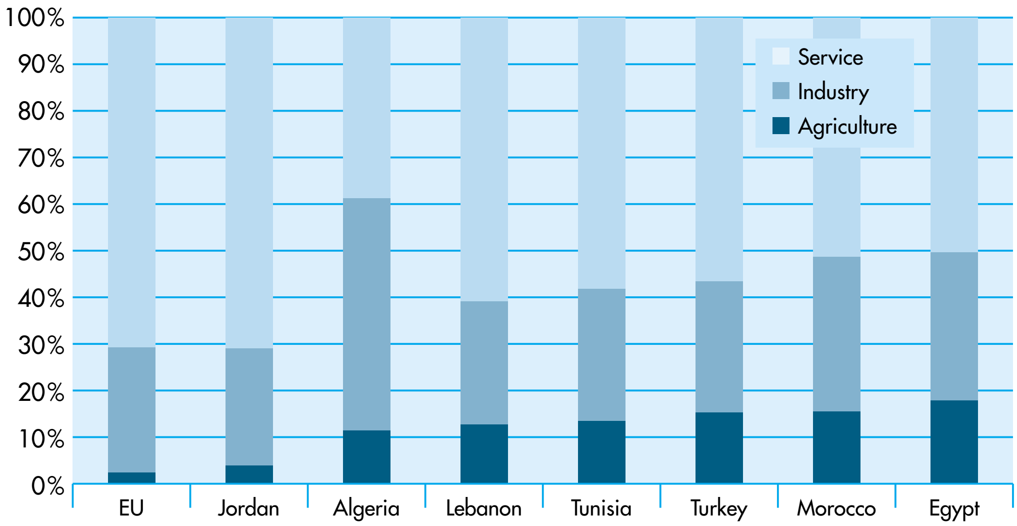
Table 3. Adult illiteracy rate and knowledge generation indicators

	Adult illiteracy rate (%) of people over 15 years old		Knowledge generation: Expenditures for R&D as % of GNP	Knowledge generation: Scientists and engineers in R&D per million people
	1997	1990	1994-97	1994-97
Algeria	40	47	..	..
Egypt	47	53	0.2	495
Israel	5	6	2.2	..
Jordan	13	19	0.3	94
Lebanon	16	20	..	..
Morocco	54	61	..	..
Syria	28	35	0.2	30
Tunisia	33	41	0.3	119
Turkey	17	21	0.4	264
Czech Rep	..	..	1.2	1210
Hungary	1	1	0.8	1049
Poland	0	0	0.8	1358
EU	..	..	2.0	2126
Middle-income	13	15	0.9	..

Source: Eurostat and World Development Indicators

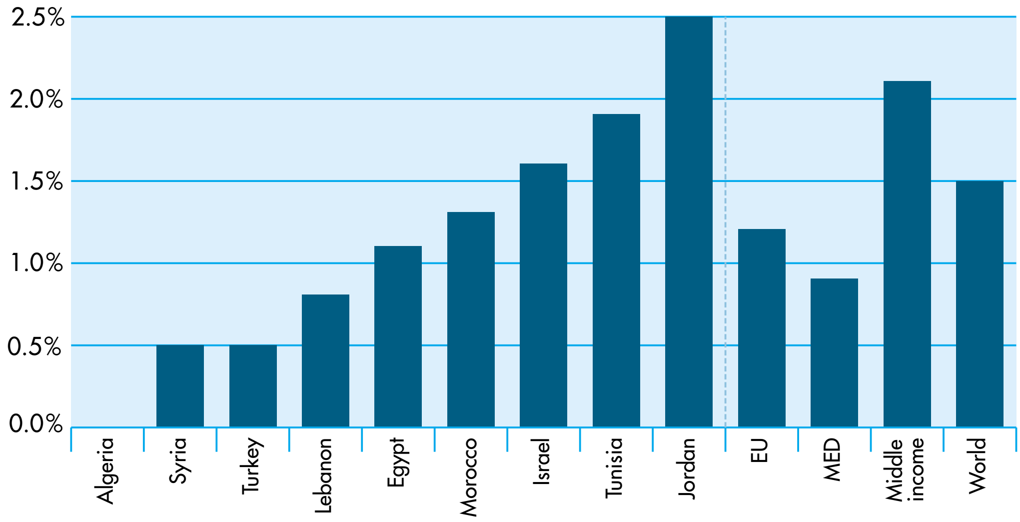
Lack of investment in skills and technology may also explain why agriculture still is important in the area (see Figure 3). For instance, in Egypt and Turkey, together good for nearly half of the region's production, agricultural value added contributes 15 - 20 percent of GDP. Industrial activity is more important in Algeria, but this is mainly due to gas production. In general, manufacturing is dominated by non-human capital-intensive sectors such as textiles, chemicals and food processing account.

Figure 3. Composition of GDP, 1997



Source: World Development Indicators

Figure 4. FDI (net inflows) as a percentage of GDP, average 1995-98



Source: World Development Indicators

Importing technological know-how through FDI would be a way out for the region, but actual FDI is lagging far behind that observed in other medium income countries.

One way for countries to deal with these issues is to import technical know-how via foreign direct investment (FDI). However, Figure 4 illustrates that, on average, net foreign direct investment reached only 0.9 percent of the region's GDP in the second half of the 1990s (increasing from 0.7 percent in the late 1980s). This should again be compared with the performance of other middle-income countries, which experienced an increase in net inflows up to 2.1 percent of GDP. Drivers behind this are meagre FDI inflows particularly in the larger economies (Egypt, Syria, Turkey), with some of the smaller countries doing better. The FDI that takes place in the region is dominated by a relatively small number of sectors including petroleum and mining (e.g. phosphates), basic industries such as chemicals, cement and steel, labour intensive export industries such as textiles and clothing, and tourism.

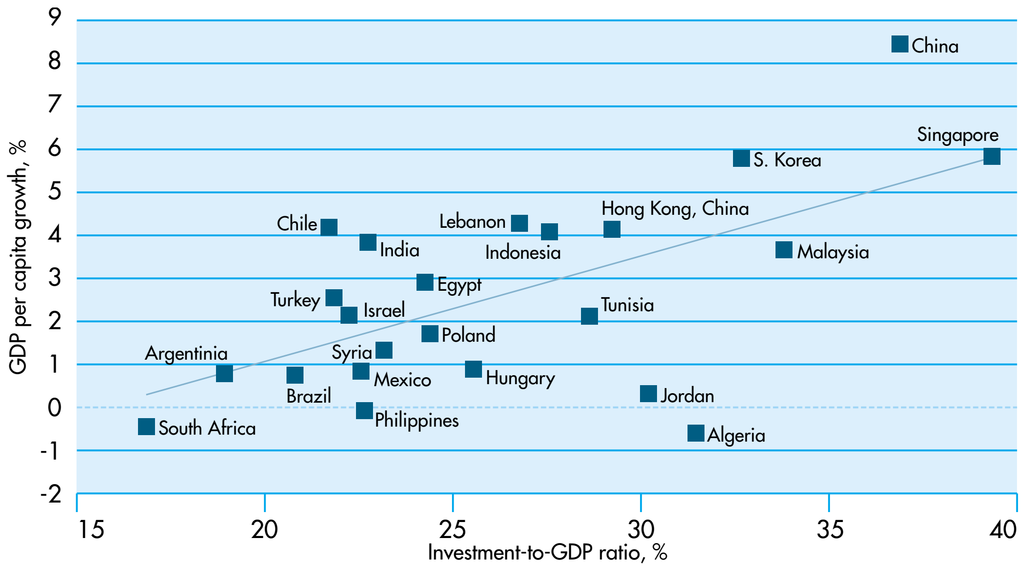
Weak capital inflows coupled with low domestic savings means that investment is too low to allow a catch-up with the EU average standard of living within a reasonable time horizon even if investment were to become much more efficient. For instance, in order for the Mediterranean region to reach 50 percent of the EU average standard of living by 2050 requires an additional 3 percent on top of the EU annual rate of growth of income per capita, or a Mediterranean per capita growth rate of roughly 4 ½ percent per annum. Figure 5 indicates this will require a high investment share - most likely of well over 30 percent. Instead, the actual regional investment level has been just over 20% of GDP. It should also be mentioned that a number of countries are situated far below the regression line, in spite of reasonably high investment shares. This observation implies that the *efficiency* of investment has been poor in these economies.

Low efficiency of investment should not surprise us too much, as a number of indicators illustrate the overextended government involvement in the region. Abrahart, *et al.*, (2000) show that public enterprises accounted for around 30 percent of GDP in Egypt and Tunisia in the early 1990s, and nearly 60 percent in Algeria, compared with only around 10 percent in other middle-income

Capital formation is too low and too inefficient to induce catch-up growth. Weak capital inflows, low domestic savings and a large public sector are key to this outcome.

countries (4). Since the pace of privatisation has been moderate, this situation has not changed substantially in the past decade. The World Bank (2000a) reports that non-military government employment still accounts for approximately one-fifth of total employment in the Mediterranean countries, twice the global average. The same study shows that this situation has been persistent. A side effect of the predominance of state enterprises is that public investment accounted for close to 40 percent of total investment in the 1995-98 period, nearly the double of that of the middle-income countries and roughly four times that of the European Union. In combination with a highly distorted incentive structure stemming from price controls, subsidised loans and import protection, it is highly unlikely that these investments have gone to projects enjoying the highest economic and social rate of return. State ownership is thus likely to be another key factor behind the persistence of low economic growth.

Figure 5. Investment-to-GDP ratio versus GDP per capita growth, 1980-98



Source: World Development Indicators

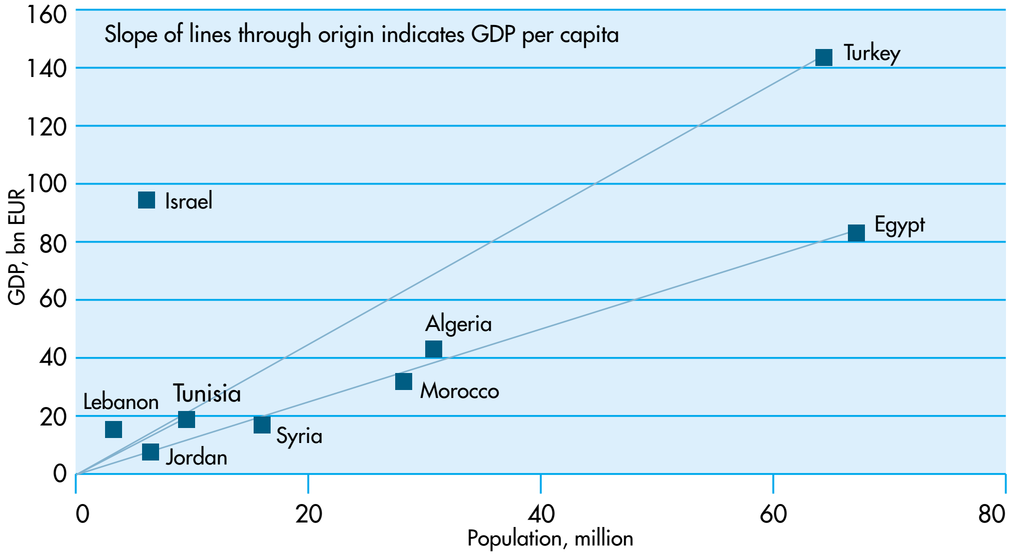
2.2 Three case studies

The general economic and structural trends outlined above apply to most non-EU Mediterranean countries. With the notable exception of Israel, all countries have relatively low levels of income as a result of a long history of modest per capita growth rates. These poor growth performances are in most cases the outcome of misguided development strategies. Behind these common threads, however, lie differences across countries. In order not to over-generalise the Mediterranean region, in this section we discuss three separate case studies of Egypt, Turkey and Tunisia (5). Figure 6 shows how these countries relate to the others in the region in terms of GDP and population. The comparison aims to show that improving economic performance may require a much more broad-based approach to reform than most Mediterranean countries have so far employed, while partial and selective reforms may continue to yield relatively small returns in terms of growth.

4) Ottolenghi (1998) notes in his context that an important problem is also the economic soundness of public banks, as they hold important portfolios of bad loans. These loans had been given priority to State-owned enterprises that turned out not to be profitable.

5) This section draws on country analysis by the Economist Intelligence Unit (2000a,b,c), the Institute of International Finance (2000, 2001a,b), the International Monetary Fund (2001a,b), and the World Bank (1998, 2000b).

Figure 6. GDP, population scatter plot



Source: World Development Indicators and Eurostat

Egypt

Recall that Egypt accounts for about one-fifth of the region's GDP; however, on a per-capita basis the country's income level is relatively low. GDP per capita stands at around EUR 1000 - only half of the regional average. This low income level is the result of a growth in per capita GDP of around 3.5 percent since 1950, or around 1.5 percentage points above that of the EU. Obviously, this means that the rate of income convergence with the richer countries is extremely slow.

While sharing some of the growth-impeding characteristics of the Mediterranean region, such as a mid-range investment ratio and a rather low stock of human capital, these factors alone may not be enough to explain Egypt's poor growth performance. Several additional factors have further undermined its ability to fully reap its growth potential. The most important such factors are:

- Competitive distortions from oil exports: The large but transitory inflows of foreign currency from oil exports in the 1980s undermined non-oil industry through the so-called "Dutch Disease", as the extra boost to domestic demand pushed up prices on non-traded goods and services more than on traded goods, thus causing the real exchange rate to appreciate. As it became more profitable to engage in domestic sales rather than exports, investment in non-traded goods sectors crowded out tradable goods production. Egypt's exports currently stand at only 7 percent of GDP, which can be compared with over 20 percent for Indonesia, an open economy that otherwise shares many of Egypt's economic and demographic characteristics. Egypt's problem with distortive oil exports has been shared by a few other Mediterranean countries, notably Algeria and Syria.

- A high reliance on non-trade income sources: The problems from oil production have been augmented by other sources of non-trade incomes. Out of total current account receipts of around USD 15 billion in 2000, non-oil goods exports accounted for only 4 billion, with the rest consisting mostly of oil exports (USD 2 billion), tourism (USD 2 billion), Suez Canal receipts (USD 2 billion) and remittances from expatriates (USD 4 billion).

- An inward-looking growth strategy: Unlike many faster-growing emerging market economies, especially in Asia and Eastern Europe, Egypt has never fully moved away from its protectionist model of economic development. Domestic industries have continued to be protected from competition with high import tariffs (averaging 30 percent in the mid-1990s compared with 4 – 9 percent in East Asia). As a result, domestic industries have become largely uncompetitive in the international market.
- Heavy regulation and inefficient state intervention in the running of the economy: Despite growing private sector activity, a large portion of the Egyptian economy has been kept in state hands. Low productivity growth in the public sector stands out as a key source of Egypt's overall poor growth performance. This is immediately observable in comparison with private sector productivity growth. Whereas the public sector still accounted for 60 percent of employment in 1997 (down from 80 percent in 1980), it only accounted for 50 percent of value added (down from 85 percent in 1980).

The growth-impeding factors outlined above have been included in empirical studies to explain cross-country differences in growth performance. Based on this research, a recent World Bank (1998) study suggests that Egypt could substantially raise its per capita growth rate by changing its economic institutions and policies. For example, Egypt could boost its per-capita growth rate by two percentage-points if its economic efficiency was raised to the East Asian level, and another two percentage-points by raising its saving rate to the East Asian level. While such studies suffer from the difficulty of disentangling different causes from each other, they indicate that Egypt's weak growth performance is largely home-made rather than the result of exogenous factors.

Some progress has been made in macroeconomic management in the past decade. A series of IMF arrangements - coupled with massive external debt relief resulting from Egypt's participation in the Gulf war coalition - helped Egypt improve its macroeconomic performance during the 1990s. Through improved fiscal and monetary policies, the government has tamed inflation, reduced budget deficits, and built-up foreign reserves.

Despite its tendency to move slowly in the areas of structural reforms and liberalisation, Egypt also faces growing pressure for change here too. Firstly, several key sources of foreign currency, such as Suez Canal income and oil exports, are stagnant or falling in nominal terms. The need to finance key imports may necessitate policies more favourable to non-oil exports. A second challenge to the status quo is that the high birth rates of the 1970s and 1980s (having fallen only in the last decade) will continue to send a great number of young adults into the labour market. Unless economic growth accelerates to create enough jobs to absorb this inflow, a growing pool of unemployed may pose a greater threat to social stability than that stemming from economic restructuring. Thirdly, by signing an Association Agreement with the EU, Egypt's government has committed itself to phasing out its barriers to trade over the next decade. This will expose the true costs of existing economic distortions.

Egypt may increase its per capita growth by reforming its institutions and economic policies.

In comparison both with the rest of the region and with more successful emerging markets elsewhere, Egypt's likely key impediment to higher economic growth is its reluctance to move away from an inward-looking development strategy. Regardless of its relative progress in macroeconomic stabilisation, high economic performance will likely continue to be elusive unless economic policies are improved on a broader front.

Turkey

With a current GDP of around EUR 144 billion and a population of 65 million, Turkey is by far the Mediterranean region's largest economy. On a per-capita basis, however, Turkey is only marginally richer than the Mediterranean region as a whole. As with Egypt, Turkey has suffered from a rather meagre growth performance, with real per capita GDP gaining around 3 percent between 1950 and 1990. The growth rate corresponds fairly well to Turkey's mid-range investment and literacy rates - at around 22 percent and 80 percent respectively. But that in itself does not explain why Turkey has not succeeded in raising either of these ratios to levels that would support higher economic growth in the medium term.

In light of Egypt's experience, a lack of openness would be a natural starting point in trying to find an explanation for Turkey's similarly weak growth. Historically, this is indeed a characteristic shared by Turkey as well. Exports of goods and services did not exceed 5 percent of GDP until around 1980. This has improved dramatically in the past two decades, however. A string of trade and capital market reforms in the early 1980s has pushed up Turkey's export ratio to some 30 percent of GDP. Turkey's greater openness, along with higher investment and literacy rates, suggests that its growth potential should have improved in recent years. But recorded performance does support such a conclusion, as per capita GDP growth has indeed slowed further from 2 percent in the 1980s to only 1.8 percent in the 1990s.

In Turkey, highly volatile growth has hampered investment.

Perhaps the best clue to Turkey's poor average growth performance is given by the highly volatile pattern of growth itself. Occasional high-growth periods have typically been interrupted by frequent and large contractions in economic activity. This growth volatility has if anything been accentuated in recent years. If another steep recession were to take place in 2001, Turkey would have experienced three contractions in excess of 5 percent within less than a decade. Understanding the causes of this macroeconomic instability is key to understanding why Turkey has failed to attain a higher average growth rate in the past two decades.

A key element of Turkey's macroeconomic instability is high inflation, which has risen to an annual average of 80 percent in the 1990s, up from 50 percent in the 1980s. Behind this high inflation rate lie large - and indeed growing - fiscal deficits, averaging a staggering 12 percent of GDP in the 1990s, up from 6 percent in the 1980s. Since these deficits have by far exceeded the growth rate of the economy, an explosive accumulation and eventually default on domestic debt has only been avoided by partially financing the deficits through central bank credit, i.e. printing money and imposing an inflation tax on money holders.

Such persistent fiscal weakness does not typically arise out of nowhere, but is the result of underlying structural and political causes. In the case of Turkey, the deteriorating fiscal situation in the 1990s can be broadly described as the outcome of incomplete and half-hearted market reforms over the past two decades. Although the economy opened up to trade and market-based activities were expanded in the 1980s, an environment suitable for a market-based economy was not created. One of the most serious policy failings was in the area of budgetary control. The mid-1980s saw a proliferation of extra budgetary funds and other quasi-fiscal entities (including State banks) over which the central government had very little control. Through its explicit or implicit backing of these institutions, the

Incomplete reforms have caused a deteriorating Turkish fiscal situation in the 1990s.

central government could not prevent the same inflationary money creation from these deficits as from its own. While some of the deficits were monetised, a rapid build-up of debt also took place in the 1990s, attracting private sector savings only by means of high real interest rates. These high real interest rates distorted economic incentives and reduced productive business investment. As a direct result of the runaway fiscal deficits, the growth potential of the economy was seriously impaired. Repeated IMF-led rescue packages have so far done little to change these dynamics.

Tunisia

Tunisia has a diverse economy, with important agricultural, mining, energy, tourism, and manufacturing sectors. However, with a population of just below 10 million and a GDP of EUR 19 billion, its economy is small by any standard. At around EUR 2 000, GDP per capita is on par for the Mediterranean region. At some 2.5 percent per annum, Tunisia's post-war per-capita growth record has been poor, although notable improvement has been seen in the past 15 years.

Looking at some underlying economic fundamentals, the reasons for the weak growth performance are at first not obvious. Tunisia has, for example, scored relatively well in the areas of aggregate investment and human capital. Averaging just below 30 percent of GDP in the past two decades, Tunisia's investment ratio also looks healthy by international standards.

As with Egypt and Turkey, the explanation for Tunisia's moderate post-war growth performance is more likely to be found in its institutional and policy environment. In particular, inefficient State ownership and protection from foreign competition have hampered innovation and productivity growth in the domestic economy. However, Tunisia has done notably better in the area of macroeconomic stability than Turkey and has a more open economy than Egypt. To the extent that its economic performance is still below its potential, Tunisia may thus represent a third distinct economic model in the Mediterranean region.

As in several other Mediterranean countries, the impetus for economic reform has sprung from crisis in the aftermath of collapsing oil revenues in the late 1980s. In the three decades following independence in 1956, moderately rising living standards were achieved in an environment of state ownership, protectionism and exports of oil and phosphates. The unsustainability of this economic model became apparent when high real interest rates and the international debt crisis hit Tunisia in the mid-1980s. In response to this, the government began implementing reforms that have gradually transformed Tunisia into a market-based economy.

Key to these reforms has been to establish macroeconomic stability through fiscal discipline, low inflation and exchange rate stability. The success in reaching these goals are likely to be key elements behind a notable recent acceleration in per capita GDP growth, from a meagre 1.6 percent in 1980-95 to 4.5 percent since 1996. However, it remains uncertain how sustainable this growth acceleration is unless macroeconomic stabilisation is accompanied by equally strong strides in trade liberalisation and structural reforms.

Starting with foreign trade, it is highly unlikely that a small economy such as Tunisia's can permanently boost growth unless this acceleration continues to be underpinned by an expansion of trade (its current export ratio stands at over 40 percent). A look at trade flows gives a reasonably favourable impression of Tunisia's competitive position. The EU market absorbs four-fifths of Tunisia's exports and this trade has helped bring about a beneficial structural shift in exports. Having been largely dependent on agricultural, oil and ore exports, Tunisia is now increasingly exporting manufactured goods. This group now accounts for four-fifths of total exports, up from less than one-third in 1980. This shift is important for economic growth because manufacturing has a greater potential for high productivity growth than is the case for primary goods.

Another positive development in opening up Tunisia's economy is its success in attracting more foreign direct investment (FDI) in recent years. Averaging 2.5 percent of GDP in the past five years, FDI inflows are above that of other low-income countries and only slightly below that of the middle-income country average. However, FDI flows to Tunisia still compare relatively poorly with that of Central and Eastern Europe, which receive FDI inflows to the order of 5 – 6 percent of GDP.

Tunisia's economic performance stands out in the region, but further structural reforms are required to ensure sustainable high growth.

Having achieved macroeconomic stability and making progress in expanding trade, the main impediment to sustainable high growth in Tunisia is likely to be in the area of structural reforms. But after decades of protection, there is also some justification for the fears of painful economic adjustments to economic and trade liberalisation. When Tunisia signed the EU Agreement in 1995, it was estimated that one-third of its industrial firms would collapse had they been exposed overnight to the full competitive pressures of free trade. To prepare the economy ahead of trade liberalisation, the government has begun implementing a programme (known as mise à niveau) aiming at upgrading the quality of industry, services and infrastructure before being exposed to free trade in 2008. So far, the programme's success rate has been moderate. While those firms undertaking the programme have succeeded in boosting output and exports substantially, two-thirds of the firms targeted by the programme had still not had their modernisation plans approved by the end of the 1990s. This has also resulted in growing pressure from businessmen to slow down the pace of trade liberalisation to give firms more time to prepare for the competition.

Despite these ongoing challenges, Tunisia stands out as the best example of a Mediterranean success story. For all its shortcomings, Tunisia has shown that better macroeconomic policies and export promotion do pay off in terms of higher growth and thus serves as a valuable role model for the region. It also shows that, despite these efforts, an even broader approach to economic reforms is required to reap the full benefits of its growth potential.

2.3 Some conclusions

The Mediterranean countries' consistent poor growth performance has prevented income convergence with the EU and the large remaining income gap poses a continuing threat to social stability on the EU's southern border. While the EU has a strong interest in assisting economic convergence, it is faced with the challenge of how best to promote such a development. It is evident from the discussion above that achieving this goal may require more decisive and broad-based economic reforms than are currently being undertaken in the region. The impediments to economic growth in the region are plentiful and often interconnected. For example, the absence of free trade is a key element in the weak state of domestic competition and innovation, which has in turn made many state enterprises unprofitable and increasingly dependent on state subsidies and soft bank loans. The overextended government sector that sustains these enterprises is in turn dependent on import tariffs as a key revenue source.

Ideally, all the different areas of the protected state-centered economies in the region should be reformed simultaneously.

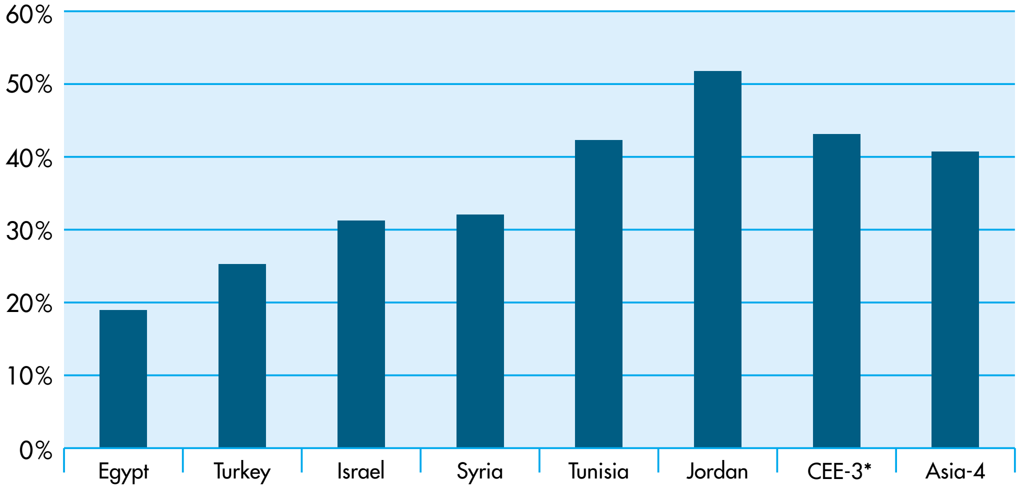
This interdependency between different areas of the protected state-centred economies in the region means that, optimally, they should all be reformed simultaneously. Even though the EU may have good reasons to encourage a more radical and broad-based transition process in the Mediterranean region, the means to achieve this are not necessarily available. On the other hand, the interdependency of different areas of economic reform can also be used to the advantage of a speedier reform process. By encouraging an economic opening-up of the region, the EU may facilitate in increasing pressures for faster reforms in other areas, such as government spending and domestic liberalisation. Even though one cannot conclude that trade agreements by themselves are sufficient in boosting substantially the growth prospects of the region, they may still serve as catalysts for broader reforms that may in the end bring the Med countries up on a higher sustained growth path. With this background let us turn to look more closely at the Euro-Med Agreements planned for the region.

3. The Euro-Mediterranean partnership

3.1 Trade in the region

As the major plank of the EU-Med strategy is trade related, it is useful to start with some more background on trade relations in the region. The case studies of the last section have already illustrated the limited openness of some Mediterranean economies. Figure 7 shows that, with the exception of Tunisia and Jordan, this is a more general phenomenon, and many countries have export ratios well below the level seen in the faster-growing economies in Central and Eastern Europe and East Asia. As mentioned in the case studies, Tunisia is an exception to the region's relative closeness in its recent progress in expanding trade, especially manufactured exports. Jordan has benefited from a free-trade agreement with the United States, although its high export ratio may also be affected by re-exports from neighbouring countries.

Figure 7. Exports of goods and services as a share of GDP, 1995-98 averages



** CEE-3 = Poland, Hungary and Czech Rep.; Asia-4 = Thailand, Philippines, Indonesia and Korea*

Source: World Development Indicators

There is a lack of diversity in the composition of trade, and the region depends heavily on the EU market.

In addition, there is a lack of diversity in the composition of trade as illustrated in Table 4. Data for the major sectors suggests that the region consists of economies whose exports are strongly focussed on fuels (Algeria, Syria, and to a lesser extent Egypt), manufactured goods (Israel, Turkey and Tunisia), or economies building on the tourism sector (Jordan, Morocco and Tunisia). Industrial goods account for the largest share in the region's imports.

Table 4. Exports and imports as percent of total, average 1995-98 or latest data

	Percent of merchandise exports or imports										Percent of commercial service exports or imports					
	Food		Agri-cultural raw materials		Fuels		Ores and metals		Manu-factures		Trans-port		Travel		Other	
	Exp	Imp	Exp	Imp	Exp	Imp	Exp	Imp	Exp	Imp	Exp	Imp	Exp	Imp	Exp	Imp
Algeria	0	3	0	6	98	3	0	2	2	65	45	57	22	14	33	29
Egypt	10	6	5	6	40	2	6	3	39	61	32	34	35	25	33	41
Israel	5	1	2	1	1	7	1	2	91	82	24	42	35	25	41	33
Jordan	25	2	2	2	0	13	24	3	49	61	21	50	43	30	36	21
Lebanon	..	..	..	..	..	..	..	..	..	..	..	..	..	..	..	..
Morocco	32	5	3	5	2	16	13	4	50	57	19	45	67	25	15	30
Syria	15	3	6	3	65	2	1	2	12	75	15	54	77	40	8	6
Tunisia	9	3	1	3	9	7	2	3	80	76	25	48	63	21	13	31
Turkey	19	5	1	5	1	11	3	5	75	71	13	28	36	20	51	52
EU	9	3	2	3	2	7	2	4	82	74	25	25	31	31	44	45
Middle income	12	3	3	3	16	9	5	3	61	72	29	34	38	26	34	39

Source: World Development Indicators

The Mediterranean basin depends heavily on the EU market for its trade. In fact, a study by FEMISE (2000), reports that the trade relations of the Mediterranean countries can be summarised succinctly as follows:

- The Mediterranean countries depend on the rest of the world for a number of agricultural products and raw materials except for petroleum - the deficits with non-EU countries range from 3/4 to 5/6 of their total deficits in these categories of products
- Mediterranean countries are much more dependent on Europe for manufactured products (the region has a deficit of USD 1 billion with the rest of the world compared to a deficit of USD 10 billion vis-à-vis Europe), and for equipment and chemicals (where Europe accounts for the vast majority of the region's trade deficit);
- On the other hand, the region enjoys a surplus in mineral fuels and, to a far lesser extent, in some commodities in the iron and steel industries. Here, the surplus is essentially directed to Europe.

Trade among Mediterranean countries themselves is extremely low.

Table 5 clearly illustrates this strong trade dependence on Europe. In general, roughly 50 percent of the Mediterranean region's overall trade takes place with the Union. Within Europe, the Mediterranean market is the most important for exporters in Greece. Over one-quarter of Greece's total exports cross the Mediterranean Sea (see Table 6). The region also accounts for about 12-15 percent of the exports from Spain, Belgium and Luxembourg, France and Italy. Southern EU countries import in turn about 10 percent of their total from the region (mostly energy imports), but the bi-lateral trade balances clearly remain in favour of the EU Member States, and have increased over time. In 1997, the European trade surplus amounted to roughly USD 30 billion, as against 12 billion in 1992.

Table 5. Share of EU in Mediterranean trade

Country	percent of the country's total exports to the EU		percent of the country's total imports from the EU	
	average 1991-95	average 1996-99	average 1991-95	average 1996-99
Algeria	69.5	62.9	59.6	58.8
Egypt	41.9	39.0	41.6	36.6
Israel	33.2	31.1	51.9	49.4
Jordan	4.4	7.0	33.2	32.2
Lebanon	15.4	21.9	51.9	47.9
Morocco	63.1	67.3	55.4	57.4
Syria	57.2	57.2	38.4	32.7
Tunisia	78.5	79.7	73.0	72.9
Turkey	51.3	50.1	47.0	52.3

Source: Eurostat

Table 6. Share of Mediterranean basin in EU trade

Country	percent of the country's total exports to the Mediterranean region		percent of the country's total imports to the Mediterranean region	
	average 1991-95	average 1996-99	average 1991-95	average 1996-99
Austria	4.9	4.4	4.5	4.1
Belgium / Lux	15.0	14.6	6.5	7.7
Denmark	4.5	4.4	2.3	2.2
Finland	4.7	4.9	1.2	1.3
France	13.0	13.5	10.0	10.0
Germany	7.0	6.9	5.7	5.4
Greece	27.6	26.3	10.5	10.9
Ireland	4.9	4.4	1.7	2.2
Italy	13.4	12.1	9.8	9.8
Netherlands	8.2	8.9	4.6	4.1
Portugal	8.3	8.6	8.3	6.3
Spain	12.4	14.8	8.0	9.2
Sweden	4.4	5.4	1.7	1.8
UK	5.9	6.5	3.1	3.5
EU	8.9	9.1	6.0	6.1

Source: Eurostat

Finally, the flow of trade among Mediterranean countries - so called South-South trade - is extremely low. Tovias (1997) illustrated that in the mid-1990s, for example, intra-regional exports averaged around 5 percent, ranging between roughly 2 percent of total exports for Algeria to about 18 percent for the outlier of Syria. Later studies, such as Comijs (2000), reinforce that South-South trade has roughly remained at that level. In fact, FEMISE (2000) reports that the development of South-South trade in the period 1970-98 has been flat, fluctuating between only 4 percent to 7 percent of the trade of the Mediterranean countries. This should be contrasted with the increase in intra-regional trade flows in other regions, i.e. a rise from 11 percent to 25 percent for South American countries (Argentina, Chile, Brazil, Paraguay), from 19 percent to 22 percent in East Asian countries, and from 1 percent to 11 percent for the Andean Pact (Colombia, Ecuador, Peru, Venezuela).

The question, then, is to what extent will new Association Agreements with the EU change this picture?

3.2 The evolving nature of EU-Mediterranean Agreements

As mentioned in introduction, the Barcelona Process calls for a Euro-Mediterranean free-trade area by 2010 covering goods, services and capital. This is to be achieved via Association Agreements between the EU and individual partner countries (5). These come with financial assistance through the MEDA program and loans from the EIB. In 2000-6, EU grants are expected to amount to about EUR 5 1/2 billion and loans from the European Investment Bank are currently envisaged to reach about EUR 7 1/2 billion. To illustrate the size of these resources note that, on an annual basis, they are equivalent to around half a percent of the region's GDP.

Although the Agreements are negotiated bilaterally between the EU and each Mediterranean partner, they have certain aspects in common. They envisage (i) reciprocal free trade in most manufactured goods, (ii) in the longer-term a move to preferential and reciprocal access for agricultural products, and (iii) working towards a gradual liberalisation of trade in services and capital. The Agreements will be implemented over a multi-year period. The freeing of trade in industrial goods is supposed to follow a specific timetable. By contrast, the Agreements are less specific in terms of opening up agricultural markets and trade in services and capital (6).

The introduction of reciprocity is one important difference between the current EU Association Agreements and previous Cooperation Agreements.

One of the key changes from earlier Cooperation Agreements between the EU and the region is the introduction of reciprocity, implying that Mediterranean countries have to grant the same concessions to the EU that they have already benefited from themselves. Another important difference is the mentioning of trade in services and capital. Finally, the new Agreements aim at encouraging intra-Mediterranean integration through the establishment of free trade not only between the EU and individual countries but also among Mediterranean countries.

5) This section draws on background material by the European Commission (1998, 1999, 2000a, 2000b, 2001a,b) and the World Bank (1993, 1995).
6) The first Agreement was negotiated with Tunisia in 1995. This became a benchmark for subsequent negotiations with other countries. Given the similarity of the Agreements and as we are interested in their general implications, the following discussion rests mainly on the Agreement between Tunisia and the EU.

Box 2. Free trade and "new regionalism"

Free trade: the ultimate goal

Traditional trade theory suggests that multilateral free trade maximises world welfare and that small countries - like those in the Mediterranean region - would benefit from a unilateral move to free trade even if the rest of the world does not reciprocate. This raises the question of why such countries do not move unilaterally to free trade and instead seek Preferential Trade Agreements (PTAs) and participate in multilateral trade liberalisation mainly in the framework of the WTO. Three explanations are worth considering:

- First, while unilateral trade liberalisation is welfare enhancing, it inevitably has distributional implications and is thus opposed by import-competing sectors.
- Second, the adjustment to a higher-welfare equilibrium is not instantaneous but takes time. As a result, liberalisation often involves up-front costs (such as temporary unemployment and balance of payments problems) whereas benefits may not come immediately. This inevitably creates resistance to unilateral steps.
- Finally, although unilateral action has its merits, reciprocal trade liberalisation is even better. Against this background, a country may regard own trade concessions as leverage for negotiating better access for its exporters to foreign markets. Of course, it is also possible that deep-rooted mercantilism leads decision-makers to believe that removing import restrictions is beneficial only if other countries reciprocate.

New regionalism

Given these political economy considerations, multilateral and preferential trade agreements seem to have been more palatable than unilateral actions toward free trade. Regional PTAs, in particular, have mushroomed in recent years and there are now well over a hundred agreements, involving most nations.

Ethier (1998) has pointed out that the new regionalism differs considerably from attempts to establish regional PTAs in 1950-60s. For one thing, it takes place in an international environment that is characterised by a more open trading system, a greater trust in markets as a means for allocating resources, and a far more prominent role of foreign direct investment. For another, new regional arrangements link one or a number of small countries that have recently embarked on wide-ranging economic reforms to a large country or trading block, envisage a modest degree of trade liberalisation, and foresee this liberalisation to take place primarily in the small countries.

Box 2 recalls the merits of free trade, sketches the difficulties in establishing it, and describes what has become known as "new regionalism". The Euro-Med Agreements have many features of this new regionalism. First, they concern the relationship of small countries with a large regional trading block. Second, the degree of trade liberalisation is modest when compared to the reduction in trade barriers already achieved under previous preferential and multilateral trade agreements. Finally, they are one-sided as most of the reduction in trade barriers is envisaged to take place in the Mediterranean countries. This is mainly because - with the notable exceptions of agriculture and textiles - most exports of Mediterranean countries already have free access to EU markets.

To fully appreciate the character of the Agreements it is useful to point out a few differences between them and the Europe Agreements with the Central and Eastern European Countries. First, the Euro-Med Agreements do not aim at the same degree of deep integration envisaged with Central and Eastern Europe and they contain no commitment to eventual EU membership. Second - and maybe related to the first point - the Euro-Med Agreements are with countries where the pace of economic reforms has been rather timid and in no way comes close to the fundamental reorientation of economic policies in Central and Eastern Europe. Third, the Euro-Med Agreements themselves seem to mirror the relative lack of reform ambition. For instance, while they aim at improving the conditions for the flow of capital to the region, (FDI) - an important impetus to economic revival in Central and Eastern Europe - has remained a sensitive issue. Last, but certainly not least, while it is a stated goal of the Euro-Med Agreements to encourage the integration among the Mediterranean countries, efforts to establish freer trade within the region have so far not been very successful. This is in stark contrast to what has happened in Central and Eastern Europe, which saw the creation and extension of free trade agreements between the countries of that region.

It is obviously futile to speculate whether or not the Mediterranean approach to economic reforms would have been akin to efforts in Central and Eastern Europe had there been the prospect of deeper integration with the EU (or whether the EU would have offered deeper integration had Mediterranean countries showed a stronger commitment to reforms). But just what may be the likely benefits and costs of the Agreements as they are currently conceived?

3.3 Benefits and costs

The main concepts relevant for this assessment are sketched in Box 3. In addition to the debate about the welfare effects of regional trade agreements on participating countries, there is a dispute as to whether such agreements foster or hinder the development of multilateral free trade: Are such agreements building or stumbling blocks on the road toward the ultimate goal of multilateral free trade? We will not address this issue, here the gist of the controversy is summarised in Box 4.

Benefits

The Agreements will alleviate market access. This has the potential to reduce uncertainty and to stimulate investment.

The Agreements confirm Mediterranean producers' free or preferential access to EU markets. At the same time they envisage the harmonisation and mutual recognition of standards, which should also alleviate market access. Overall, this should reduce uncertainty and as such the Agreements have the potential to stimulate investment for export production. However, the positive effect is likely to rest mainly on reducing uncertainty given that Mediterranean manufacturing has already fairly free access to EU markets and, more importantly, that a further opening of the EU for agricultural products is bound to be limited.

In assessing the potential benefits of the Euro-Med Agreements, a number of commentators, such as Hoekman and Djankov (1996) and Ghesquiere (1998), have emphasised that the Agreements provide an institutional framework for the Mediterranean countries to enhance the scope and credibility of far-reaching economic reforms. They highlight that such reforms would add to the dynamic benefits often associated with the creation and deepening of regional trade agreements, in particular if they stimulate the inflow of foreign direct investment.

The role of regional trade agreements as a catalyst for an overall economic reform strategy and for foreign direct investment has also been emphasised by Ethier (1998). Seen in the context of the Euro-Med Agreements, his analysis suggests, however, that not all countries can hope to attract foreign direct investment but only those that can positively differentiate themselves from their peers.

Only those countries that will successfully differentiate themselves from their peers will be able to attract substantial foreign direct investment.

Box 3. Welfare consequences of regionalism

Intuition suggests that if free trade is welfare-enhancing for small countries and the world at large, any reduction of barriers to trade - even if on a preferential basis - will also be beneficial. Viner (1950) demonstrated that this conclusion is, in general, not correct. He introduced the by now classic distinction between the welfare effects of trade creation and trade diversion. Preferential Trade Agreements (PTA) result in welfare enhancing trade creation between PTA partners. At the same time, however, they could induce a welfare-reducing diversion of imports from cost-efficient non-members to less efficient PTA members. In addition to having these static welfare effects, PTAs may foster economic growth in member countries, eventually spilling over to non-member countries. In fact, the possibility that PTAs generate dynamic gains for non-members is the main reason why WTO rules allow a waiver for such agreements although they violate the principle of non-discrimination. A stimulation of economic growth can be expected if PTAs enable the exploitation of economies of scale, increase intra-industrial specialisation, enhance competition among firms in the PTA, accelerate innovation, and stimulate saving and investment.

Nevertheless, even with the possibility of dynamic gains the welfare consequences for PTA members - let alone the world at large - are *à priori* unclear. In essence, the underlying issue represents an application of second-best theory. A multilateral trade system that is characterised by non-discriminatory trade restrictions is clearly not as good as the first-best solution of free trade. However, introducing free(r) trade for a subset of countries and, thereby, deviating from the Most-Favoured-Nation (MFN) principle may make things worse. Under these circumstances, it would be better to stick with the second-best solution of multilateral, non-discriminatory trade restrictions.

The question of whether PTAs are good or bad remains controversial. Looking at the raw numbers we do typically see expansions both in trade within the blocs and in external trade, suggesting that there is no significant evidence of trade diversion. However, looking at the raw data alone fails to distinguish the trade effects of regional integration from other economic changes. For instance, a larger GDP or population will by itself induce more demand, and hence trade. To identify the effects of the regional integration agreement, the researcher must try to control for such other changes, and this can be done with varying degrees of sophistication.

The standard way to control for other effects is to build an econometric model of trade, and to see whether the estimated relationships change as consequence of implementing the regional trade agreement. The usual model for such purposes is the gravity model, which estimates bilateral trade between countries, generally for a sample of many countries and for several different dates. It explains trade between pairs of countries as a function of i) their GDPs and populations - as mentioned, larger economies trade more; ii) the distance between countries as a proxy for transport costs, cultural similarity and business contacts, and iii) physical factors such as sharing a land border, and being landlocked or an island. Subsequently researchers add to the list dummy variables that capture whether or not countries are in a particular regional integration agreement at the time. If these show up positively for pairs of countries, then they indicate that these countries trade more than would be suggested by the other factors as a result of the association. A fall in the value of a dummy for trade between a member and non-member is indicative of trade diversion, particularly if the fall shows up after formation of the association agreement.

Using this technique, Soloaga and Winters (1999a,b) investigated the effect of the revival or creation of nine major blocs over the period 1980 and 1996. The results indicate that following regional integration schemes the EU, EFTA, and NAFTA became more intensively involved in within-bloc trade than would have been suggested by other factors, but the effect has been fading away over time. The impact of the Association Agreements on between-bloc trade has in general been negative, and robustly so for the EU and EFTA. Taken together, these findings are seen as sufficient evidence for trade diversion within the regions as a result of the Association Agreement.

The analyses for four other regional integration agreements (CACM, Andean Pact, Mercorsur, and ASEAN), however, suggest no convincing evidence of trade diversion. By contrast, the Association Agreements could be identified as key to both increasing propensities to import and export, suggesting strong creative effects from general trade liberalization. The exception was Mercorsur, where imports and export propensities displayed opposite movements. The authors conjectured that here the increased trade performance has been more influenced by competitiveness than by trade policy.

What do we learn from all this? It is extremely difficult to control for other determinants of trade, but once one does there appears to be weak evidence that between-bloc trade is smaller than it otherwise might have been in at least some of the investigated revived or newly created associations. However, the picture is sufficiently mixed, so that it is not possible to conclude that trade diversion has been a major problem - if it did, it appeared to be in the relatively highly developed regions.

Moreover, Ethier (1998) considers the controversy about trade diversion less relevant for recent regional trade arrangements. Stressing the distinguishing features of new regionalism, he finds reform creation and investment diversion more pertinent consequences. For small, reform-minded countries, a regional agreement with a large partner provides an opportunity to lock-in political, institutional, and economic reforms - including trade liberalisation - making them difficult to reverse for subsequent governments. In that sense, the new regionalism may help, if not create, reforms. A regional agreement with a large partner also signals a country's commitment to reforms, making it a more attractive location for foreign direct investment. As Ethier finds it unlikely that the new regionalism will boost foreign direct investment in general, he anticipates investment diversion rather than creation. An important insight of Ethier's discussion is that the smaller partner country may find a regional agreement appealing even if it is expected to deliver most of the trade concessions. And then, if overall foreign direct investment is limited and tends to cluster geographically, an individual country may want to reach such an agreement before others do.

One could argue that the timely and determined implementation of the Euro-Med Agreements and, more importantly, of far-reaching economic reforms are a means of successfully attracting foreign investors. Overall, there may be a first-mover advantage, with a virtuous cycle of commitment to reform, foreign direct investment, and successful reform implementation occurring in those Mediterranean countries that step into the cycle first.

It seems obvious to mention EU financial assistance on the benefit side. However, to some extent the purpose of this assistance is to cover the costs arising from implementing the Agreements and, thus, there may not be any net benefit. But it is also true that most of the costs, which we analyse below, are temporary or address questions of income distribution in the countries concerned. After all, the general point made in Box 2 is that free trade, even if implemented unilaterally, is in the long-run interest of the Mediterranean countries. If this is so, the EU financial and technical assistance is indeed a net benefit and, in fact, the availability of such assistance is a strong incentive for Mediterranean countries to seek regional trade agreements in lieu of liberalising trade unilaterally or in the context of multilateral trade negotiations.

Costs

Like any change in relative prices, a reduction in trade barriers forces structural change. As it takes time to put a new economic structure in place, there may be temporary costs such as transitional unemployment, idle capacity, and a weakening of the balance of payments. Although benefits are anticipated to more than offset costs later, the temporary burden is real and may slow down or even prevent the implementation of the associated reforms.

Box 4. Building blocks or stumbling blocks

Even if regional trade agreements are (world) welfare-enhancing in the short to medium term, they could eventually lead to results that are inferior compared to what can be achieved via multilateral trade agreements. In essence, the question is whether regional trade agreements are "building blocks or stumbling blocks" toward multilateral free trade (Bhagwati 1991). An optimistic scenario could read like this: An initially shallow Preferential Trade Agreement gradually turns into a single market with an increasing number of participants; due to its increasing strength, the single market succeeds in negotiating substantial trade liberalisation with the rest of the world, which may or may not include regional trading blocks and/or other single markets. A less promising outlook would envisage the emergence of a limited number of deeply integrated regional blocks, each having numerous PTAs or FTAs with countries not belonging to any of the blocks. Obviously, things could be worse: The regional blocks could clash, leading to an escalating trade war between blocks and an increase in intra-regional protection.

Walters (1999) reviews the literature about whether regional trade agreements are building or stumbling blocks and concludes: "We don't know yet". Dornbusch (1993) and Ethier (1998), for instance, present the case for regionalism whereas Bhagwati, Greenaway and Panagariya (1998) and Bagwell and Staiger (1999) - to name a few - see regionalism as a threat to the ultimate goal of multilateral free trade. In fact, Bhagwati (2001) considers the future of the multilateral trading system at risk and identifies as the main culprit the "European disease" of ever-expanding discriminatory trade liberalisation.

Despite many open questions, there is consensus that a positive impact of regionalism on free trade is the more likely the deeper the process of integration. As to the European context, Sapir (1999) makes the distinction between EU integration and EU regionalism, with the former capturing deep integration, such as the creation of the EU Single Market, and the latter characterizing various PTAs and FTAs between the EU and non-EU countries. He suggests that there is broad support for deep integration whereas shallow forms of integration rightly encounter scepticism.

In this context, it is worth noting that the Agreements could initially imply an increase in the "effective" protection of national manufacturing. This is because the sequencing of removing import tariffs is such that tariffs on inputs and machinery will be given priority relative to those on final products, thus reducing the domestic cost of inputs before output prices fall. As a result, the temporary costs discussed here are essentially shifted forward in time - indeed import-competing industries may reap transitory gains. As Hoekman and Djankov (1996) note this makes the Agreements politically more palatable but it is clear that the burden will be even larger as and when all import tariffs are finally abolished.

The decline in import tariff revenue when trade barriers will be taken down is a particular issue in the Mediterranean political debate.

As mentioned, regional trade agreements could induce partner countries to forego cheaper import options from non-member countries. Such negative trade diversion is the more likely (i) the smaller is the share of EU imports in overall imports of Mediterranean countries and (ii) the higher are import tariffs prior to implementing the agreements. How trade diversion will affect the Mediterranean regions remains essentially an empirical question, and, as we have seen in Box 3, the general evidence does not give clear guidance . Let us only note that countries such as Egypt, Jordan and Syria import less from the EU than other Mediterranean countries and are thus more exposed to negative trade diversion effects than other Mediterranean partners.

A particular worry of Mediterranean countries is the decline in import tariff revenue that is unavoidable if tariffs are abolished. Indeed, taxing external trade is an important source of government revenue in the region, typically accounting for about one-sixth of revenues (see Table 7). These numbers help explain some of the anxiety on the part of the Mediterranean countries and the slow pace in negotiating and ratifying the Agreements.

It is important to bear in mind that in the case of regional trade agreements the government revenue problem involves more than simply clawing back lost import tariff revenue with other government taxes and levies, which is clearly a challenge in its own right. In contrast to a non-discriminatory import tariff reduction, dismantling tariffs only for EU imports may not reduce domestic import prices if these are set by imports coming from the rest of the world. In these circumstances, there would be no trade creation, but only trade diversion. The decline in import revenue would accrue as a rent to EU exporters. In principle, EU financial transfers could compensate for the shifting of rents to the EU, but they would have to be additional to what Mediterranean countries would receive in the absence of the Euro-Med Agreements. In this context, Ghesquiere (1998) alludes to concerns of the Lebanese government that financial transfers are mainly determined by the size of the population, per capita income, and progress in carrying out economic reforms but that the costs of implementing the Agreements are not sufficiently taken into account.

Preferential and free trade agreements may give rise to a "hub-and-spoke" problem.

Table 7. Taxes on international trade and share of government revenue

	percent of central government revenue	weighted mean import tariff, percent, 1998** based on effectively applied rates		
	1998	all products	primary	manufactured
Algeria	16	14.1	8.5	17.1
Egypt	13	13.7	7.4	17.5
Israel	1	..	..	..
Jordan	23	..	..	..
Lebanon	44	..	..	..
Morocco	15 *	21.1	26.0	19.6
Syria	12	..	..	..
Tunisia	14	28.9	21.4	30.2
Turkey	2	6.0	8.1	5.2
EU	0	2.7	1.8	3.0

Notes: *) Morocco: 1995; **) Turkey and Morocco: 1997, EU: 1999.

Source: World Development Indicators

A final issue is examined in detail by Sapir (1998). Compared to a non-discriminatory tariff reduction, preferential and free trade agreements may give rise to a hub-and-spoke problem. In the presence of intra-Mediterranean trade restrictions, the Agreements provide an incentive to locate the production of goods for the Mediterranean region in the EU. EU producers, say, in Greece would use their location (the hub) to supply duty-free various Mediterranean countries (the spokes) although production in the Mediterranean region enjoys a comparative advantage.

Net benefits

As the Agreements have been in existence for only a short period of time, it is too early to measure their actual impact on the Mediterranean countries. However, a number of studies gauge the net benefits on the basis of computable general equilibrium models for Morocco, Tunisia, and Egypt. Stern (1999) reviews these studies, emphasising the following results:

- In the case of Morocco, establishing free trade with the EU is estimated to increase welfare by 1.7 to 2.4 percent.
- For Tunisia, free trade with the EU is modelled to increase welfare by 3.3 to 4.7 percent.
- Egypt is estimated to reap a welfare gain of 2 percent following the creation of free trade with the EU. Another study indicates that under optimistic assumptions welfare gains of up to 5.3 percent are possible.

These estimates are broadly confirmed by Rutherford, Rutström and Tarr (1999). Using the same type of model, they expect welfare gains of 3 to 5 percent for the typical Mediterranean economy. In general, these analyses also find that a non-discriminatory unilateral removal of import restrictions and the creation of multilateral free trade would be somewhat more advantageous. While not negligible, the estimated welfare gains from the Agreements seem modest. One should bear in mind, however, that the dynamic gains are inherently difficult to model and the positive impact on the Mediterranean countries could be much larger.

The Euro-Med Agreements will help the region on its way to a more prosperous path of economic development. They will not, however, suffice by themselves.

Weighing the pros and cons of the Euro-Med Agreements, and taking the broader political economy view discussed before, we are confident that the Agreements help getting the Mediterranean region on a more prosperous path of economic development. Having said this, it is obvious that there is scope for improvement (7). Ideally, one would like to see the EU and its Mediterranean partners moving jointly toward further trade liberalisation on a multilateral basis. Not only would this address the problems of trade diversion and rent shifting within the Euro-Mediterranean trade area, but it would also bring benefits for the rest of the world.

The creation of free trade between Mediterranean countries is an important objective of the Agreements, but so far progress seems to have been very limited. Introducing the Agreements country-by-country rather than with a “big-bang” for the region may be part of the explanation. But a positive effect of intra-Mediterranean free trade would mitigate the hub-and-spoke problem if, at the same time, rules of origin and the content rule are not too binding. This would be further improved by establishing an EU-Mediterranean customs union - ideally coming along with a further reduction in common external tariffs. But even then, EU locations may still have an edge. When locational and technological externalities in the Member States outweigh transport costs to the Mediterranean countries, it remains in the interest of firms to locate in the economic “core” rather than the “periphery”.

When discussing this hub-and-spoke phenomenon we noted that it tends to stimulate investment in the EU rather than in the Mediterranean region. While this is true, it would be grossly misleading to consider this an important reason for the lack of foreign direct investment in Mediterranean

7) See also Hoekman and Djankov (1996) and Ghesquiere (1998).

countries compared to what we have witnessed in Central and Eastern Europe and in other emerging markets. The low level of foreign direct investment seems to largely reflect deficiencies in the economic framework of the Mediterranean countries, which - by and large - does not make them prime destinations for foreign investors. Improvements in economic policies may be more important than better aligning the Agreements with the objective of multilateral free trade.

This observation leads us to some final comments on the way ahead for the region.

4. The main ingredients for future prosperity

Increased openness is only one ingredient in a broad range of required reforms.

When one compares the poor growth performance documented in Section 2 with the likely benefits of the Association Agreements set out in Section 3, it becomes clear that increased openness is only one element in a broad range of economic reforms that the Mediterranean region would need to apply in order to permanently boost its growth prospects. Indeed, the region's historically low trade ratios are not exogenously determined, but are the result of decades of inward-looking development strategies, dominated by extensive trade protection, domestic regulation and state ownership.

The need to apply economic reforms on a broad scale stems from the mutual dependency of trade protection and state involvement in the Mediterranean economies. On the one hand, government ownership and subsidies are in many cases motivated by the desire to sustain inefficient and loss-making state enterprises for political reasons. These inefficiencies stem from a combination of trade protection, subsidies and domestic regulation, which distort incentives and hamper competition and innovation. On the other hand, the high levels of government spending are themselves a source of persistent high import tariffs because of the difficulty of replacing this key source of government revenue with more broad-based domestic taxes. As is often the case in underdeveloped fiscal systems, broad domestic tax bases are hard to develop due to poor administration, low incomes and widespread tax evasion in the unofficial economy. As a substitute for import tariffs, governments have been tempted to resort to taxing profits and capital gains in the official corporate sector, but doing so excessively risks undermining its further development and expansion. From this perspective, it is difficult to see how sharply reduced import tariffs can be achieved without simultaneously scaling back government spending to more sustainable levels.

Reducing trade barriers quickly has, of course, become a sensitive issue in the Mediterranean countries particularly because of the low level of efficiency and competitiveness of domestic industries. Decades of heavy import protection have contributed to an undermining of external competitiveness that has led to the perpetuation of tariffs. As we argued earlier in the case study of Egypt, import protection tends to raise the return on investment on import-substituting production relative to exportable goods. As a result, economic resources are allocated disproportionally to domestic import-substituting goods and services, starving the growth of export industries. The undermining of exports has been reinforced in several cases by extraordinary sources of hard currency, such as oil exports, foreign aid and remittances. These inflows of foreign currency have tended to appreciate real exchange rates and thus further undermined the competitiveness of exports. As a result, export ratios in the Mediterranean region have tended to be low by international comparison even though exports as such have not generally been subject to explicit trade barriers. While domestic concerns of a too rapid exposure of domestic industry to international competition are understandable, they also seem to underestimate the ability of a freely determined exchange rate to restore competitiveness. Rather than wiping out domestic industries on a wide scale, free trade combined with a competitive exchange rate is more likely to stimulate a realignment of economic activity. In effect, slow progress in liberalising exchange rates is undermining the goal of removing trade barriers.

The Agreements between the EU and individual Mediterranean countries have largely neglected the opening up of borders to trade and capital flows between Mediterranean countries. The strategy so far seems based on "static comparative advantage" and inter-industry trade, essentially viewing individual countries as a cheap production base for low-tech manufactured goods, aiming at a world market. This view may be associated with some problems, however. Since manufacturing is typically characterised by increasing returns to scale, trade in manufactured goods tends to develop along the lines of scale economies and intra-industry rather than inter-industry trade. When economies of scale are key to competitiveness, the size of the market becomes crucial. FDI and other investment in the manufacturing industry typically target local and regional demand as much as they aim for exports to the rest of the world. In this sense, remaining trade barriers between the Mediterranean countries themselves may pose a serious problem for the development of a manufacturing-based export industry by fragmenting the regional market. While progressing slowly, there are promising signs in this area, with a free trade area having been established between Tunisia and Morocco in 1999 (8), and an agreement between Egypt, Jordan, Morocco and Tunisia this year working towards a free trade zone.

The process is slow, but the interdependence of the various elements of reform raises the prospect that the region may embark on a more radical transformation to a market economy.

On balance, the Mediterranean countries are continuing a gradual reform process that began with macroeconomic stabilisation and is now broadening to trade liberalisation. Unless this process is reversed, it is likely that increased economic openness will also reinforce the economic and fiscal pressures for deeper structural reforms and the scaling back of state-centred economic models. While the process remains relatively slow, the interdependency between different elements of the reform process at least raises the prospect that the region may eventually embark on a more radical transformation to market-based economic models that would allow it to realise its real growth potential.

8) The agreement of March 1999 provided for the suppression, with immediate effect, of all duties on some 2 000 non-agricultural products carrying a customs duty below 10 percent. Other custom duties will be gradually lowered up to 2007.

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