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Intra-Regional Trade

Potential Catalyst for Growth in the Middle East

Bernard Hoekman

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Abbreviations

A.V.E.	ad valorem tariff equivalent
D.C.F.T.A.	deep and comprehensive free trade agreement
ESCWA	Economic and Social Commission for Western Asia (United Nations)
E.U.	European Union
F.D.I.	Foreign Direct Investment
F.T.A.	free trade agreement
G.C.C.	Gulf Cooperation Council
G.D.P.	Gross Domestic Product
I.I.T.	intra-industry trade
I.M.F.	International Monetary Fund
I.T.C.	International Trade Centre
L.P.I.	Logistics Performance Indicators (World Bank)
MENA	Middle East and North Africa
N.T.M.	non-tariff measure
O.E.C.D.	Organization for Economic Co-operation and Development
PAFTA	Pan-Arab Free Trade Agreement
R&D	research and development
S.T.R.I.	services trade restrictiveness indices
VC	value chain
U.A.E.	United Arab Emirates

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Summary

Economist Bernard Hoekman analyzes the state of economic integration in the Middle East and North Africa and concludes that MENA countries have failed to reach their economic potential in large part due to trade barriers, failure to diversify their economies, and lack of investment incentives. He questions the prospects of relying on top-down, traditional trade agreements such as those typically pursued by the Arab League, and instead proposes cross-border economic cooperation on an à la carte, bottom-up, pragmatic basis. This strategy, he argues, offers greater prospects for countries of the Middle East to establish conditions for shared prosperity.

Key Findings

- In recent years, MENA accounted for 3 percent of agriculture exports, 2 percent of manufactures exports, and 2.5 percent of services exports globally

- A typical MENA country exports less than half, and as little as one quarter, of its potential

- Ambitious 'top-down' regional initiatives central to MENA international relations have failed to bring about increased trade and economic growth

- Intra-regional trade offers an opportunity for MENA to boost economic growth and job creation through lower non-tariff barriers and reduced trade costs

- Regional cooperation in MENA offers better prospects for supporting growth if pursued on an à la carte, bottom-up, pragmatic basis involving greater participation from businesses and communities

- Much like Europe, regional cooperation could generate long-term payoffs for MENA that go beyond economic growth by creating incentives to sustain peace and security

Introduction

It has often been argued that countries in the Middle East and North Africa (MENA) can do much more to leverage international market opportunities to accelerate economic growth and job creation. Excluding petroleum exports, the MENA region,[1] with over 400 million people, exports roughly the same amount as Switzerland.[2] With a population of over 500 million inhabitants and an average per capita income of some $36,000 in 2014,[3] the European Union is a major market in close geographic proximity to many MENA states. India, China, other parts of Asia, as well as sub-Saharan Africa, offer dynamic markets and great potential as sources of demand for goods and services. Major economies in the region offer good trade growth prospects as well, most notably Iraq and Iran, both countries that in the past have played an important role in the regional economy.

"the MENA region, with over 400 million people, exports roughly the same amount as Switzerland."

Harnessing this potential is a necessary condition for the MENA region to generate the broad-based economic growth and job creation it so urgently needs. The pursuit of policies by many governments in the region, designed to benefit specific politically connected groups in society, and an unwillingness to establish an environment supportive of private sector dynamism have proven very costly.[4] They helped to generate the dynamics that resulted in the conflicts convulsing many parts of the region and the resulting destruction of property, refugee flows, and internally displaced people. The asymmetrically distributed benefits of the policies implemented before the Arab Spring also created a significant opportunity cost in the form of reputational harm done to the policy recommendations long advocated by international organizations such as the European Union, International Monetary Fund, and World Bank. Avoidance of an overvalued exchange rate, an open trade and investment regime, pro-competitive regulation, contestable markets, transparency, accountability, and rule of law remain fundamental elements of any incentive framework conducive

to sustained high rates of investment in tradables, employment growth, and rising household real incomes. Overcoming public distrust, generating the political support needed for implementing policy reforms supportive of investment and trade, and establishing the institutions shown to be necessary for sustained high growth in other parts of the world are key challenges confronting MENA policymakers.

MENA countries vary widely in the degree to which they are integrated into the global economy. As discussed below, some countries are at the top of globalization rankings for specific dimensions of international integration. Most countries do not participate in the forms of value chain production and trade that have driven growth in East Asia and in Central and Eastern European countries. A prominent feature of the region is that there is only limited trade between neighboring countries, despite regional integration long having been a purported goal of the Arab states. A variety of initiatives have been pursued in the past 50 or so years to promote Arab cooperation, including gradual market integration under auspices of the Arab League, such as the Pan-Arab Free Trade Agreement (PAFTA),[5] and the creation of a common market involving Saudi Arabia, Kuwait, the United Arab Emirates, Qatar, Bahrain, and Oman within the Gulf Cooperation Council (G.C.C.). In some dimensions, such as intra-regional capital and labor flows, Arab states are relatively highly integrated, but intra-regional trade in manufactured products within MENA and with neighboring economies such as Turkey is far below levels observed in many other regions.[6]

"MENA countries vary widely in the degree to which they are integrated into the global economy."

There has been extensive analysis of the reasons why MENA countries 'punch below their weight' in economic terms on global markets and why there has been only limited success on the part of energy exporters to diversify. Such factors include state dominance of the economy and mismanagement of the real exchange rate and associated 'Dutch disease.' The role of the state has been reflected in high shares of government employment; extensive subsidies with associated fiscal burdens; 'crony capitalism;' high barriers to trade to

protect (connected) incumbents; weak economic governance and 'red tape' resulting in high transaction costs; and an absence of effective pro-competitive regulatory frameworks. Addressing the reasons for the region's longstanding underperformance is important from a political stability and social perspective. Other parts of the world have shown that more effective exploitation of world markets, reflected in increasing exports of higher value-added goods and services, will generate both employment opportunities and higher wages and household incomes.

This paper briefly reviews the extent to which MENA countries are integrated into the global economy and with each other, and some of the relevant policy areas that impact trade performance and investment incentives. The specific focus is on the question of whether re-energizing efforts to integrate markets regionally can help address the various factors thought to impede the implementation of policies needed for a broader economic growth strategy. Clearly a precondition for any such initiatives for the countries currently mired in conflicts is a re-establishment of peace, political stability, and economic security. The discussion that follows does not engage with the here-and-now challenges of ending conflicts, nor does it address directly the short-term fiscal consolidation and macroeconomic challenges that are currently confronting many governments as a result of low energy prices and weak global demand, except to note that this may potentially change the incentives to pursue regional cooperation more seriously. The focus is on the medium term. A case is made that regional integration can and should play a role in addressing the constraints that, to date, have held countries back in benefiting from international market opportunities, but to do so it must contribute to overcoming the political economy forces that have precluded beneficial trade and investment policy reforms. A business-as-usual approach to intra-regional cooperation is unlikely to do so, given the dismal track record to date.[7] The region needs new approaches that are more pragmatic and directly involve constituencies and interest groups with a clear stake in successful cooperation.

The plan of the paper is as follows. Section 1 briefly reviews indicators of the extent of international integration of the MENA region, both with respect to the world and intra-regionally. Section 2 summarizes the state of play on trade policy and trade costs, important factors affecting the ability of firms to exploit trade opportunities and support economic growth. Section 3 discusses whether and

how regional cooperation could help promote policy reforms that are needed to attract greater investment in the region and increase the participation of firms in the international value chains that are driving global trade. Section 4 concludes.

International Integration: State of Play

The MENA region accounted for 6.6 percent of global merchandise trade in 2014.[8] Fuels and other natural resources account for some 77 percent of total export value, manufactures for 20 percent, and agriculture for 3 percent. MENA's share in world exports of manufactures was only 2 percent, similar to its share in global agricultural trade. Regional export growth in the pre-Arab Spring/global financial crisis period was driven mostly by expansion of existing products to new markets and new products to existing markets—that is, along the extensive margin.[9] This can be explained partly by declining sales to a number of traditional export markets in Europe,[10] but is also an illustration of a gradual increase in participation in international production sharing arrangements in sectors such as motor vehicles and aeronautics (Morocco) and chemicals (G.C.C. oil exporters).[11] These were positive developments, but limited to only a subset of countries and did not generate enough new opportunities for workers through the growth of enough productive firms that together could 'move the needle' in contributing to export growth and diversification. The MENA region lacks "teams of world class exporters to surround and emulate the number ones," the firms that are the market leaders in their sectors.[12]

The share of global services exports in 2013, as measured by the balance of payments, is somewhat higher at 2.5 percent. Transportation and travel (tourism) account for the bulk of services exports, with the region as a whole having a 5.2 and 6.5 percent share of the global total, respectively. Egypt, Morocco, and Tunisia rank among the world's 30 largest net exporters of services (in value), helping to partially offset merchandise trade deficits. However, services exports have been mainly concentrated in transport and travel. MENA accounts for only 1.7 percent of global trade in other commercial services, the largest and most dynamic category of global services trade. For all of the three major service categories, no MENA country has a global share that exceeds 1 percent. Egypt comes closest with a 1 percent share of global transportation services

(reflecting Suez Canal revenues). At less than 0.3 percent,[13] the region barely figures in global exports of services related to goods—manufacturing services using physical inputs owned by others, a measure of participation in global value chains.

Global flows of F.D.I. tripled in the decade preceding the 2008 financial crisis, but inflows into MENA economies increased at an even higher rate—rising from 0.2 percent in 1990 to 4.6 percent of G.D.P. in 2008. Since 2008, F.D.I. inflows dropped by half, to the equivalent of some 2 percent of G.D.P.[14] In 2013, total F.D.I. inflows were some $45 billion, down from $93 billion in 2008.[15] In addition to the drop in overall inflows of F.D.I., there have been shifts in the allocation since 2008. The U.A.E., Iraq, Kuwait, and Morocco have seen their shares of the total increase substantially, while that of Saudi Arabia has fallen from 42 to 20 percent.[16] With a 22 percent share, the U.A.E. was the largest recipient of F.D.I. in 2013.[17] What has not changed is that in most countries F.D.I. tends to go primarily to the energy and natural resource sector and to nontradables, such as real estate and construction, with little going to export-oriented manufacturing or high-tech services.[18]

"There is significant heterogeneity across countries in the region in terms of production structure and trade specialization."

The trade and investment data makes clear that there is significant heterogeneity across countries in the region in terms of production structure and trade specialization. For the 'region' in the aggregate, fuels and natural resource exports dominate, with only limited change in recent decades in the share of manufactures. Services are somewhat more competitive, as reflected in higher global trade shares, but the two categories of services where the MENA share is highest are not activities with high value added. On some measures, MENA countries are among the most globalized countries in the world. In a recent compilation of globalization indices that considers labor remittance and F.D.I. flows, as well as trade in goods and services, Lebanon ranks second, after

Singapore. Oman ranks fifth, Bahrain 14th, Kuwait 16th, Jordan 17th, and the U.A.E. 22nd.[19] Algeria, Syria, and Iran are the least connected internationally in this exercise, ranked as 115th, 120th, and 143rd respectively.[20] Of course, any such ranking is heavily influenced by what is included in the indicators and the weights given to constituent components. In the case of Iran, the very low ranking reflects the impact of economic sanctions, while the ongoing conflict is a major factor in the case of Syria. Nonetheless, this data serves to illustrate that many MENA economies are closely linked to the international economy. This is partly due to the small size of many of the economies and the structure of specialization—oil exporters often have high trade/G.D.P. ratios, employ ('import') substantial numbers of foreign workers, and generate major inward and outward flows of F.D.I. that, in turn, give rise to remittances and repatriation of investment earnings. Thus, the G.C.C. as a group ranks 31st in the ESCWA exercise, compared to 73rd and 71st, respectively, for the Maghreb and the Mashreq countries.[21]

"There is less integration, or interdependence, if the focus is limited to intra-regional trade flows."

Such globalization indicators measure 'connectivity' with the world as a whole. Since the global financial crisis, the Arab Spring uprisings, and the violent conflicts that have erupted in several countries, connectivity indices have fallen for many economies, augmented by a drop in the price of oil resulting from weak global demand. However, notwithstanding these disruptive events, compared to 2000 there is still a positive trend for many countries: with the exception of Saudi Arabia, the G.C.C. has become more connected (globalized), as have Egypt, Morocco, and Tunisia. Several major economies, however, registered declines in globalization rankings since 2000, including Iraq (-71 percent), Saudi Arabia (-22 percent), and Iran (-15 percent).[22] One implication is that Iraq and Iran offer the prospect of substantial trade and investment expansion, including greater intra-regional exchanges.

There is less integration, or interdependence, if the focus is limited to intra-regional trade flows. This has insulated countries, to some extent, from the effects of the conflicts in parts of the region: the direct trade spillovers have

been less than they would have been if the region had been more integrated.[23] Intra-regional exports of goods are particularly important for Syria, Lebanon, and Jordan (over 40 percent of total exports) and have doubled for Bahrain and Egypt since 2000, exceeding 20 percent of total trade in 2013. Intra-regional trade in intermediates has also grown, from some 15 percent of the total to the low 20 percent range.

Linkages through movement of people are often stronger than linkages through trade in MENA, even though a large share of foreign workers in G.C.C. countries are not from the region, but instead come from South and East Asian countries. As a share of total migration, intra-Arab flows have stayed essentially constant since 1990, at around 37 percent of the total stock.[24] Many of the workers that send back remittances to their families work outside the region. Only 29 percent of outward remittance flows from Arab countries goes to other Arab countries,[25] although the figure is much higher for some countries—50 percent of remittance flows to Egypt are from workers in the G.C.C.; 60 percent for Jordan. One dimension where intra-regional flows are high is for banking—in 2009 some 60 percent of all foreign banks in Arab countries are of Arab origin, up from 43 percent in 2000.[26]

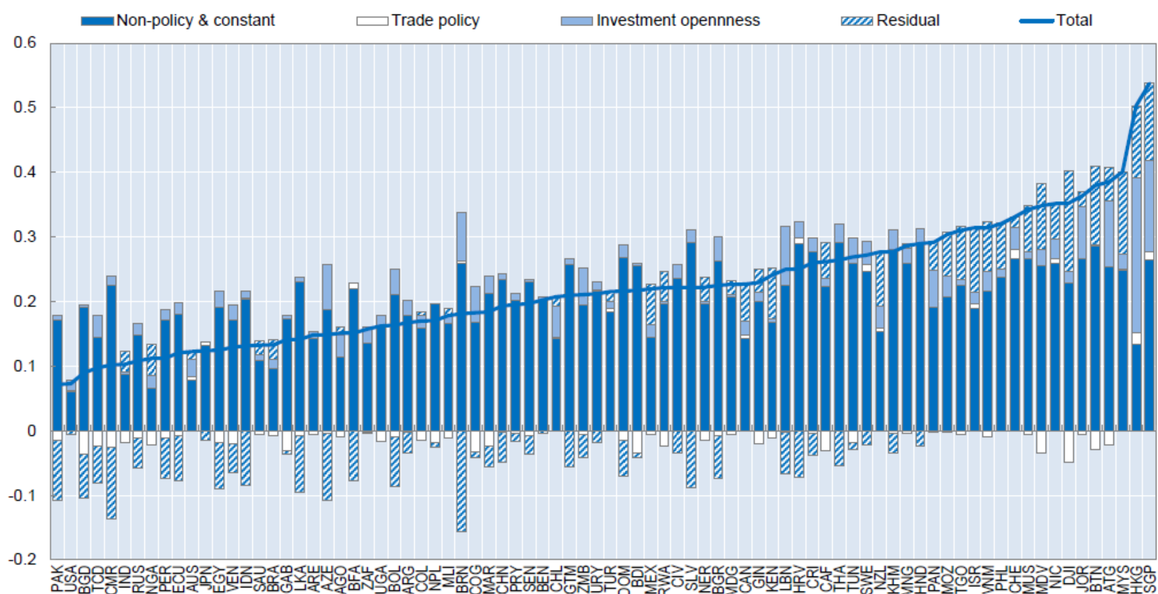
Goods and services increasingly are produced in regional or global value chains (VCs), with value being added to a product by firms located in different countries. Much of this foreign value comprises services inputs such as research and development (R&D), design, finance, marketing, and distribution. The geographic fragmentation of production is reflected in rising vertical specialization, with firms in countries producing outputs that are exported and further processed in the importing country, which in turn may be exported to a third country, and so forth. Some 30-40 percent of world trade today is vertical in nature.[27] A large share of this VC trade is intra-firm—involving exchanges between plants that are part of the same company—which implies that such trade is closely linked to F.D.I., and that barriers to F.D.I. will constrain the ability of a country to participate in global supply chains.

A striking feature of the MENA region as a whole is that it participates to only a very limited extent in international VCs. In the case of oil and mining product exporters, VC participation is at the upstream stage, providing inputs that are used in other countries—so-called forward linkages in the literature. For oil-importing countries, exports of manufactured and agricultural goods and

services account for some 35 percent of G.D.P., which is quite high compared to other developing regions. These exports are largely for final consumption, however, meaning they do not comprise goods that are processed further in the destination market. The same applies for so-called backward linkages, which is the use of imported inputs that are embodied in a processed product that is exported.

An often used crude measure of vertical specialization is intra-industry trade (I.I.T.): a measure of the relative importance of imports and exports of similar products. Analysts have pointed out for decades that levels of I.I.T. for MENA countries are very low. I.I.T. rose somewhat in the 2000s, but remains far below what is observed in other regions. Tunisia has the highest share of I.I.T. in the MENA region, attaining some 40 percent in the late 2000s, followed by Morocco and the U.A.E. The only country in the region with a significant share of components in its total exports—a key feature of vertical specialization—is Tunisia, which saw the share of parts and components in total exports expand from less than 4 percent in 1985 to 10 percent in recent years.[28] Tunisia is also one of the few countries in the MENA region where F.D.I. in manufacturing

Figure 1. Share of imported value added in exports, 2005



Note: Share is given by solid line; bars indicate estimated contribution of different determinants.

Source: Kowalski et al. (2015).

sectors is substantial as a share of total F.D.I. inflows—around 15 percent of greenfield investment. As mentioned, export-oriented F.D.I. in several manufacturing sectors is also substantial in Morocco. This has been associated with increasing demand for locally produced inputs: for example, the Renault plant sources 40 percent of its inputs locally, including from suppliers that have also invested in the country.[29]

More detailed analysis of VC participation has become possible as a result of major research projects to measure the value-added content of trade. Figure 1 shows that backward participation in VCs varies across countries in the MENA region; Egypt, Saudi Arabia, and the U.A.E. are at the low end with a share of around 15 percent, followed by Morocco and Turkey with a ratio of some 20 percent. The most integrated MENA countries on this measure of VC participation are Lebanon, Tunisia and Jordan. Over 35 percent of the value of Jordan's gross exports reflects imported intermediate inputs. Relative to what is predicted based on fundamental factors such as G.D.P., the share of manufacturing in G.D.P., and proximity to a global industrial hub, VC participation in many MENA countries is below what is predicted by fundamentals. In a number of cases policy is found to be relatively supportive, but as discussed further below, the O.E.C.D. analysis concludes that trade policies in Morocco, Tunisia, and Egypt constrain VC participation, whereas in all MENA economies included in the sample, F.D.I.-related policies (investment openness) are a positive factor, especially in the countries with the highest VC participation performance—Tunisia, Jordan, and Lebanon.[30]

Table 1. Bilateral trade costs for industrial products (percent)

	Maghreb	Egypt	Mashreq	Fr/It/Sp	Greece
Maghreb	95	126	152	75	151
Egypt	126		112	119	163
Mashreq	152	112	77	149	185
France/Italy/Spain	75	119	149	50	96
Greece	151	163	185	96	
G.C.C.	167	111	96	132	169

Source: Shepherd (2011).

Trade costs are often argued to be one reason for the limited participation in VCs. Computations of bilateral trade costs for MENA countries indicate that trade costs are typically twice as high in the region as they are in E.U. countries, especially for trade between Arab countries. Maghreb countries have lower trade costs with Europe than between themselves (Table 1).[31] The cost differentials relate mainly to distance, trade logistics, and the existence of non-tariff measures (N.T.M.s). Trade costs are consistently higher for agricultural products. This reflects the higher transportation costs (per unit value) and time sensitivity of perishables, but also potentially the impact of more controls at the borders and non-tariff measures. In short, MENA's geographic advantages in terms of connectivity to major markets such as the European Union are more than offset by trade costs. Container dwell times are often substantially above the O.E.C.D. average and what prevails in emerging economies in Asia.[32] Markets for logistics services, including trucking, are fragmented by country, with many small providers and few incentives for consolidation and efficiency gains. There are relatively few active transport corridors between countries in the region.[33]

Trade-Related Policies and Costs

In the 1990s, many countries made significant progress in lowering import tariffs and other explicit trade restrictions. Tariffs in Egypt, for example, were reduced to less than 10 percent on average, (down from over 40 percent in the late 1980s), most quantitative restrictions were removed, and the trade regime was greatly simplified. Similar reforms were implemented in other Mediterranean MENA countries. A mix of unilateral, autonomous reductions in import tariffs and regional liberalization through trade agreements with each other and with major trading partners, such as the European Union, reduced tariff barriers significantly. Based on the results of a 2008 survey of trading firms, Hoekman and Zarrouk conclude that tariffs were mostly removed on intra-Arab trade and customs procedures were perceived to be much less of a problem than in the late 1990s.[34] In 2001, tariffs were ranked as one of the most important barriers to intra-regional trade; in 2008, they were ranked last. Instead, transport-related infrastructure and real trade costs, such as trade facilitation, were ranked as

the most important constraints. More recent assessments come to the same conclusion.[35]

Factors limiting a positive supply response to trade policy reforms include the continued dominant role of the state in many economies[36] and barriers to entry and high costs of investment in new activities resulting from a plethora of regulatory impediments.[37] Even on the trade policy front, less was achieved than was needed to encourage investment in tradable activities. The average uniform tariff equivalent of all applied tariffs (ad valorem and specific) for a number of MENA countries remains substantially above that in other parts of the world.[38] Moreover, the prevalence of N.T.M.s is extensive. Research suggests that the gap introduced between domestic and world prices for a given product as the result of N.T.M.s is typically large in countries for which data is available (Morocco, Tunisia), especially for agricultural goods.[39] While progress has been made in streamlining N.T.M.s over the last two decades, this has been offset by an increase in the use and incidence of technical regulations, product standards, procedural requirements, and administrative processes that result in delays and high costs of compliance. Firm-level surveys by the International Trade Centre reveal that N.T.M.s are considered a major factor impeding trade and reducing profitability, especially for intra-regional flows.[40] Noteworthy is that firms regard procedures and requirements implemented by their own governments as much of a burden on exports as those imposed by foreign countries.

"Trade costs are typically twice as high in the region as they are in E.U. countries."

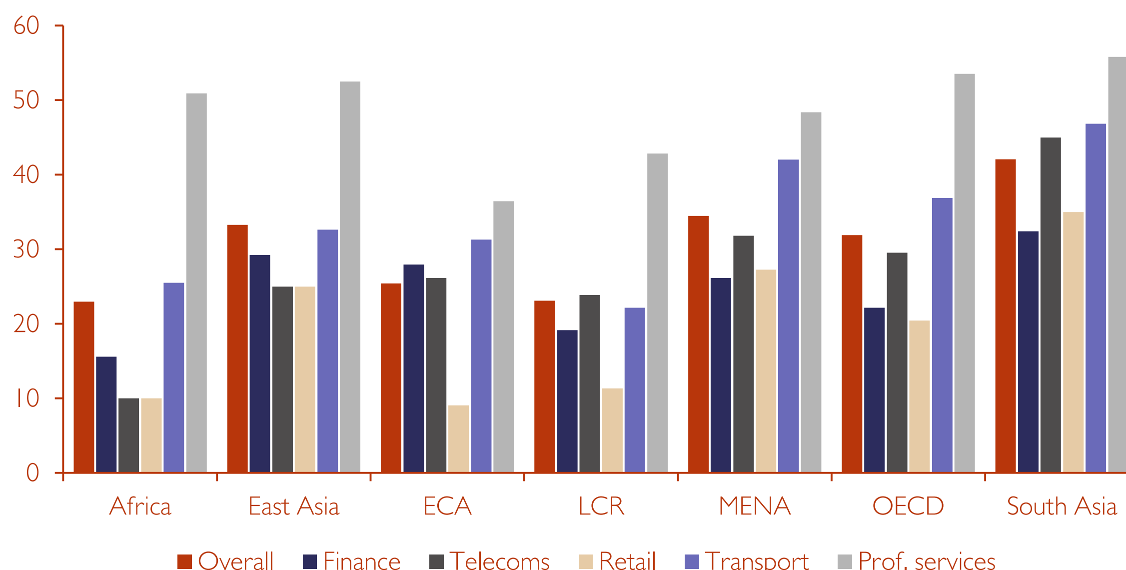
Jaud and Freund argue that in many MENA countries, high trade and transaction costs, partly resulting from overvalued exchange rates[41] and partly a reflection of trade barriers that remain relatively high, are a major factor reducing competition and competitiveness. Trade-related policy reforms, while significant relative to the status quo ante, did not go far enough, especially as countries elsewhere in the world did more to remove barriers to trade and lower operating costs for firms. The continued prevalence of high 'red tape' costs—especially in comparison to 'competing' countries such as Turkey and Central and Eastern

Europe—and dominance of the state in the economy limited the positive effects of trade reforms. Behar and Freund conclude that a typical MENA country exports less than half, and as little as one quarter, of its potential, controlling for standard determinants of trade such as country size, income, and distance to partner markets.[42] Similarly, Bhattacharya and Wolde also find that a typical MENA country exports much less than what it should, given fundamental trade determinants,[43] although imports are much closer to what would be expected.[44] Bourdet and Persson estimate that improving export and import procedures to the best practice level prevailing in the region could increase the value of South Mediterranean exports by 34 percent and the number of products exported by these countries by 21 percent.[45] If exporting Mediterranean countries attained best trade practices prevailing in the European Union, predictions estimate that total exports from the countries analyzed would increase by some 40 percent on average. Countries have much to gain from improving sub-regional trade corridors, regional trade facilitation frameworks, and transit systems.

There is robust evidence that a country is unlikely to become a major exporter if its firms do not have access to a wide variety of competitively priced inputs.[46] This includes access to services inputs, such as professional services and logistical support. The competitiveness of firms and their ability to use and participate in VCs is a function of the cost and quality of the inputs they have access to. Sector-level measures of trade and F.D.I. policies are positively associated with manufacturing productivity: lower levels of trade policy restrictiveness and trade costs help improve the productivity of firms. This applies to services inputs as much as to goods.[47]

Barriers to trade and investment in services sectors often are significant in the region.[48] Expanding production and exports of services will often require F.D.I. However, as noted previously, F.D.I. goes primarily to the energy/natural resource sector and to nontradables (real estate and construction), with little going to export-oriented manufacturing or high-tech services.[49] Averaging across countries, services trade restrictiveness indices (S.T.R.I.)—a measure of barriers to trade and investment in services—in MENA is twice as high as in Europe and Central Asia (Figure 2).

Figure 2. Overall services trade restrictiveness index by region, 2010



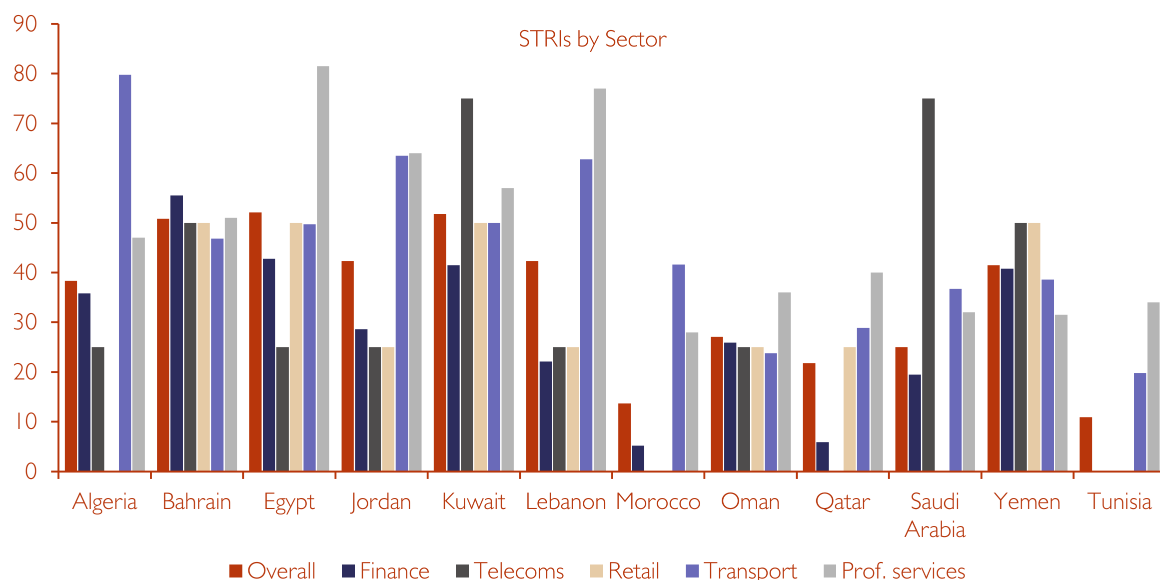
Note: Indices range from 0 to 100, with 100 being completely closed to foreign competition. Data is only available for 2010.

Source: Compiled from World Bank, http://iresearch.worldbank.org/servicestrade/default.htm.

Morocco has the least restrictive services trade and investment policies among MENA economies, consistent with some of the sectoral performance measures discussed below. Professional and transport services tend to be the most restricted sectors in the MENA regions (Figure 3); the latter will have negative consequences for the efficiency of logistics-related services; the former for the productivity performance of firms in general given that professional services are one channel for the diffusion of knowledge regarding good practices (management consulting, accounting, legal services, etc.).

Jafari and Tarr have estimated the ad valorem tariff equivalents (A.V.E.s) implied by the S.T.R.I.s reported by the World Bank, using the methodology developed by the staff of the Australian Productivity Commission.[50] These suggest that there is significant variance in A.V.E.s across sectors and countries, with Morocco standing out as the country with the lowest levels of discrimination against foreign providers of air and road transport among the North African countries, but with significant levels of protection in the maritime transport sector (Table 2). Such high levels of trade restrictions reduce the ability of firms to participate in value chain-based production.

Figure 3. Services trade restrictiveness indices by sector, 2010



Note: Indices range from 0 to 100, with 100 being completely closed to foreign competition.

Source: Compiled from World Bank, http://iresearch.worldbank.org/servicestrade/default.htm.

Table 2. Estimated ad valorem tariff equivalent of S.T.R.I.s (percent)

Sector	Algeria	Egypt	Morocco	Tunisia	Turkey	Bulgaria	Romania
Accounting	56	56	27	79	75	20	37
Legal services	52	73	47	69	73	47	47
Air transport	55	40	0	39	44	0	37
Rail transport	93	93	59	90	93	84	84
Road	30	12	8	21	15	15	15
Banking	14	44	2	10	2	1	5
Insurance	28	35	26	29	14	17	18
Fixed line	10	18	13	12	6	5	5
Mobile line	10	13	9	9	5	4	5
Retail	5	7	1	6	1	1	1
Maritime	22	58	51	54	26	11	0

Source: Jafari and Tarr (2015), based on World Bank S.T.R.I. data.

All this matters for economic performance. Hoekman and Shepherd show that local services productivity is an important determinant of manufacturing productivity at the firm level, with services productivity mattering more for those firms that use services relatively intensively in their overall input mix, and that this in turn impacts on merchandise trade performance.[51] They also find that S.T.R.I.s are one determinant of the value of bilateral merchandise trade flows. Policies affecting investment in retail distribution and transport are particularly important—a result that is intuitive, given that these services directly affect the ability of goods producers to get their production to market. A country that maintains high barriers to trade in services, and that does not have a supportive business environment for investment, effectively taxes its firms and impedes their ability to be or become competitive on world markets. If there are both high tariffs on imports of intermediate products and barriers to trade and investment in services, this will negatively affect the prospects for firms to connect to international production networks and global supply chains.

Additional Measures to Boost Integration

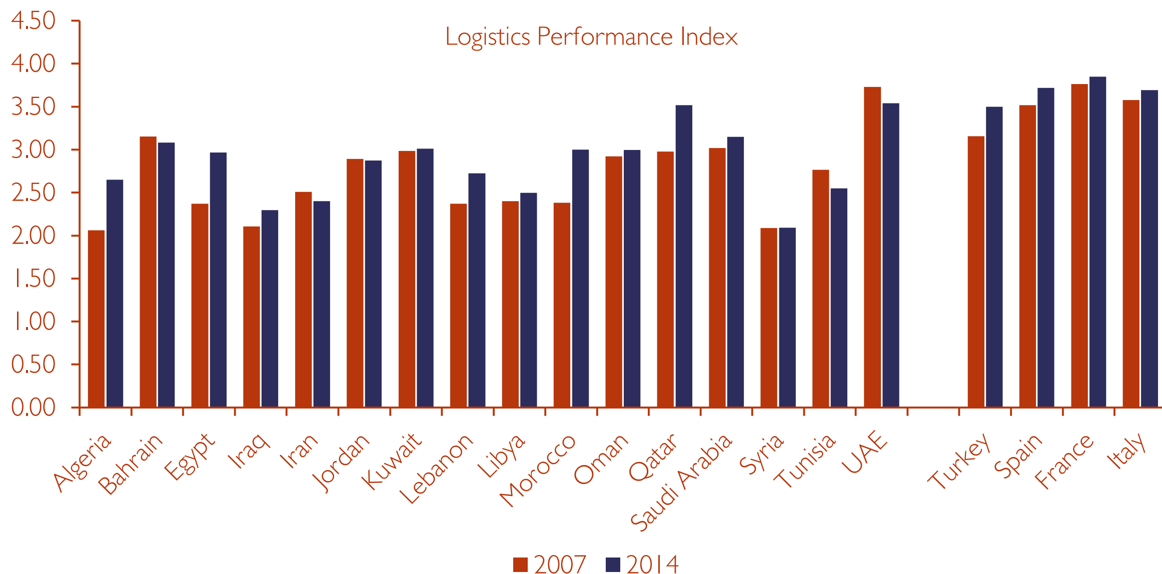
Of course, more than an open trade regime is needed to develop competitive services sector offerings domestically. Infrastructure, education, and the quality of institutions and governance matter greatly. Beverelli, Fiorini, and Hoekman find that the positive economic effects of more open services trade regimes on downstream sectors are strongly conditional on the quality of economic governance and related institutions.[52] The implication is that countries with better institutional and business environments will benefit from a more open services trade regime. Beverelli et al. argue that their finding may be due to the characteristics of services and services trade. The non-storability of many services often will require a foreign firm to invest or otherwise establish a physical presence in an importing market to provide a service. This in turn subjects the firm to local regulation and the prevailing business environment.

A large part of the competitiveness reform agenda revolves around improving the operation of services sectors. Trucking services are an example. Informality and relatively short distances prevent the emergence of a network of high-quality

medium-size transport operators, which has implications not only for logistics, but also for road safety and urban management. Intermediary professions (e.g., brokers, agents) also tend to be fragmented, with insufficient quality control and nationality requirements for brokers in some countries, reducing competition. These are areas where some countries have been pursing action. Morocco has implemented measures to abolish nationality requirements for brokers, promoted the development of new logistics services for the manufacturing industry (e.g., logistics zones in Tangier and Casablanca), opened up the sector to F.D.I., and adopted new customs procedures that are more suitable for logistics activities.[53]

The World Bank's Logistics Performance Indicators (L.P.I.s) provide a comprehensive measure of the overall quality of logistics services across 160 countries.[54] LPI level has been found to be an important determinant of the trade costs that prevail between any given pair of countries: improving LPI performance would reduce average bilateral trade costs ten times more than an equivalent percentage reduction in average tariffs.[55] Many countries have registered improvements in LPI scores since this data began to be collected in 2007, although Tunisia and the U.A.E. are perceived by transporters and traders

Figure 4: Logistics Performance Index, 2014



Source: World Bank, http://lpi.worldbank.org/.

as having seen a deterioration in trade logistics performance during the 2007-14 period. There is substantial heterogeneity in country performance, with the G.C.C. countries perceived to have the best logistics performance, approaching that observed in the European Union. (Figure 4).

Road transport is the dominant mode of regional transport. The region has extremely limited railway connectivity. However, air transport linkages have expanded substantially in the last 15 years, and there have been major improvements in liner shipping connectivity. Between 2004 and 2014 the U.A.E., Morocco, Egypt, Saudi Arabia, Oman, Lebanon, Bahrain, and Jordan all registered an increase in liner shipping connectivity, in some cases more than tripling (Morocco, Lebanon). Four MENA countries are in the global top 20 for liner shipping connectivity: the U.A.E. (ranked 14th in 2014), Morocco (15), Egypt (17) and Saudi Arabia (18).[56] That said, transport and logistics related costs remain a major burden.[57]

Addressing Sources of Underperformance: (How) Can Regional Cooperation Help?

While there is still much to be done to improve the incentive structure confronting firms in tradable activities, some MENA countries have increased rates of participation in international VCs—e.g., Tunisia and Jordan—and some have been successful in attracting F.D.I. in advanced manufacturing sectors—e.g., Morocco. On some dimensions, policy regimes in a number of MENA economies are comparable to those in countries that have been much more successful in leveraging trade opportunities into sustained economic growth.[58] What is missing is sufficient volume, or a sustained step increase in export production and performance, driven by productive firms that are leaders in their sector.[59] Research has identified a number of policy factors that underlie the weak trade performance, and there have been decades of piecemeal and partial efforts to put in place a more supportive incentive framework. The challenge is to recognize and deal with the political economy factors that result in policies—and the absence of policies—that create high transaction costs and uncertainty.

There is a vast literature that generally finds that better performance on the types of indicators discussed above is associated with better economic outcomes. While this literature is useful at a general level, it is not always helpful

in assisting governments and stakeholders to identify priority areas for reform or to mobilize and sustain action to improve matters. In the case of MENA countries, there is a long-standing line of research that points to the dominant role of the state as an employer, including in industrial activities and rent-seeking and rent-protection efforts by politically connected agents, as well as through trade policy-related lobbying.[60] Post-Arab Spring, the importance of such 'crony capitalism' has become more transparent and clearly documented in several of the countries concerned (Egypt, Tunisia), based on new data that became available on the ownership and control of industries, and the behavior of companies that were politically connected to the regime.[61]

In practice, there will often be several policy areas that jointly need to be the focus of reform efforts. Dealing with one without dealing with others that reduce the contestability of a market or create high costs may make little difference. A consequence is that top-down efforts to improve a country's performance on one or more specific trade policy metrics may not have the desired impacts as they do not change the underlying political economy dynamics. An example is a program to reduce import tariffs for goods that are subject to exclusive distribution arrangements: lower tariffs may then not do anything to lower prices for consumers; instead what used to be collected as tariff revenue by the government will now simply be transferred to exclusive license holders. Major efforts to automate customs so as to improve clearance times may do little to reduce the cost it takes to get goods from the port to the retailer or the factory gate because of a lack of competition in the road transport sector. The same is true for international cooperation. Fixing a customs post on a land border with a neighboring country may do little if the neighbor has an inefficient regime that creates blockages or generates high transactions costs. In many areas of policy, bilateral or regional cooperation is a necessary condition for reducing trade transactions costs or permitting any trade to occur at all. Examples include access to and interconnection of telecom and financial services, the treatment of e-commerce transactions, digital trade and data security, the ability of providers of services that are based in one country to use infrastructure in another, and so forth. More specifically, there may be a need for investment in regional connectivity and associated infrastructure.

There is undoubtedly scope for regional integration to boost trade and related economic activity in MENA countries. This is most obviously the case for countries that have been or are in conflict—Iraq, Iran, Syria—and that

historically have traded with each other or are simply neighbors. In other parts of the region, it is less obvious that intra-regional trade has great potential relative to trade with the rest of the world. Part of the question here is whether regional initiatives can help capture gains in areas outside narrowly defined trade in goods or services and more generally be used to deal with the political economy underlying the policies—and absence or ineffectiveness of policies—that have led to low-level equilibrium traps and reduced the economic returns to past reform efforts.

Economic integration with neighboring markets has been an effective component of the growth strategies of many countries. Free trade agreements (F.T.A.s) offer one path toward greater regional integration; customs unions and common markets another. An F.T.A. allows members to retain full independence or sovereignty regarding external tariffs on third countries, while the parties provide tariff-free access to imports originating in their countries. A customs union requires members to adopt the same trade policy, i.e., the same external tariffs, as well as mechanisms to distribute tariff revenues to member countries and to determine what external trade policy should be. Members of customs unions are precluded from negotiating F.T.A.s with other countries. Research has shown that the greatest benefits from trade agreements come from the deep aspects of the agreements involving removal of N.T.M.-related costs, not from the preferential tariff liberalization.[62]

> "Post-Arab Spring, the importance of such 'crony capitalism' has become more transparent and clearly documented"

PAFTA and the G.C.C. are the two primary trade integration agreements among MENA countries.[63] The G.C.C. is the deepest integration arrangement in the region, with the aim being to create a common market and monetary union among the six member states. The transition period to the G.C.C. customs union—the common external tariff—was fully completed in 2015, and substantial progress has been made in permitting cross-border movement of citizens and capital. PAFTA is a looser arrangement that operates under the auspices of the Arab League. It includes the G.C.C. members as well as the Maghreb and Mashreq states.[64] The focus of PAFTA has been on removal of

tariffs on intra-PAFTA trade. This was mostly achieved by the late 2000s with the exception of excluded lists of products, which in some cases cover a large number of products—as in the case of Algeria. Moreover, restrictive rules of origin mean that traders may still have to pay tariffs.[65] Surveys suggest that various N.T.M.s are more important as a source of intra-regional trade barriers, including product standards and regulatory requirements.[66]

In principle, the aim of PAFTA is to extend services trade and investment policies as well as non-tariff barriers to intra-PAFTA exchange, but little progress has been achieved in these areas. Arab League countries have indicated that the long-term goal is to establish an Arab customs union/common market.[67] Achieving this will prove to be difficult given the need to agree on common policies in a variety of areas, including a common external tariff. The strong resistance by states in the region to cede sovereignty suggests that the customs union/common market path is not a credible prospect.[68] PAFTA permits members states to conclude bilateral or regional trade agreements with other countries. Most MENA countries have F.T.A.s with the European Union; many have a F.T.A. with the United States; and some have concluded F.T.A.s with Turkey. PAFTA members have also signed F.T.A.s amongst subsets of Arab countries—as in the example of the 2003 Agadir Agreement between Egypt, Morocco, Tunisia, and Jordan. This goes further than PAFTA in the area of rules of origin, government procurement, and other non-tariff policies. The G.C.C. is, of course, the premier instance of a deeper integration arrangement among a subset of PAFTA members.

"Research has consistently found that MENA trade agreements have done little to promote trade."

Research has consistently found that MENA trade agreements have done little to promote trade.[69] One reason is that with the exception of the G.C.C., Arab countries have generally failed to seriously implement most of the preferential trade agreements that have been agreed upon since the 1960s. Fawzy argues that concerns over the distribution of gains from integration across and within countries, a desire to retain national sovereignty, and the potential adjustment costs resulting from increased competition explain the weak implementation.[70] This suggests a need to put in place institutional mechanisms that can address the political economy factors impeding closer integration. It also suggests

focusing on policy areas where sovereignty concerns are less prevalent and the economic payoffs to joint action are significant. The potential payoffs of targeting cooperation to further integrate the markets for services and factors of production—key 'inputs' that determine productivity and competitiveness of firms—appear to be large, suggesting that this could be a focus of regional cooperation.

It is doubtful that an ambitious 'top-down' regional initiative of the type that has long been a central feature of MENA international relations will do more than has been possible in the past to remove N.T.M.s. This observation may not apply to the deep and comprehensive free trade agreements (D.C.F.T.A.s) that the European Union is seeking to negotiate with Tunisia and Morocco. However, even in that context, much depends on the design of the associated implementation mechanisms, the degree to which convergence with E.U. norms in the various policy areas will occur, and how much this will result in greater efficiency (lower trade costs). Experience with D.C.F.T.A.s with countries in Eastern Europe suggests that to be effective in generating improved trade conditions for firms, there is a need to tailor them to the specific institutional circumstances of a partner country and for flexibility in both the substance and sequencing of implementation of reforms.[71]

Potential Areas of Cooperation

Hoekman and Messerlin conclude that focusing (limiting) cooperation efforts to specific policy issues where there are clearly defined benefits for specific groups or stakeholders may offer greater prospects to reduce trade costs and integrate markets.[72] Focusing on areas of cooperation where issues of sovereignty are less problematic and the economic payoffs to joint action (cooperation) are significant should help increase support for regional integration initiatives. Trade facilitation and better regional connectivity to lower trade transaction costs are possible focal points. Given that any border crossing by definition involves two countries, effective trade facilitation will require cooperation. The same is true for enhancing the contestability of transport services markets—such as air and road transport—through agreement on the equivalence of standards, or through agreement to permit transporters supply services without confronting additional costs or entry barriers, are actions that benefit all sectors of economic activity. Another potential area for deeper cooperation could involve the establishment

of regional regulatory bodies to oversee network services (telecommunications, electricity, railways, air transport).[73] Many of the countries in the region have adopted competition laws, but there are large differences in the substance of competition regimes. Cooperation in this field, building on international experience, could generate significant benefits, including as a means to combat 'crony capitalism'-type anti-competitive arrangements. While substantive convergence in such sensitive areas of economic policy will be difficult, regional cooperation could help increase transparency, awareness, and accountability through objective analysis and advocacy.

What is needed are approaches that identify the policy areas that matter most in terms of negative impacts on (potential) exporting firms and that require action by two or more governments. This must start with generating information on how complementary 'bundles' of policies impact incentives to invest. The way policies and public expenditure (investments) are designed and implemented by governments differs significantly from how businesses go about assessing investment decisions and organize their production. Businesses think 'supply chains,' whereas governments focus on specific policy instruments that are under the control of a particular authority or entity. Progress in addressing barriers to trade may be facilitated if the value chain methodology used by businesses is applied to identify desirable policy reforms and priorities for cross-border or regional cooperation.[74] This need not occur in the framework of a formal trade agreement or extant Arab integration initiatives such as PAFTA.

Trade agreements are potential instruments to reduce the effects of protectionist policies and N.T.M.s. The problem is that if political will is missing, and political economy forces are too strong, implementation of an agreement will be partial at best. Past Arab integration initiatives have been ambitious on paper, aiming for the creation of common markets and an economic union. This continues to be the case: in 2009 the Arab League agreed to pursue an Arab Customs Union, to be operational by January 2015. This deadline, as have many before it, came and went. In practice, the political will and commitment to implement such initiatives have been missing[75] and this continues to be the case. A necessary condition for reducing N.T.M.-related trade costs is that negatively affected interest groups have sufficient incentives to sustain the focus and effort needed to ensure implementation of reforms. The challenge is to identify areas where there are clear 'win-wins' in the sense that groups in the different countries involved have strong incentives to push for cooperation by their governments

to implement desirable reforms, and to put in place mechanisms through which such groups can hold their governments accountable for results.

The traditional approach to negotiating trade agreements fits poorly with the reality of how international production is organized. Trade agreements are not designed with a view to assist governments to put in place a policy environment that will support vertical specialization and integration of firms into international value chains. They generally do not engage much with private sector interests or communities that have a strong stake in reducing cross-border trade frictions. Hoekman suggests that one way of determining priorities and defining an action agenda is through the creation of public-private partnerships that involve the active engagement of the business community, economic policy officials, and civil society groups, organized around the supply chain as a whole in a sector.[76] In practice, there often will be several factors that generate impediments to trade. If only one policy area is addressed, another may turn out to be equally constraining. To most effectively lower trade costs, information is needed on the specific sources of trade frictions. To generate such information, mechanisms need to be designed that support cooperation between the groups in society that are negatively affected.

> "Trade agreements are potential instruments to reduce the effects of protectionist policies and NTMs."

Rather than seeking to address trade problems through traditional government-to-government negotiations and trade agreements, bottom-up, specific initiatives may be more effective in mobilizing the engagement and support of business on both sides of a border. Business representatives and industry organizations have hands-on knowledge of the impacts of prevailing policies and the potential returns to investment in specific areas. Business interests and affected communities on both sides of a border are likely to have many common interests in lowering trade costs. Such bottom-up efforts will by their nature involve subsets of countries and may well be limited to bilateral cooperation. In other instances a number of countries will be implicated, for instance in infrastructure-related investments and related policy reforms to enhance connectivity within a region. What the focal points for cooperation might be are endogenous and need to be determined through public-private partnerships and processes along the lines just discussed. This can build on the extensive

research and analysis of sources of trade costs and market segmentation in the region, some of which was discussed in Section 2. The main point is that top-down textbook types of regional integration are unlikely to be effective. This does not mean they are not relevant or should be abandoned, but that businesses and communities need to be mobilized in ways that trade agreements have not done and are unlikely to do. Indeed, there may be scope to use existing institutional mechanisms to provide an 'authorizing framework' for the proposed integration à la carte approach.

Conclusion

Addressing the constraints that, to date, have prevented many MENA countries from benefiting more fully from the opportunities offered by both regional and global markets can potentially do much to help generate the employment and income growth that is so urgently needed. For regional integration to be a useful instrument for governments to do what is needed, it must contribute to overcoming the political economy forces that have held Arab countries back for decades. It is not at all obvious that intra-Arab cooperation based on traditional trade and investment agreements will be able to play such a positive role. Outside of the G.C.C., the track record to date has been dismal. Those countries that have done best essentially have gone their own way and focused on either the large market to the north (Morocco/Tunisia—European Union) or pursued a global strategy anchored on diversification into services (U.A.E.).

There are two complementary ways of regarding opportunities to pursue regional cooperation with a view to promoting cross-border trade and investment. One is to view it through the lens of supporting or cementing peaceful relations—as was the case for the establishment of the European Coal and Steel Community in 1951. Another is to take a more narrow economic perspective and to focus on projects and programs that generate direct gains to communities in participating countries by addressing coordination failures and capturing economies of scale. Whatever point of view is taken, it is important that efforts to re-energize regional integration efforts be part of a strategy to make Arab countries more competitive in general. What is needed are measures that will stimulate investment (F.D.I. and domestic) and employment in export activities broadly defined, including direct and indirect exports of services. The latter are a key driver of overall productivity and may be one area where on a

sectoral basis there are incentives for regional cooperation to play a positive role, such as connectivity, network infrastructure and related services.[77]

Regional cooperation may be best pursued on an à la carte, bottom-up, pragmatic basis—as opposed to relying on the type of trade agreements that have been the focal point to date in the region and largely failed to deliver. Formally, the top-down, traditional approach toward regional integration continues to be the purported goal in the context of the Arab League—as exemplified by the stated goal of moving from the Pan-Arab Free Trade Area to a customs union. The difficulties that were experienced by G.C.C. countries in agreeing to a common external tariff, despite being a group of countries that mostly had low tariffs to start with, illustrate how difficult it will be to achieve this objective. It would seem more feasible, both politically and in terms of generating win-win outcomes, to use the PAFTA structure that is already in place as an umbrella to pursue measures that are more piecemeal. These could be limited to subsets of countries that have direct interests in joining forces on specific investment/infrastructure programs or collaborating to reform specific policies (non-tariff measures) that preclude investment by the private sector in projects that involve value chain activities spanning a number of MENA countries.

> "Regional cooperation may be best pursued on an à la carte, bottom-up, pragmatic basis."

The historical experience of Europe points to the large potential payoffs of creative use of regional cooperation to generate economic incentives to sustain peace and security. If countries in the region are able to pursue a similar strategy, building pragmatically on multiple fronts on a decentralized basis, this can help establish conditions for greater shared prosperity. If, instead, they continue to pursue a business-as-usual approach of prioritizing regional competition over cooperation, this will increase the pressure on individual countries and polities to accept and implement urgently needed economic policy reforms on their own.

Endnotes

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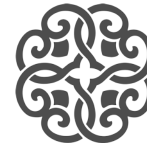
63. There is also the Arab-Maghreb Union but this is effectively defunct as a result of long-standing political tensions and closure of the border between Morocco and Algeria.
64. Algeria became the most recent member, joining in 2009.
65. Bernard Hoekman and Jamel Zarrouk, "Changes in Cross-Border Trade Costs in the Pan-Arab Free Trade Area, 2001–2008," World Bank Policy Research Paper No. 5031 (Washington, DC: World Bank, 2009), accessed April 5, 2016, http://documents.worldbank.org/curated/en/2009/08/11017288/changes-cross-border-trade-costs-pan-arab-free-trade-area-2001-2008.
66. *Making regional integration work.*
67. "Arab Integration: A 21st Century Development Imperative," (New York: United Nations Economic and Social Commission for Western Asia, 2013).
68. Research suggests that the economic benefits of establishing a customs union are limited, unless this generates very substantial improvements in connectivity and reductions in trade costs. See "Assessing Arab Economic Integration: Towards the Arab Customs Union," (New York: United

Nations Economic and Social Commission for Western Asia, 2015).

69. Caroline Freund and Alberto Portugal-Perez, 2013, "Assessing MENA's Trade Agreements," in *The Arab Spring: Implications for Economic Integration*, ed. Michael Gasiorek (London: Centre for Economic Policy Research, 2013).
70. Fawzy, "The economics and politics of Arab economic integration."
71. DCFTA negotiations were launched in 2013 but halted in July 2014 after four rounds of talks by Morocco, which indicated it wanted to assess the results of impact assessments it had commissioned, reflecting concerns expressed by Moroccan industry and NGO groups that a DCFTA would not benefit the country. See Guillaume Van der Loo, "Enhancing the Prospects of the E.U.s Deep and Comprehensive Free Trade Areas in the Mediterranean: Lessons from the Eastern Partnership," CEPS Commentary (Brussels: Centre for European Policy Studies, 2015).
72. Bernard Hoekman and Patrick Messerlin, "Initial Conditions and Incentives for Arab Economic Integration: A Comparison with the European Community," in *Arab Economic Integration: Between Hope and Reality*, eds. Ahmed Galal Bernard Hoekman (Washington DC: Brookings Institution, 2013).
73. Hoekman and Sekkat, "Arab Economic Integration."
74. Bernard Hoekman, *Supply Chains, Mega-Regionals and Multilateralism: A Road Map for the WTO* (London: Centre for Economic Policy Research Press, 2014).
75. Fawzy, "The economics and politics of Arab economic integration."
76. Hoekman, *Supply Chains*.
77. Examples of areas where bilateral or regional cooperation could have significant economic payoffs are discussed in Chauffor, *From Political to Economic Awakening in the Arab World*; and Malik and Awadallah, "The Economics of the Arab Spring."



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