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Initial Conditions and Incentives for Arab Economic Integration

Can the European Community's Success Be Emulated?

Bernard Hoekman

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Abstract

Hoekman and Messerlin compare the European Community's "trade fundamentals" prevailing in the 1960s with those applying in Arab countries today. The fundamentals differ significantly—Arab countries trade much less with each other than EC members did, and the importance of such trade in GDP varies greatly. This suggests that a viable Arab integration strategy must follow a path that differs from the preferential trade liberalization-led approach implemented by the European Community. An alternative is to complement long-standing attempts to liberalize merchandise trade with an effort that revolves around service sector reforms and liberalization. This may prove to be an effective mechanism to support reforms as, in principle, there is a

major constituency in each Arab country that has an interest in improving the performance of services—the natural resource-based and manufacturing sectors. A key condition for such an approach to be feasible is that Arab cooperation helps overcome political economy resistance to national, unilateral action, or, generates direct gains from cooperation in specific policy areas. The EC experience suggests that a services-based integration strategy will be complex and must be carefully designed and sequenced. Given the importance of services-related trade and logistics transactions costs, a first step might focus on bringing such costs down through a concerted joint effort.

This paper—a product of Trade, Development Research Group—is part of a larger effort in the group to investigate the economics of regional integration. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Paulina Flewitt, room MC3-333, telephone 202-473-2724, fax 202-522-1159, email address pflewitt@worldbank.org. Policy Research Working Papers are also posted on the Web at <http://econ.worldbank.org>. The authors may be contacted at bhoekman@worldbank.org or patrick.messerlin@sciences-po.fr. October 2002. (43 pages)

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Initial Conditions and Incentives for Arab Economic Integration: Can the European Community's Success Be Emulated?*

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Introduction

Regional integration is a central element of the trade strategies that are being pursued by many Arab countries. All countries in the region have concluded numerous bilateral agreements to reduce trade barriers on a preferential basis. Many members of the Arab League are engaged in an effort to abolish tariffs on intra-Arab trade flows altogether. Most Arab countries around the Mediterranean have also signed free trade agreements with the European Community (EC). The latter aim at the elimination of tariffs on trade in goods with the EC (with the exception of agriculture) and also embody elements of ‘deeper’ integration—provisions calling for cooperation in trade-related regulatory areas and future negotiation to liberalize investment and services flows.

While preferential trade liberalization efforts between Arab countries have been limited in scope, this is beginning to change with the implementation of the 1998 Arab League Greater Arab Free Trade Area (GAFTA), which obliges signatories to gradually eliminate tariffs by 2006 (Zarrouk, 2000). However, the GAFTA is a traditional agreement that is limited to merchandise trade. In contrast to the EC treaty, the GAFTA does not imply the creation of a common market for services, investment and other factor flows. Nor does it involve the establishment of common institutions to address regulatory issues.

This paper asks what can be learned from the European integration experience for efforts to pursue Arab integration. We do not address the issue whether there is (or will be) political support for greater economic integration—instead we investigate what the incentives are for Arab countries to pursue alternative forms of regional economic cooperation. The approach we take is to identify the initial conditions that prevailed in the EC and to describe how European member states dealt with major political obstacles to integration through the design of institutions. We then compare EC ‘trade fundamentals’ to those that apply in the current Arab context. We conclude that the fundamentals differ significantly, suggesting that Arab integration will have to follow a path that goes beyond a purely merchandise trade liberalization-based approach.

One alternative path that is identified is a service-sector driven integration strategy. Given the importance of improving service sector performance in many Arab

countries and the potential gains from regional cooperation in the regulatory domain, this may be a more effective route towards greater integration, not just regionally—where there is only limited potential and thus likely to be limited political support—but into the world economy more generally. The EC experience suggests a services-based integration strategy will be complex and should be carefully designed and sequenced. Intra-Arab cooperation in this area could start by focusing on addressing high logistics and trade-related transactions costs (trade facilitation), establishing focal points and benchmarks for pro-competitive regulation of key ‘backbone’ service sectors such as transport, distribution and communications, and a concerted effort to remove entry barriers and government restrictions on competition more generally.

1. Key Dimensions of the EC

The basic principle guiding the formation of modern Europe has been to use an economic process for a fundamentally political goal: “an ever closer union of the peoples of Europe” (Treaty of Rome, preamble, first paragraph). It is important to understand that this goal was based on a number of historical and economic factors.¹ For one, the notion of integration had a long history. For example, in the nineteenth century, Europe had been integrated through force of arms by Napoleon, which led to a significant convergence in legislation and administrative procedures. Also relevant was how numerous German states had combined through the mechanism of the Zollverein into a federal Germany. However, more recent history played the primary role in the formation of the EC, in particular the Second World War. The desire to prevent war was an overriding objective of many of those who supported European integration in the 1950s. There was a strong perception that there was a positive correlation between trade and peace.²

Before the war European countries relied heavily on trade with each other. The collapse of trade in the 1930-40s provided a strong incentive to remove the barriers that had been built up. The challenge was to satisfy the political need to maintain critical

¹ What follows draws in part from Messerlin (2001). See Milward (1992) for a historical analysis of European economic integration.

² Mansfield (1994) has concluded that, controlling for other factors, there is a robust negative relationship between the volume of trade between country pairs and the probability of a war between them.

national industries and the support of powerful interest groups while allowing for greater gains from trade to be captured. As is well known, the inter-war years had been characterized by large-scale intervention in trade and beggar thy neighbor competitive devaluations. The objective of integrating Europe provided the foundation of a mechanism to reopen European markets.

An important feature of the EC is the success it has had in managing the trade-off between *net* economic costs and political benefits for members. Europeans eager to create some kind of federal Europe were ready to adopt a series of policies that are more interventionist and costly from an economic efficiency point of view than Europeans “merely” interested in peaceful coexistence between European states. The search for balance between economic and political aspects has played a major role in the Community’s history. Political objectives were critical in the development of the EC, in the sense that costly decisions from an economic perspective were possible because of associated political gains. A consequence of this is that perceptions that the political gains from European integration are decreasing require a reduction in the economic costs of European unification to maintain the balance. Political gains from integration are subject to diminishing returns. The political idea of a perpetual peace between France and Germany had a profound appeal to Europeans born before the 1960s. However, as of 2001, the idea of a Franco-German war is so remote that younger Europeans do not see the need to pay the economic costs that previous generations of Europeans were ready to pay. Such shifting balances have led to efforts by the EC to expand membership and deepen integration, and help explain why external protection has fallen over time.

Institutions

The basic constituent elements of the EC are well known. A major objective of the Treaty of Rome, which established the European Economic Community, was the realization of the four freedoms: free internal movement of goods, services, labor and capital, including the right of establishment. Thus, the EC aims to establish a common market with a common external commercial policy. The Community is unique in that it goes beyond inter-governmental cooperation. This is reflected, *inter alia*, in the fact that EC law has direct effect and that there are supra-national institutions—an executive (the European

Commission), a political oversight body (the European Council); a judiciary—the European Court of Justice (ECJ), and a (directly elected) European Parliament. Of these the Commission and the ECJ have been the most important in the pursuit of political and economic integration.

The supranational institutions of the EC have played a major role in the process of integration. The Commission has been the driver and guardian of the integration objective. It has the power to propose directives and regulations, which, if approved by the Council, and increasingly the Parliament, become EC law. As these laws have direct effect, they supersede national legislation in the area concerned. The Commission is a bureaucracy, staffed by nationals of the EC who are formally independent of their governments. The Council provides national level political oversight, comprising of the relevant Ministers of member states, or Heads of State, depending on the subject matter under consideration. The Council must approve all Commission proposals, working either on the basis of unanimity or weighted voting, again depending on the topic. Over time, an increasing number of issues have become subject to voting.

The Commission administers the common policies of the EC, including trade and agriculture—the two most important areas.³ It also enforces the various treaties that have been concluded or amended over time. Of great importance here is enforcement of rules on ‘fair’ competition—disciplines on state aids (subsidies) and restrictive business practices by firms that have the effect of impeding trade (and the realization of an integrated internal market). The Commission has an interest in both expanding its ambit—through promulgation of new rules in the pursuit of integration—and in enforcing the negotiated rules of the game. The Commission, an independent *European* bureaucracy with its own financing—partly obtained from the revenues generated by the common external tariff—has been a defender of the European integration objective in times when member states have been less than enthusiastic (Winters, 1997). The Commission played a major role, for example, in forming a coalition with the private sector in the 1980s to re-vitalize integration through the proposal of the Single Market

³ The Treaty of Rome grants the Community (not the Commission, but a complex mixture of the Council of Ministers and the Commission) the *exclusive* competence in trade policy. However, the way the Treaty defines the scope of this common and exclusive competence is rather clumsy. Article 133 (113 in the initial

Program ('EC-1992'). This proved to be a powerful instrument to move further towards achieve the objective of economic integration by introducing the principle of mutual recognition and 'competition in rules' and taking a series of concrete measures to enhance competition on services markets. This resulted in a boom in FDI inflows and cross-border mergers and acquisitions, and induced the accession of a number of countries that concluded that the costs of being outside the EC had become greater than the benefits.

The Commission plays a major role in administering various mechanisms that redistribute income and resources across groups in the EC. Any trade liberalization will give rise to losers, who depending on their political power, may need to be compensated. Indeed, if powerful, such compensation is a precondition for liberalization to occur, unless there are other groups in society whose gains are sufficient to induce them to mobilize against those who benefit from status quo trade restrictions. The compensation required to make trade reform politically feasible can take the form of an exception to trade liberalization, long transition periods, transfers from the budget (subsidies), or issue linkage. All of these mechanisms were used in the EC. The common policies on trade and agriculture were designed carefully to maintain relatively higher rates of protection for 'sensitive' industries, complemented by transfers (subsidies) to disadvantaged regions and soft lending by the European Investment Bank for infrastructure and related types of projects.

The second major player in the integration venture has been the ECJ, which over time developed a huge case law interpreting the validity (legality) of national policies. As the ultimate arbiter, the ECJ's decisions are final and binding on the member states. The ECJ played a key role in the design of the Single Market Program by identifying the significant scope that existed for the principle of mutual recognition to overcome national non-trade policies that impeded cross-border competition (see below). More generally, it has ensured objective and consistent application and interpretation of EC law.

Treaty of Rome) only provides a non-exhaustive list of trade policy instruments. As a result, determining what is and what is not covered required decades of rulings by the ECJ.

Trade and Trade Policy

The first milestone in the realization of the common market was the creation of a customs union, that is, the adoption of a common external tariff (CET) and the implementation of internal trade liberalization. To a very large extent trade and trade policy constituted the glue that held the EC together.

Trade: In the mid-1950s, each of the six founding EC Member states exported more than 25% of their total exports to the rest of the Community *and* all of them together represented more than 18% of intra-EC trade (except Italy with only 11%). Thus, all the founding members had both a substantial stake in intra-European liberalization of trade, and enough ‘power’ to play a role (have a voice) in the process of the creation of the EC. Germany, the largest member country, exported almost 30% of its total exports to the rest of the EC, accounting for one third of total intra-EC trade. This ‘initial condition’ is of great importance in understanding the success of the EC—members not only had great political interest in cementing a binding peace, but also had great economic interest in revitalizing and further expanding intra-European trade. Note that the trade involved merchandise. Trade in services, labor and capital was quite limited, in contrast to other parts of the world.

Trade policy: Agreeing to a CET is a major source difficulty for many customs unions. The more unbalanced are initial tariffs across prospective members, the harder the task, unless high protection countries are seeking to use the customs union as an instrument to liberalize trade. Agreeing on a CET and applying it has been among the most difficult aspects of implementing customs unions—as illustrated by the GCC, as well as many other attempts to form a customs union (World Bank, 2001). Sustaining the CET can be equally if not more difficult. Any common tariff will imply adjustment pressure as industries relocate. Industry interests will diverge across countries. Thus, in the nineteenth century the American South objected strenuously to the high protective tariffs sought by US ‘infant’ industries, which were mostly located in the North. The tariffs raised production costs in the South and implied a transfer of resources to the North, exacerbating the tensions that led to the US civil war. Similar tensions associated with industrial agglomeration and implicit transfers helped cause the demise of the East African Common Market (World Bank, 2001).

The initial conditions confronting EC members regarding the formation of the CET were relatively favorable. The EC created its common tariff from four initial tariff schedules (as Belgium, the Netherlands and Luxembourg were already a single customs territory, the Benelux, with a common tariff schedule). Two territories (Germany and Benelux) had rather low tariffs, and two (France and Italy) relatively high tariffs—an ideal circumstance for using the simplest possible harmonization rule: the unweighted average of the four tariff schedules. This greatly facilitated agreement on the level of the external tariff, limiting disputes between EC member states to those tariff lines where duty rates were different enough to make everybody unsatisfied by the outcome of the unweighted average method. There were a non-negligible number of such cases—about 20 percent of all tariff lines (Messerlin, 2001). The GATT helped resolve many of these conflicts by lowering tariffs across the board through multilateral negotiating rounds—making the results of the averaging method more palatable to the more open Member states, while offering compensation to more protectionist members through better access to global export markets.

As discussed below, liberalization of internal trade was accompanied by managed trade in key sectors such as coal, steel and agriculture, as well as the implementation of a common external trade policy. The latter played a major role in the EC, and to some extent became a substitute for foreign policy. The absence of other means for the EC to take international action—there being no common foreign policy—induced it to carve out zones of political influence through the intensive use of discriminatory trade agreements. These agreements have had almost no economic impact on the EC. Rather, their role has been to strengthen the hegemony of certain EC member states or to establish this. The primary example of this over the past 40 years, is the role EC trade policy played in supporting the ‘territorial expansion’ of the EC, which grew from the 6 founding members in 1957 to 9 (1973), 10 (1981), 12 (1986), and 15 (1995) member states (leaving aside the direct enlargement to eastern Germany in 1990, which had been prepared for since the Community’s birth, and was confirmed by special trade arrangements between the former German Democratic Republic and the EC starting in the 1960s).

Common Sectoral Policies

European integration has been driven in part by two sectoral ‘engines’: agriculture and coal/steel. In both areas the EC has common policies. In both cases, the focus of the common policy is on managing production and trade. In the case of coal and steel, the 1951 Treaty of Paris establishing the European Coal and Steel Community (ECSC), the precursor of the EC, reflected a strong tradition of collusion between steel firms backed by national governments.⁴ In the early 1950s intra-EC free trade in steel was impossible given German comparative advantages—substituting prevailing private barriers for public management and control thus made a lot of political sense. But the price paid was to inhibit and distort competition in this industry for the next five decades. Perhaps equally, if not more important, it also provided a demonstration effect for other sectors, which were given an incentive to push for and support industrial policies that benefited them.

Although the coal and steel industries were of fundamental importance in the design and launch of the European integration effort—not least because they were seen as a major potential source of conflict between France and Germany—agriculture was equally important. In all 6 founding members, farmers in the early 1950s constituted a significant share of the labor force and GDP. Managed trade in this sector was seen as a necessary condition to pursue integration more broadly. The Common Agricultural Policy (CAP) aimed to: (1) increase farm productivity, (2) ensure a fair standard of living for the agricultural community, (3) stabilize markets, and (4) assure the availability of supplies at reasonable prices. Until the early 1990s, the CAP was essentially based on using *one* instrument (price supports) to reach *all* these objectives, causing steadily increasing distortions and costs. The political rationale for the CAP—as in the case of coal and steel—was that free trade, even in principle, was neither feasible nor desirable. As far as the two major players were concerned, Germany wanted access to the large

⁴ The ECSC provisions were influenced by the “Entente Internationale de l’Acier” (International Steel Cartel), set up in 1926 by steel makers from Belgium, France, Germany, Saarland, and Luxembourg. The “Entente” reflected the prevailing view that cartels were a good mechanism to ensure market stability in the context of intra-European trade liberalization. The ECSC pricing rules (broadly similar to the US Pittsburgh basing point system abandoned in 1924 following an antitrust order) were a major element of ‘managed trade’ in this sector.

French market, which was highly protected—as were almost all EC markets— but could be bought off by the promise of higher prices for agricultural produce (Winters, 1997).

Over time, virtually all agricultural goods became subject to common market organizations (CMOs). Until the 1992 CAP reform, the CMOs relied essentially on a set of multiple guaranteed prices determined on an annual (or half-yearly) basis by the Council of Ministers. Because these guaranteed prices were unrelated to world prices, the CAP required import barriers to insulate the product markets concerned from the world market. These barriers took the form of variable import levies. Adjusted on a daily basis, these raised import prices to the level prevailing in the EC. In the 1970s, export subsidies began to be necessary to dump surpluses into world markets. In an effort to limit excess supply caused by high guaranteed prices. As of the 1980s the CAP imposed such a budgetary burden on the Community that quantitative limits on production were imposed, voluntary set-aside programs were adopted, and subsidies were granted to low-income consumers to increase demand.

The CAP was a great success in terms of expanding output and increasing self-sufficiency in food. Indeed, it was too successful—imposing serious budgetary strains and, more importantly for the rest of the world, imposing major costs on non-European food producers and generating decades of multilateral tension. Although the *raison d'être* for the CAP has largely disappeared, agricultural reform remains highly contentious in the EC. Support for agricultural and related rural policies to support farmers remains strong, although increasing driven by environmental and public health concerns—which ironically are due in part to the production-increasing incentives of the CAP.

Domestic regulation

It has been argued that Europe could not make much progress toward trade liberalization until “it was discovered ... that further progress depended on ... some policy of ‘positive’ integration ... because the removal of discriminatory policies threatened to undermine just as many entrenched interests as [policy integration] would have done.” (Milward 1984, p. 421). The rhetoric of EC policy makers and their advisors suggested that ‘deeper’ integration—extending to domestic regulatory regimes and economic policies—was necessary to attain intra-EC free trade. Policy makers such as Jelle Zijlstra, the Dutch

Minister of Economic Affairs, were not alone in arguing in the early 1950s that credible tariff removal required “common policies on taxes, wages, prices and employment policy” (Milward, 1992, pp. 188ff). Many felt that policy harmonization was required to equalize costs, and that without it a customs union would not be feasible, because countries would impose new forms of protectionist policies. Thus, the Belgian coal mining industry argued in the late 1940s that a common market could only be accepted if German wage and social security costs were raised to Belgian levels.⁵ French officials persistently demanded policy harmonization in the social area—equal pay for both sexes, a uniform length of the working week—as a precondition for trade liberalization, given that French standards were higher than in other countries.

Underlying these concerns was generally a fear by interest groups of an erosion of rents, or a worry that domestic policies may be used to re-impose protection. Abstracting from the common policies for coal/steel and agriculture—where managed trade and production was seen as desirable and necessary—in a number of policy areas the EC established disciplines on the ability of governments to use domestic policy instruments as a substitute for trade policy. Disciplines on enterprise behavior that impedes the realization of the common market and on government assistance—subsidies—were enforced by the Commission with varying degrees of intensity, but had an important effect on ensuring that the ‘conditions of competition’ became more equitable over time.

A noteworthy feature of the EC has been actions towards ‘deeper’ integration through harmonization of national policies dealing with regulatory objectives. This focused on efforts to limit the market segmenting effects of national regulations pertaining to health and safety. Progress toward harmonization was very slow, in part because adoption of a Community-wide norm required unanimity. It took 14 years for agreement to be reached on the composition of fruit jams; 11 for a directive on mineral water (Vogel, 1995). Over 1962-79 only nine directives on foodstuffs were adopted.

In 1979, the ECJ threw out a German ban on the sale of a French product (Cassis de Dijon) used to prepare an aperitif (kir) because it could not be justified on the basis of

⁵ In the discussion of proposals for a European customs union in the early 1950s, virtually every question that came to be addressed in the Maastricht treaty was discussed: a common European currency, monetary policy, whether there should be freedom of labor, mutual recognition of professional qualifications, a

public safety or health. This established the principle that goods legally introduced into circulation in one member state could not be barred from entering and being sold in another. This principle was later incorporated into the 1987 Single European Act and the 1992 Maastricht Treaty on European Union. The “new” approach differentiates between standards that have health and safety (public interest) dimensions from those that did not. For the latter it made harmonization redundant by requiring governments to accept foreign regulations as equivalent to their own. For the former a process of determining common minimum standards (“essential requirements”) was agreed to. Progress towards development of these standards was made easier by a decision to accept qualified majority voting on issues affecting the functioning and completion of the single market, and defining standardization as a Single Market Programme issue.

In sum, integration in the EC was driven very much by the engine of trade in goods—all members had strong incentives to see intra-EC trade liberalized. Trade in services and factors of production—labor, capital—played only a minor role. The EC’s success was based in part on an almost perfect balance of economic power. It was ‘financed’ by three large countries (France, Germany and Italy) of almost equal size in terms of population and income, and two smaller countries—but large and skilled enough to play the key role of mediators (Belgium and the Netherlands). These countries had almost perfectly symmetrical and large stakes in the EC endeavor. The EC founding countries traded more than 30 percent of their total external trade with the other members. This mutual trade dependence and relative symmetry allowed the EC to use trade liberalization as a vehicle for integration—there was no need to rely significantly on integration of services or labor markets to achieve the members’ goals.

This balance was maintained in the enlargement process—the initial balances were never seriously put into question. Britain was as powerful as France or Germany, and Spain was comparable to Italy. Other new members were similar in size to the smaller founding countries. A retrospective sense of the ‘luck’ that accompanied the birth and development of the EC during its first fifty years is best provided by the sudden, but short-lived, hesitations in Europe that accompanied German reunification. Britain and

common company law, a free capital market, or common workplace and products safety standards (Milward, 1992, p. 191).

France immediately showed old instinctive reactions of fear, while other member states also demonstrated concerns. These reactions suggest that the EC would probably not have been founded if there had been a unified Germany.

Integration also had an overriding political objective that was strongly supported by all members—preventing another war in Europe. The EC is the child of three terrible wars (1870, 1914 and 1939) that were responsible for millions of deaths in the six EC founding countries. It was born in a world divided into two political and economic regimes (market-driven democracies vs. central-planned dictatorships). During its first 30 years, it grew under the constant pressure of the Cold War.

What follows asks to what extent the economic factors that prevailed in the EC apply to the Arab context, focusing in particular on the initial trade ‘dependence’ conditions. As the motor of European integration was to a very large extent the liberalization of intra-regional trade in non-agricultural merchandise (agriculture being the subject of managed trade and EC-wide policies), an obvious question is whether such trade could also be the basis of Arab economic integration.

2. Merchandise Trade Fundamentals in Arab Countries

Countries in the region can be divided fairly naturally into three groups: relatively natural resource-poor countries (less than one third of exports comprise natural resources), oil exporters (more than two thirds of exports consist of natural resources—mostly fuels); and an intermediate group where exports of fuels and ores constitute between one and two-thirds of total exports). For completeness and purposes of comparison we report data for other ‘regional’ countries—Cyprus, Israel, Turkey and Iran—as well as for Arab states.

Small product markets – nationally and regionally

The *economic* size of the Arab region is limited. Arab countries that are members of the Greater Arab Free Trade Area (GAFTA)—noted with an asterisk in Table 1—represent a little less than Spain’s GDP. Only one Arab country (Egypt) has more than 60 million inhabitants. One implication of the ‘smallness’ of many of the countries in the region is that the costs to trade and investment due to differences in national laws or regulations

are higher than for the EC. (Four EC Member states have a population of more than 60 million, and only two Member states out of fifteen have a population of less than 5 million.) The limited market size of the Arab countries is a crucial factor why all efforts to achieve regional economic integration since the 1950s have failed—even if one leaves aside the fact that they were conceived behind high protection with respect to the rest of the world.

There is another powerful economic force working against integration: Arab countries are relatively similar to each other and compete more with each other for the same export markets. Most Arab countries in the sample are either oil-rich or rely heavily on oil exports. As the fundamental motive for trade is to take advantage of differences in endowments (comparative advantage) between trading partners, this situation suggests limited prospects for large benefits from regional economic integration. Offsetting this is the fact that Arab countries exhibit a wide range of GDP per capita, from less than US\$500 (Yemen) to US\$17,000 (UAE and Qatar). Such large income differences generate incentives to trade by inducing product differentiation in order to respond to different incomes and related tastes. But these differences appear too wide for the small markets involved to be a powerful force for significantly greater intra-regional trade. That leaves the possibility of production sharing or processing-type of trade, where labor, energy or water-intensive parts of the production process is undertaken in countries where such factors are in relative abundance. This type of trade has become important in Central Europe, North America, and East Asia. However, a pre-condition for this to materialize is a substantial increase in the efficiency of services (reduction in transaction costs)—discussed further below.

In sum, the data suggest that: *(i)* the region is fragmented into relatively small economies, and, taken together is relatively small in economic size; *(ii)* many have similar production structures, which limits their incentives to trade; and *(iii)* the wide income differences in the region are unlikely to overcome the resulting trade resistance.

Product concentration and differentiation

As natural resources dominate exports of a majority of countries, we have focused so far on “inter-industry” trade. This is based on specialization in production, with countries

producing different products using different factor intensities. Such trade may be associated with a concentrated export structure if the country's comparative advantage in a limited range of products is very strong. Inter-industry trade is complemented by "intra-industry" trade, involving the exchange of different varieties of similar "products," or the exchange of goods that form part of a production chain (importing components and exporting the processed goods). In most high-income and newly industrializing countries, intra-industry trade accounts for a large and growing share of total trade.

The scope for intra-industry trade is more limited for fuels than for consumer electronics, but exists even within the oil sector broadly defined. There are many varieties of fuels, and numerous possibilities to produce differentiated oil-based industrial products, such as chemicals. The potential for specialization and intra-industry trade is augmented by the fact that oil and chemical markets are oligopolistic enough to induce the few large firms operating in such markets to follow a policy of profit maximization through market segmentation and product differentiation. More generally, intra-industry trade is driven by economies of scale that make it profitable for enterprises to specialize in similar but differentiated goods, and for countries to exchange these.

Various measures of the structure and composition of trade are reported in Table 2. Two indicators of product concentration in trade are reported: the number of distinct product categories exported, measured at the 3-digit level of the Standard International Trade Classification (SITC),^{6/} and the "Herfindhal-Hirschmann index" (HHI).^{7/} As expected, oil-rich countries have concentration indices that are much higher than those of natural resource poor countries—reflecting the concentration in oil (ores) and oil-derived exports imposed by their very strong comparative advantages in fuels (ores). However, this generalization requires some qualification. The UAE and Saudi Arabia have relatively diverse exports, reflecting entrepôt activity as well as processing and light manufacturing activities in the UAE, and the chemical sector in Saudi Arabia. Note also

^{6/} The SITC is a UN statistical classification for international trade. There are 239 different SITC items at the 3-digit level. The SITC measure of concentration is defined as the ratio between the number of 3-digit items for which exports exceed US\$100,000 and the total number of 3-digit items (there are 239 such items). For small countries an additional criterion of at least a 0.3 percent share in total exports is used.

^{7/} The HHI is defined as the sum of the squares of the market share of each export item in total exports. The lower the HHI are, the less concentrated exports are. The HHIs are calculated at the 3-digit SITC level.

that the number of product categories exported increased substantially in some oil exporters, e.g., in Qatar. The shares of intermediate or resource poor Arab countries are below those of Asian comparator economies, suggesting a narrower industrial base.

In a number of countries, especially Egypt, Morocco and Tunisia there has been a significant diversification of the export base as measured by the SITC indicator. Indeed, on average, the last two decades have seen trade in the region become less concentrated. The HHI index suggests that this trend is more general than the SITC measure—concentration appears to have been falling pretty much across the board. In the case of oil-rich countries this reflects the oil price decline that occurred during this period, which made the production of fuels less profitable compared to the production of oil-derivatives or other goods. But for a number of countries, especially resource poor or less endowed with oil, it reflects the pursuit of domestic reforms. Egypt registered a particularly large increase in diversification, rising from 33 to 68 percent on the SITC diversification measure, while the HHI fell from 0.58 to 0.28. Similarly large reductions in the HHI occurred in Morocco and Tunisia.

Table 2 also presents data on the magnitude of intra-industry trade.⁸ The higher the intra-industry trade (IIT) index, the more the trade of a country involves the exchange of different varieties of a similar type of product. IIT of Arab countries is far below the ratios registered by Asian comparators, which have IIT indices in the 0.60 range. Among Arab countries, Tunisia has the highest intensity of IIT (30 percent), followed by Morocco and the UAE. The magnitude of IIT has been growing rapidly in a number of other countries, however, especially Egypt and Jordan. Oil-rich countries exhibit very low IIT indices, due to their comparative advantage in a limited number of products. The UAE is an exception, reflecting the *entrepôt* trading activity of this economy.

Finally, Table 2 presents data on the share of parts and components in total manufactured exports and imports. This indicator provides information on the relative importance of ‘assembly’ activity in total trade. A high share of components in imports combined with a low share of components in exports is observed in all Arab countries, except Oman. This compares with much higher ratios and more balanced trade for

dynamic exporters in East Asia (Table 2). For countries with relatively high GDP per capita (interpreted as a proxy for relatively high wages), a combination of high import share of components and low export shares suggests a high level of assembly activities for domestic or neighboring markets, and hence a relatively high degree of effective protection against imports of final (assembled) products. Such situations are often the source of large rents for firms (wholesalers or retailers) that are able to import for local assembly. This may also prevail in countries with lower GDP per capita levels, but a low share of components in exports could also mean that these countries are used as assembly centers for re-exports of assembled goods. However, data on outward processing trade collected by the EC suggests this is not the case.

To summarize: (i) most Arab countries tend to have relatively concentrated exports, although this has been changing rapidly for some nations (Egypt, Morocco, Tunisia); (ii) there are low levels of intra-industry trade; and (iii) a high ratio of imports to exports of components. This suggests important assembly activities directed at domestic markets that are likely to require high protection against imports.

Political economy implications of intra-Arab trade patterns

The geographical pattern of exports of Arab countries mirrors what has been said about export structure by product—to a large extent, it is the “corollary” in the geographical context of the economic forces at work in the production, demand, and trade patterns. The share of exports going to other Arab countries ranges from 0.9 (Kuwait) to 13.1 percent (Oman) for oil-rich countries, mirroring the production concentration of these countries (reflecting their comparative advantages in the world markets), and the fact that oil is consumed everywhere in the world (Table 3). For the largest oil producer/exporter (Saudi Arabia), the share is only 7.6 percent. The “hard-core” set of countries that tend to trade substantially with other Arab countries (around 20 percent or more of total exports) is limited to Jordan, Lebanon and Syria (some 34, 45 and 18 percent of total exports,

⁸ The index is defined as $IIT = 1 - [\sum \sum \sum |X_{ijk} - M_{ijk}| / (X_{ijk} + M_{ijk})]$, where X_{ijk} represents the exports of products from industry i from country j to country k and M_{ijk} represents the imports of products from industry i by country j from country k . In this study industries are defined at the three digit level of the SITC.

respectively). With the exception of Oman, for all other Arab countries, regional exports account for less than 10 percent of total exports.⁹

An important policy question concerning Arab economic integration is whether these levels of intra-regional trade are 'too low' because of barriers to trade. An often used index of the intensity of regional trade is helpful in determining whether the value of trade between two countries is above or below what would be expected on the basis of their importance in world trade. Identification of bilateral combinations where trade is below expected levels can also help to identify the existence of major barriers to trade. Table 4 reports data on the intensity of trade.¹⁰ Values below (above) unity indicate that trade between two countries is lower (higher) than expected. The data suggest that intra-Arab trade flows are not consistently lower than what should be expected. The only countries that trade less with other Arab countries than 'expected' are Algeria and Kuwait. The share of Egypt's exports to the region is about three times larger than what would be expected. Trade intensity indices for Jordan and Lebanon are the highest, followed by Syria. Overall, the intensity index for all regional intra-trade is more than double the 'expected' level.

A criticism of the intensity indices is that they do not control for factors such as GDP and trade costs as determinants of trade flows. A commonly used technique to incorporate such variables is the gravity model.¹¹ Gravity model regressions on *non-oil* trade for the period 1970-98 suggest that in the 1970s, being located in the Middle East and North Africa region had no effect on bilateral trade volumes (Chang, 2000). In 1980; Arab countries' trade is actually less than predicted by the model. In 1990 and 1998 this pattern reversed, with intra Arab exports and imports becoming larger than predicted by the model. Research by Al-Atrash and Yousef (2000) concludes that while intra-regional

⁹ There is some uncertainty on the direction of trade given weak reporting by several countries.

¹⁰ The "trade intensity" index is defined as the share of one country's exports going to a partner divided by the share of world exports going to the partner. That is, $TI_{ij} = [x_{ij}/X_{it}] \div [x_{wj}/X_{wt}]$ where x_{ij} and x_{wt} are the value of i 's exports and world exports to j , X_{it} is i 's total exports and X_{wt} are total world exports. An index of more (less) than unity indicates a bilateral trade flow that is larger (smaller) than would be expected given the partner country's importance in world trade.

¹¹ The gravity model explains bilateral trade between country (i) and country (j). Normally, the amount of trade is directly proportional to size (income, population, land area, etc.) and inversely proportional to the distance between trading partners i and j . It is expressed by the following equation:

$T_{ij} = AY_i^{\beta_1} P_i^{\beta_2} Y_j^{\gamma_1} P_j^{\gamma_2} D_{ij}^{\delta}$ where T is the amount of trade between two trading countries, Y is the GDP of the country, P is the population, and D is the distance between the trading partners. Often additional variables such as existence of a common border or language are also included as explanatory variables.

trade in the Maghreb and among the Gulf Cooperation Council states is less than predicted, this is not true for the Mashreq countries. Thus, the available evidence is somewhat ambiguous on the question whether intra-regional trade flows are lower than what would be expected given levels of GDP, population and geography. Simple shares and trade intensity indices suggest intra-regional trade is not that low and has been expanding; the gravity regressions suggest that trade is less than what would be expected. However, there has been a noticeable change in the last 10 years, with trade now being larger than what the standard gravity model would predict. (See the Appendix for a brief discussion of trends in bilateral trade over the last 30 years).

Two questions that are particularly relevant for the prospects of trade-led Arab economic integration initiatives deserve attention. First, to what extent do Arab countries that export a lot to the rest of the region (relative to their total exports) also account for a major share of intra-Arab exports? Second, how important are exports to other Arab nations in GDP terms for individual Arab countries? The first question captures the balance between the incentives of each country to go to a hypothetical regional Arab economic integration conference, and its capacity to influence the outcome of such a conference. The second question provides a very rough sense of the importance of intra-Arab trade for the national economy of each prospective member. It can be seen as a crude indicator of the strength of domestic political support for a regional Arab trade option. Despite appearances, trade policy is fundamentally a *domestic* policy—that is, a set of domestic bargains between conflicting domestic interests. This perspective suggests it is important to ask if there is a sufficiently large domestic coalition in favor of regional trade within key Arab countries. The importance of this question is amplified when it is recognized that a country has alternatives to regional trade. Many Arab countries are already pursuing discriminatory agreements with one (or more) large industrial country(ies). A significant number of countries have signed Euro-Mediterranean Partnership Agreements with the EC. And, of course, many are members of the WTO and have the option of pursuing multilateral liberalization.

The Arab countries that have substantial exports to other Arab nations (more than \$1 billion)—Oman, Saudi Arabia and the UAE—are all oil exporters. These three countries account for almost 60 percent of total intra-Arab trade. As already mentioned,

with the exception of Oman, in none of these cases do intra-regional exports account for more than 10 percent of the country's total exports (Table 5). In the case of Oman and UAE, these exports are equivalent to 7-8 percent of GDP and go beyond oil and oil derivatives, suggesting there may be significant political support for Arab economic integration in these countries. However, it should be recognized that these are not large countries in the regional context and therefore will have only have a limited capacity to push such an initiative forward. Countries with a high share of their total exports going to the Arab region—such as Jordan, Lebanon and Syria—represent only a small share of total intra-Arab trade (3, 2, and 5 percent, respectively), implying that their potential influence in a regional trade process is also likely to be small.

If we look at the ratio between exports to Arab countries and GDP, in addition to Oman and the UAE, there are three countries where the share is above 5 percent: Bahrain, Jordan, and Syria. This is not insignificant and suggests that these countries have an interest in the pursuit of Arab economic integration. In the case of Saudi Arabia the figure is 3.3 percent; for Tunisia 2.7 percent and for the other countries, Arab trade is less than 2 percent of GDP.

These numbers suggest that the situation is significantly different from that prevailing at the creation of the EC. In the mid-1950s, all prospective EC Member states exported more than 25 percent of their total exports to the rest of the Community. Intra-Arab trade shares are much lower for almost all Arab countries. Moreover, EC trade amounted to more than 3 percent in the domestic GDP of all the future EC Member states (5 percent for Germany), with Italy being the only exception at 2.8 percent. While the Arab trade/GDP ratios for many countries are similar, an important difference is that the variance is much higher—for a number of countries, including Egypt—which would have to be an important member of any integration initiative—the ratio is quite low. Thus, the balance between alternative trade agreements is tilted away from Arab integration.

To summarize: the available data suggest that: *(i)* intra-Arab trade is not less than what would be expected given fundamentals, especially for non-Maghreb countries; *(ii)* economies that sell a large share of their exports to the region (the potential 'hard-core' supporters of Arab economic integration) account for small shares of total intra-Arab trade; *(iii)* conversely, for countries accounting for a large share in total intra-Arab trade,

such trade accounts for only a small share of their total exports; and (iv) there is a large variance in the magnitude of intra-Arab trade relative to domestic GDP for Arab countries. All this suggests that the political economy of Arab integration based on preferential merchandise trade liberalization is not propitious.

3. Towards a Services-based Integration Strategy?

What are possible alternatives? An obvious candidate is to focus on other markets. Options include factor markets—labor, investment—and services. Labor movement and associated remittances accompanied by relatively large (official) capital flows—mostly transfers from oil-rich countries were important in the region during the 1970-85 period. Page and Van Gelder (2002) argue that such flows go a long way towards explaining the relatively good performance of the Arab region in reducing absolute poverty and the lower extent of income inequality that prevails in many Arab countries. These flows diminished very substantially in the 1990s following the decline in oil prices and the repercussions of the Gulf war. While a resumption of official transfers is unlikely to re-emerge, there is substantial scope for expanding the mobility of labor. This will be closely associated with an expansion in trade in services, as many of the persons who have incentives to move will be service providers.

Reforms in service-sector policies to reduce domestic production and trade costs are needed in their own right. They may also have a high payoff in facilitating further liberalization of trade of goods by enhancing the ability of firms to compete on world markets. Services-related costs are high in many Arab countries. As far as trade is concerned, logistics-related costs are often high due to government policies and regulations that result in limited competition. Public monopolies in ports and port services, combined with poor infrastructure for loading and storing goods, made the costs for discharging a container two to three times higher in Alexandria than in other Mediterranean ports. Port service charges in Arab countries can reach up to 10 percent of the value of imported intermediate components (Cassing et al., 2000). Monopoly shipping and domestic policies favoring national carriers result in low-quality, low-frequency, and high-cost services. Similar observations can be made for air transportation, telecommunications and utilities. Policies restricting trade in land

transport services, such as prohibitions on drivers originating in certain countries, arbitrary changes in documentary requirements, surcharges and discriminatory taxes, and prohibitions on obtaining cargo in the country of destination to take back to the country of origin, impose severe costs on intra-Arab trade (Zarrouk, 2000, 2002).

More generally, inefficient services place a substantial burden on manufacturing and agricultural sectors. Service inputs—ranging from financial intermediation and insurance to the design and marketing of products and access to high quality low cost telecommunications—are a major determinant of the competitiveness of firms. Because services are often not tradable, service sector liberalization involves a mix of deregulation (the dismantlement of barriers to entry—investment—and promotion of competition) and re-regulation (the establishment of an improved legal environment, strengthening specialized and independent regulatory agencies). The limited tradability of services implies that FDI is an important avenue through which to acquire access to best practices and new services. Given that many service activities are subject to investment restrictions (e.g., nationality requirements, restrictions on movement of personnel, limits on foreign equity shareholding), service sector reform is closely tied to privatization and removal of licensing and related entry and operating restrictions.

Arab countries have tended to approach service reform in a piecemeal fashion. Privatization has been slower than in other parts of the world; barriers to entry often remain forbidding, both for domestic and foreign investors; and there are few independent regulatory agencies to ensure markets are contestable. Privatization proceeds generated in the Arab region constituted only 3 percent of the worldwide total in the 1990s. While the trend is upward—rising from some \$22 million in the early 1990s to \$2 billion in 1995 to more than \$6 billion in the second half of the 1990s—the role of the state remains much higher than in other regions (ERF, 2001). Private sector participation in infrastructure is very limited. Between 1984 and 1997, projects in the region added up to only \$9 billion, compared to a worldwide total of \$650 billion, for a share of just 1.4 percent.¹² Given the inefficient operation and management of state-owned and controlled

¹² Examples of recent initiatives include water supply and wastewater treatment (Oman), power (Egypt, Morocco, Tunisia, and several GCC countries), transport (a port terminal in Yemen and a container terminal in Oman; toll roads in Jordan, Lebanon, Morocco and Tunisia; port services in Morocco and Tunisia), and telecommunications (the GCC countries, Jordan, Lebanon, and Morocco). See ERF (2001).

utilities, there is an urgent need to move to a sector-wide approach that includes a combination of competition, incentive regulation, and private ownership (ERF, 2001).

Because services often cannot be traded, increasing access to domestic service markets is likely to require the entry of foreign competitors through FDI. This will have two effects: a reduction in what Konan and Maskus (2002) call the cartel effect—the markup of price over marginal cost that incumbents are able to charge due to restricted entry; and an attenuation of what they call the cost inefficiency effect—the fact that in an environment with limited competition marginal costs of incumbents are likely to be higher than if entry were allowed. Pro-competitive reforms can then have major impacts on economic performance as many services are critical inputs into production. Moreover, in sharp contrast to what happens with merchandise liberalization, services entry (FDI or domestic) generates demand for *domestic* labor. Foreign banks, retailers, or telecommunications operators all need local labor. Thus, while the deregulation of entry inevitably will result in the restructuring of domestic industry, services reform has less far-reaching implications for sectoral turnover and aggregate sectoral employment than the abolition of trade barriers for merchandise. The simulation analysis undertaken by Konan (2002) suggests that reforms in services are less demanding in terms of labor adjustment than merchandise liberalization.

Services reforms can have a large indirect payoff as well—by generating political support for—and thus facilitating—merchandise trade liberalization. Trade barriers are still high in the region, not only because of tariffs but also due to a variety of nontariff measures that raise trade costs (Zarrouk, 2002). As a result there remains substantial anti-export bias in many Arab countries (Galal and Fawzy, 2002). Traditional (nondiscriminatory) trade liberalization therefore remains a priority. One reason progress in this area has been slow is that liberalization will invariably result in contraction/adjustment of domestic industries that benefit from protection, while industries in which the country has a comparative advantage will expand. Many of the latter initially are likely to be small and dispersed, whereas the former are likely to be concentrated. Thus the well-known political problem of building support for trade liberalization—those that stand to lose often will have a substantially stronger political voice as they have more information and more of an incentive to organize. Frequently it

will not be known beforehand which sectors and activities will become growth areas—hence an additional lag between those who will lose and those who will gain from liberalization. This makes the early transition process politically difficult and can impede liberalization altogether.

Political constraints to trade liberalization may be overcome if reforms target the service sector. Such reforms can lower trade-related transport, logistics and transaction costs, and reduce the cost and increase the variety of key inputs such as finance, telecommunications, marketing, distribution and similar services. Pro-competitive reforms that facilitate entry by new firms will also generate employment opportunities for skilled and unskilled workers who currently are employed by government or import-competing private manufacturing, or who are unemployed. Indeed, a political precondition for public sector downsizing is that such alternative employment opportunities emerge. Fears of employment loss need to be addressed *ex ante* through the establishment of safety nets and transitional adjustment assistance, but what matters most is that employment opportunities are created elsewhere in the (regional) economy following reform. A major benefit of a concerted strategy towards service sector reform is that this will in itself generate greater demand for labor by the private sector—both in services and goods-producing industries (Markusen, Rutherford and Tarr, 2002).

A central issue is the rationale for pursuing services trade and investment liberalization in a regional context. Much of what is needed could be pursued through unilateral action. Indeed, in other work we have argued that in general the need for reciprocal exchange of policy commitments should be much less necessary in the area of services than it is for merchandise trade liberalization (Hoekman and Messerlin, 2000). This is supported by recent experience in many parts of the world, especially Latin America and Eastern Europe, where great progress has been made since the late 1980s to privatize and increase competition in the service sector. A feature of many of these efforts has been that reforms were pursued as part of macroeconomic stabilization or transition programs—situations that have not arisen in the Arab context.

One possible explanation for the limited progress in addressing services-related trade costs (trade facilitation, transport) and expanding competition and private participation in ‘backbone’ infrastructure services in Arab countries is that there are

political economy factors that impede pro-competitive, unilateral reforms.¹³ Another is simply a lack of information and understanding of the potential gains. Related to this could be uncertainty regarding the design of complementary regulation and development/strength of implementing institutions that are needed to ensure competition prevails, universal service obligations are met, etc. Understanding what inhibits unilateral reform is a critical question. Whether and how an Arab integration-based effort to liberalize services can help to overcome the national political constraints to domestic reform depends on which of these potential factors are relevant.

One clear case for concerted action (regional cooperation) in the services area is if there are regulatory economies of scale or scope. But such cooperation can also help deal with the factors just mentioned. In the case of uncertainty, concerted action in the context of an Arab economic integration initiative could facilitate services reforms by creating focal points, mobilizing the needed high-level attention and engagement by senior decision makers, political leaders, and civil society. In the case of political economy based resistance to reform—more on this below—it could be a mechanism for governments to make credible commitments to a reform path. Only if there is a credible commitment will manufacturing and other interest groups have the incentive to invest resources and political capital in supporting implementation of services reforms and resisting backsliding. Regional cooperation can provide a mechanism to “lock-in” a reform path through pre-commitment to specific targets or outcomes.

What type of political economy constraints may impede national (unilateral) reform in services in Arab countries? One possible constraint is related to the large role of the State in many Arab economies. Greater participation by the private sector will require privatization and abolition of entry restrictions for new firms. Government policies and procedures are also the cause of high transactions costs at the border (red tape). Thus, a major factor determining the relevance of any integration strategy will be to what extent it will be used by governments to pre-commit to actions aimed at reducing the role of the State. This implies the focus must be on *government services* as well as ‘backbone’ infrastructure, both hard and soft. Two interest groups play a major role in

¹³ It is illustrative that only Algeria, Kuwait, Tunisia, and Turkey currently have (weak) competition laws, while efforts to adopt such legislation in Egypt, Jordan, and Morocco have proved contentious.

this connection—government employees in general, and more specifically, those responsible for enforcement of regulatory policies and procedures at the border (Customs) and for specific service industries (sectoral regulators).

Cross-country experience suggests the latter group can be a serious constraint to the adoption of more pro-competitive policies. Sectoral ministries or regulators that oversee service industries often will be more concerned with supporting domestic incumbents and maintaining the status quo, having little incentive to actively encourage new entry and greater competition—be it from domestic or foreign suppliers. The bureaucratic incentives confronting sectoral regulators generally will imply that little weight is put on the economy-wide dimensions of policies.

The resulting entry barriers often create significant rents for incumbents, who have a strong interest in blocking attempts to increase the contestability of “their” markets. It is important to ensure that potential entrants are free to enter service markets, and that policies do not discriminate against foreign as opposed to domestic entrants. Entry barriers in many service activities tend to be justified by invoking market failure rationales that revolve around information asymmetries, fears of excessive entry, the need for universal service, etc. While there is often a valid rationale for intervention (regulation), this does not generally require the creation of legal entry barriers.

Regional cooperation might also assist in the removal of national entry barriers by providing a focal point for reform and mechanisms to monitor progress. In addition, there are also potential regulatory economies that can arise. One element of such cooperation could include establishment of regional regulatory agencies to oversee network services (telecommunications, electricity, railways and other critical “backbone” activities) and move to “de-balkanize” Arab markets for such services. Regional regulatory agencies could facilitate cooperation between Arab countries that are investing in and managing the physical networks through the issuance of region-wide licenses for a market that would be large enough to attract global players. A regional effort to agree to the creation of a common competition authority may help to identify private collusive arrangements and public policies that restrict competition on regional markets.

The sequencing of reforms will be important to make and sustain progress. One possibility is to start with a regional effort on trade facilitation (broadly defined to include

key government ‘services’ that influence trade transactions costs), followed by initiatives to promote more effective competition on the regional market for network-type service industries and to liberalize entry into markets through investment (establishment). Starting with trade facilitation puts pressure on only a small subset of the civil service and will benefit foreign and domestic producers equally. Red tape costs large represent social waste—they do not generate revenue or rents. Consequently, reducing these costs can benefit the economy substantially.

As documented by Zarrouk (2002), trade costs in the region are high, in part because of government imposed restrictions and controls at the border, and in part because of a lack of competition in port, transport and related services. This is an area that is generally recognized as a priority by the private sector. Regional cooperation in this area could help governments move forward by setting quantitative benchmarks for improvement, establishing mileposts and creating transparency and oversight mechanisms to monitor progress achieved. Cross country experience suggests that moving forward to facilitate trade by addressing regulatory and logistics restraints requires high-level engagement by political authorities, something that is difficult to sustain. A regional initiative could help ensure that the necessary attention and support is provided over time, as the needed reforms will generally take a substantial amount time as well as resources—for training, upgrading of hardware and infrastructure, and so forth.

To the greatest extent technically possible, regional initiatives should aim to reduce costs for all trade and all traders, irrespective of origin. The primary rationale for undertaking this effort in a concerted fashion is to create clear focal points and objectives, and to mobilize the high level support that will be needed to make progress. There is no rationale for differentiating between goods of Arab and other origin—trade facilitation should apply on a most-favored-nation basis. The same applies to services reforms more generally—these should be applied on a nondiscriminatory basis.

A second potential area for regional cooperation is to develop mechanisms to increase the contestability of markets, especially for ‘backbone’ infrastructure services. Examples of such cooperation could involve the establishment of regional regulatory agencies to oversee network services (telecommunications, electricity, railways and other critical “backbone” activities). Regional regulatory agencies could facilitate cooperation

between Arab countries that are investing in and managing the physical networks through the issuance of region-wide licenses for a market that would be large enough to attract global players. Arab economic integration could also be a vehicle through which regional competition disciplines are agreed and enforced to discipline private collusive arrangements and public policies that impede entry or restrict competition on regional markets.

A regional effort to liberalize ‘backbone’ services could start with defining the “relevant market” in a more appropriate way. For instance, liberalizing air transport without liberalizing airport slots does not lead very far: the price of air travel will mirror *both* competitive pressures in terms of routes (if there are several airlines in presence, which is not necessarily the case) *and* monopoly rents related to airport slot monopolies. The same is true for maritime transport—Francois and Wooton (2000) estimate that the welfare gains from trade liberalization (better access to markets) may be doubled if complementary actions are taken to increase competition in the shipping sector. These are all examples of the types of interactions that tend to be ignored by national sectoral regulators and could be addressed more efficiently in a region-wide approach.

4. Lessons from the EC experience

The EC experience suggests careful consideration will need to be given to the design and sequencing of regional cooperation on services policies. Although a central pillar of the EC integration strategy was preferential merchandise trade liberalization, a common external trade policy and common management of agriculture, the EC also covers services and factor flows (investment and movement of workers).¹⁴ A number of lessons can be drawn from the EC experience.

First, there must be an overarching vision with respect to the ultimate objective of the exercise. Second, a clear path or strategy to achieve the objectives must be developed. Third, the implementation of the strategy must result in an overall balance of gains for

¹⁴ Another option is to focus on liberalization of trade in factors of production, something that is not discussed in this paper. Trade in labor services has traditionally been relatively important among Arab countries, albeit hampered by significant barriers and high transactions costs (Schiff, 1996). There are close links between temporary movement of people and liberalization of trade in services. What is required in the case of labor services is primarily a relaxation of quantitative restrictions—imposed through visas and economic needs tests and investment controls.

members at any point in time. This will require flexibility and may imply a need to carve out some sectors from the liberalization objective (as agriculture was by the EC). Rather than simply exempting ‘difficult’ sectors from the ambit of the customs union, the EC brought them under the umbrella of the integration goal through a common policy approach that was administered by the EC institutions. To a significant extent, the joint management of these common policies became the focus of day-to-day interaction at the Community level and helped make the EC a ‘reality’ for national bureaucracies and stakeholders. In addition, the EC developed transfer mechanisms that redistributed income to disadvantaged groups and regions. Finally, the supranational nature of the EC was important in maintaining the venture over time—a self-interested bureaucracy that was given a mandate to pursue integration proved very effective at mobilizing support for new initiatives, while enforcement of the ‘rules of the game’ was pursued via the independent ECJ.

The EC experience illustrates that regional cooperation to liberalize trade and investment in services is hard. The Common Market was limited to goods—although the manufacturing sector accounted for less than one third of EC GDP. Most services (representing the lion’s share of GDP) were left untouched by intra-EC liberalization until the 1990s. In part, this reflected the fact that many service providers in the EC were public monopolies (or firms to which member states granted special or exclusive rights). While these were subject to specific Treaty provisions on state-owned enterprises and state aids, only in the late 1980s did EC member states begin to embark on a major effort to privatize and introduce regulatory reforms for services. Following Article 52 (ex 63),¹⁵ the EC focused primarily on only a limited number of service sectors—those perceived as constituting the “infrastructure” backbone of the economy: financial services, telecoms, and transport (land, air, and sea). The late 1990s witnessed painful (and not always successful) efforts to extend the list to electronic commerce, electricity and natural gas, railways, and postal services.

In the Arab context, it is very difficult to assess *ex ante* which sectors will be ‘sensitive’, where there is a commonality of interest, and what is the balance of national

gains and potential losses (adjustment costs). This will require detailed analysis and extensive political debate and discussion. However, a case can be made that national interests regarding services reforms should be relatively balanced. In all countries, many industries stand to benefit significantly from services liberalization and policy reform. Manufactures and agricultural producers should have a strong interest in seeing their input costs decline and the variety and quality of services offered increased. They can therefore be expected to be a powerful force supporting regulatory reforms in services *if* a credible case can be made that the integration effort will result in such outcomes.

This will require the elimination of entry barriers created by explicit discrimination (e.g., no right of establishment and FDI) and regulatory differences that result in market segmentation. Doing so in a cooperative manner is difficult. Perhaps the most powerful force that can be unleashed through an integration process is to increase competition through relaxation of entry constraints—explicit barriers as opposed to implicit ones created by regulatory differences—and the adoption of mechanisms to discipline state aids and anticompetitive business practices. This would require institutions of the type created by the EC to monitor and challenge the behavior of governments, and to address anticompetitive practices by incumbent firms. State aids and intervention, as well as an absence of effective competition legislation, are two important factors in many Arab economies. This suggests that in terms of common institutions and disciplines attention should focus on those areas. Another priority area for institutional cooperation and development relates to dispute settlement. As mentioned in Section 2, the ECJ played a major role in advancing the integration effort in the EC. Without a mechanism to enforce commitments on FDI and entry into services, the effort will inherently be much less credible to the private sector, both in- and outside the region.

The feasibility of rapid movement to emulate the institutional complexity that prevails in the EC is of course limited. In the EC, this has grown incrementally, and the same would be true in the Arab context. Cooperation in regulatory areas and common competition policies will undoubtedly only emerge gradually. What matters most in this connection is to agree on the vision and to launch the process. This could encompass

¹⁵ Article 52 (ex 63), reads: “Priority for liberalization shall as a general rule be given to those services which directly affect production costs or the liberalization of which helps to promote trade in goods.” It

possible ‘half-way houses’ that could be used to build support for pro-competitive reforms. One option could be a regional mechanism to increase the transparency of government policies, including assessments of the economic effects of regulations and other policies that limit competition. Such information is a necessary condition to mobilize national constituencies that are negatively affected by such policies. Mechanisms to generate such information are discussed in Hoekman and Mavroidis (2000).

Whatever the specific features and modalities of cooperation, the economy-wide benefits of services reforms will be greatest if regional reforms and disciplines are applied on a nondiscriminatory basis. In contrast to preferential liberalization of trade in goods, concerted services reforms are less likely to give rise to serious trade and investment diversion, insofar as policies will often be applied equally to both foreign (non-regional) and regional suppliers. A reason for this is that regulation should be aimed addressing market failures, and thus be applied on a nondiscriminatory basis. The same will often be true in practice for policies affecting the major mode of contesting service markets—FDI. These generally do not distinguish between foreign investors on the basis of nationality. However, in principle this can certainly be done, and on the investment front such discrimination is pursued (on paper) in the Arab League context through an Arab rule of origin (a minimum required Arab equity ownership share). It is important that such discrimination be minimized.

5. Concluding Remarks

Arab economic integration efforts that revolve around merchandise trade liberalization face substantial impediments: *(i)* markets are generally small; *(ii)* strong comparative advantages in certain products (natural resources) generate export concentration and require geographical diversification of exports beyond the region to reduce risk; and *(iii)* major Arab countries do not appear to have strong incentives to take the lead in pursuit of merchandise trade-based economic integration, while smaller countries that do have the incentive do not have the influence to ensure implementation. Arab countries confront an incentive structure that is quite different from what prevailed in the context of the

again illustrates the predominance of trade in goods as the focus of the EC process.

creation of the EC in the 1950s, suggesting that emulating the EC approach—one that is based on preferential merchandise trade liberalization and the creation of a common external merchandise trade policy, leaving services reform for later—is unlikely to be a fruitful strategy for Arab countries.

For Arab economic integration efforts to be successful there must be sufficiently large domestic coalitions that favors it over all alternatives (Galal, 2000). Given the limited magnitude and potential for intra-Arab trade—and thus political support for efforts to expand such trade—complementary instruments and approaches are needed. One option discussed in this paper is to focus on the service sector—defined to include both government and major ‘backbone’ infrastructure-type services. Integration efforts that focus on services could potentially generate large gains that are a multiple of those that could be obtained from preferential merchandise trade liberalization (Konan, 2002). Indeed, preferential trade liberalization is unlikely to generate significant benefits—the best trade policy strategy for the region is to pursue nondiscriminatory liberalization. The latter is critical for many countries in the region—trade barriers are among the highest in the world outside of South Asia and anti-export bias is consequently strong.

A key question concerns the need for a regional or concerted approach to services reform. The incentives to pursue such reforms are large, and other parts of the world have implemented service sector reforms on a unilateral basis. However, progress in this area has been slower in Arab countries, suggesting there are political economy constraints that are more binding. To become an engine for Arab integration, the joint pursuit of services reforms will have to be an effective vehicle to help overcome political economy resistance to unilateral reforms.

The European experience illustrates that for integration strategies to be successful and to be sustained, powerful constituencies must see such efforts as contributing to the realization of objectives they care about. While political objectives were paramount in the EC, their realization involved the identification of economic measures that benefited all citizens in an average sense, while ensuring that concerns and interests of key ‘blocking’ coalitions and groups were satisfied. The challenge for supporters of Arab economic integration initiatives will be to identify objectives that are supported by citizens, and mechanisms of regional cooperation that will attain those objectives. Decision makers

must be able to make a compelling case that “going regional” will generate significant benefits that cannot be realized through unilateral action.

While there is certainly potential for a services-based approach to generate such benefits, it must be recognized that the design and implementation of concerted action will be complex. A major lesson of the EC is that the pursuit of political objectives may come at a high economic cost—the Common Agricultural Policy is an example. An integration path that focuses on service markets therefore should be designed so as to minimize the scope for capture by—and creation of—vested interests. In this regard there is less potential for trade diversion under a services strategy as regulatory reforms will often be applied on a nondiscriminatory basis. It is important that this be the case, as discriminatory regional regulation may result in economies becoming locked-in to less efficient regional suppliers and standards that impede the ability of more efficient foreign firms to contest the market at a later date even if the discriminatory policy is removed (Mattoo and Fink, 2002).¹⁶

Any regional approach to services reforms must recognize the fact that many Arab countries have now signed agreements with the EC and that many are also engaged in negotiations on goods and services trade in the WTO. The Euro-Med agreements all include provisions calling for the development of disciplines for investment (establishment) and services trade. They also embody numerous provisions calling for the EC to provide cooperation and technical/financial assistance in trade-related regulatory areas. These agreements can and should be taken into account in the design of any Arab integration strategy. Indeed, while the focus here has been on Arab cooperation options, a similar strategy can be pursued in the context of agreements with major high-income economies such as the EC and US. Deep integration agreements with such partners may well give rise to greater benefits through enhanced credibility effects and the likely associated financial and technical assistance transfers that will be associated with them (World Bank, 2000).

¹⁶ Mattoo and Fink (2002) discuss a number of issues that affect the sequencing of preferential and multilateral liberalization of services. They point to the potential problem of negative path dependence if preferential liberalization in services occurs for network industries with sunk costs—the end result may be durable entry restrictions against more efficient non-regional suppliers.

More generally, an Arab services integration-cum-cooperation strategy can and should be anchored in the WTO to ensure that policies are applied on a nondiscriminatory basis wherever possible. Of course, making commitments in the WTO allows concessions to be obtained from trading partners, expanding the potential gains from committing to reform. Given that the focus of negotiations at the WTO is on the depth of policy “bindings,” the fruits of regional reforms can be used as negotiating coin. Anchoring domestic liberalization in the WTO can also help Arab countries make reform more resistant to backsliding (as negatively affected foreign suppliers will oppose domestic efforts to re-impose trade barriers). That said, it must be recognized that WTO negotiations on services have not progressed very far to date, general disciplines on investment and competition policies do not exist, and many of the regulatory service reform priorities remain outside the ambit of the WTO.

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Table 1: Overview of economies in the Middle East and North Africa: trade aspects, 1998

Countries [a]	WTO status [a]	Population (millions)	GDP \$Mn [b]	GDP per capita (\$)		Goods & services [b]		Trade openness ratio (%) [d]	Shares of natural resources in total exports (%)		
				[b]	[c]	Exports \$ Mn	Imports \$ Mn		All	Fuels	Non fuel
	1	2	3	4	5	6	7	8	13	14	15
Natural resource-poor countries											
Israel **	**1962	5.8	98973	17064	15920	32085	40763	73.6	1.9	0.6	1.3
Turkey	**1951	62.5	198006	3168	2780	49021	55894	53.0	3.9	0.9	3.0
Cyprus	**1963	0.8	8970	11649		3948	4639	95.7	8.9	0.3	8.6
Lebanon */**	no	3.1	8352	2660	2660				11.3	1.4	9.9
Morocco *	**1987	27.3	35546	1302	1110	8133	9675	50.1	13.2	2.1	11.1
Tunisia *	**1990	9.2	19936	2162	1820	8464	9103	88.1	16.0	15.0	1.0
Intermediate countries											
Jordan */**	*2000	5.8	7306	1266	1510	3548	5090	118.2	34.7	0.0	34.7
Egypt *	**1970	62.1	82710	1332	790	13932	19274	40.1	53.2	48.5	4.7
Bahrain *	**1993	0.6	6184	10307		4838	4202	146.2	67.3	37.1	30.2
Oil-rich countries											
Syria */**	no	15.0	69112	4623	1120	21498	21756	62.6	81.7	80.7	1.0
Oman *	no	2.4	14192	5913	4820	5508	5826	79.9	83.0	82.7	0.3
UAE *	**1994	2.6	44673	17315	17400			141.5	85.1	83.1	2.0
Iraq *	no	21.2									
Iran	no	60.7	187423	3088		15494	15650	16.6	85.6	85.1	0.5
Yemen *	no	16.5	5729	348	260			91.5	90.0	89.4	0.6
Saudi Arabia *	no	19.5	128377	6587	7040	45605	39434	66.2	90.5	90.2	0.3
Qatar *	**1994	0.6	9193	16128				73.2	93.3	93.3	0.0
Algeria *	no	29.1	41158	1417	1600						
Libya *	no	5.8						NA	96.3	96.3	0.0
Kuwait *	**1963	2.0	25523	12890	17390	11380	12217	92.5	96.7	96.6	0.1
Memo items								(avg)			
All countries	--	277.9	950205	3190	2062			80.6	68.3	66.8	1.5
GAFTA *	--	222.6	497991	2237	1799			87.5	--	--	--

Sources: IMF, International Financial Statistics. World Bank. WTO-Trade Policy Reviews. UN COMTRADE.

Notes: [a] *: Greater Arab FTA (GAFTA) Members, **: GATT (**) or WTO (*) membership and accession dates. [b] [c] in millions of US dollars, at current exchange rates. Year 1995 for Algeria, 1997 for UAE, Yemen, Qatar, Bulgaria and Poland. [d] Estimates (for 1995) from World Bank Development Report. [e] Ratio of the sum of exports and imports over GDP.

Table 2 Structure of exports: product concentration and differentiation

	Share of SITC items exported (%) [a]		Index of concentration [b]		Intra-industry trade index [b]		Share of components in total industrial trade (% 2000)	
	1980	1997	1980	1997	1988	2000	Imports	Exports
Natural resource-poor countries								
Israel	0.84	0.84	0.26	0.28	0.64	0.62	19.5	19.0
Turkey	0.79	0.93	0.23	0.10	0.22	0.31	12.5	3.9
Cyprus	0.50	0.46	0.15	0.15	0.22	0.32	12.8	3.1
Lebanon	0.81	0.67	0.16	0.13	0.26	0.18	11.8	3.5
Morocco	0.42	0.66	0.32	0.18	0.14	0.24	19.2	2.5
Tunisia	0.53	0.75	0.48	0.21	0.23	0.29	14.4	7.4
Intermediate countries								
Jordan	0.45	0.47	0.35	0.27	0.09	0.16	18.4	8.5
Egypt	0.33	0.68	0.57	0.28	0.07	0.18	24.7	3.1
Bahrain	0.24	0.45	0.79	0.63	0.24	0.18	16.5	6.9
Oil-rich countries								
Syria	0.44	0.45	0.63	0.56	0.03	0.11	7.6	0.4
Oman	0.42	0.61	0.92	0.72	0.25	0.14	18.8	14.0
UAE	0.82	0.88	0.87	0.62	0.11	0.22	20.8	10.9
Iran	0.37	0.72	0.81	0.80	0.02	0.08	25.6	2.2
Yemen					0.02	0.03	19.6	6.7
Saudi Arabia	0.77	0.73	0.94	0.74	0.13	0.13	19.0	7.1
Qatar	0.01	0.30	0.93	0.73	0.04	0.07	20.4	3.7
Libya	0.18	0.12	0.96	0.77	0.03	0.04	21.3	1.6
Kuwait	0.79	0.65	0.72	0.56	0.06	0.07	17.0	3.9
Memo items								
Malaysia	0.85	0.94	0.30	0.19	0.58	0.64	23.1	22.5
Korea	0.85	0.92	0.09	0.14	0.40	0.57	17.6	18.3
Taiwan	0.87	0.93	0.12	0.12	0.43	0.57	17.1	24.3

Sources: UNCTAD, Handbook of Trade Statistics, 1997 and 2000; UN COMTRADE.

Notes: [a] Percent of SITC items with "substantial" exports. [b] See text and footnotes for definition.

Table 3: Geographic Destination of Exports, 2000

Country	World (\$ Million)	Exports as % of Total Exports										
		All Indus Countries	Indus. Europe	North America	Asia & Pacific	All Non- Indus Co.	Africa	Asia	Europe	Arab nations	Latin America	Not Specified
Algeria	20,468	83.4	66.7	16.5	0.2	16.6	1.3	0.8	6.2	1.1	8.2	0.0
Bahrain	5,701	16.8	6.9	5.6	4.4	83.2	3.4	27.4	0.6	9.7	0.2	42.1
Cyprus	953	39.6	36.9	2.4	0.2	60.4	2.5	2.8	15.6	26.1	0.3	11.8
Egypt	5,633	61.1	43.8	14.9	2.4	38.9	2.6	11.2	4.5	9.7	1.0	10.8
Iran	28,345	43.7	25.6	0.9	17.3	56.3	0.0	30.0	3.9	7.5	0.2	14.7
Israel	31,910	69.6	28.6	37.7	3.4	30.4	1.5	15.3	4.3	0.3	2.9	6.1
Jordan	1,897	6.8	2.6	3.4	0.8	93.2	3.3	22.0	1.2	33.8	0.3	33.9
Kuwait	17,752	55.9	14.6	15.2	26.1	44.1	0.1	41.8	0.9	0.9	0.5	0.0
Lebanon	715	36.2	27.0	8.0	1.3	63.8	6.7	4.2	6.9	45.2	0.6	1.4
Libya	12,688	88.2	88.1	0.0	0.1	11.8	2.7	0.5	7.5	3.3	0.2	0.1
Morocco	8,228	73.6	62.7	5.9	3.7	19.0	1.3	8.5	3.3	4.4	2.4	7.4
Oman	10,542	22.5	1.3	2.5	18.8	77.5	0.9	63.4	0.0	13.1	0.0	0.0
Qatar	11,527	51.0	1.1	3.7	46.3	49.0	0.8	31.9	0.1	6.3	0.1	9.8
Saudi Arabia	74,688	54.9	17.9	18.2	18.8	45.1	2.6	32.9	1.2	7.6	1.5	0.0
Syria	4,981	63.5	59.6	3.5	0.3	36.5	1.1	1.5	13.7	18.1	0.2	3.0
Tunisia	5,986	80.2	79.1	0.8	0.3	16.0	3.4	2.5	1.7	8.9	0.9	3.1
Turkey	27,768	66.4	53.4	11.9	1.0	33.6	3.2	2.9	11.2	9.5	1.0	5.6
UAE	41,068	42.0	5.1	2.4	34.5	58.0	1.7	32.6	0.8	9.7	0.2	13.3
Yemen Rep.	4,076	12.3	2.4	6.2	3.8	87.7	1.9	76.2	1.1	4.2	1.6	2.7
Total	314,926	56.3	28.8	12.5	15.0	43.4	1.8	24.4	3.4	6.9	1.5	6.1
All Developing Countries	2,075,378	53.9	23.7	17.2	13.0	46.1	1.7	28.7	6.3	5.0	4.2	0.1

Source: IMF, Direction of Trade Statistics Yearbook, 2001.

Table 4: Trade Intensity Indices for Middle East and North Africa Countries' Exports in 2000

Country	All Industrial Countries	Of which: Industrial Countries			Developing countries	
		Europe	N. America	Asia & Pac.	Asia	Arab
Algeria	1.25	1.77	0.74	0.03	0.04	0.40
Bahrain	0.25	0.18	0.25	0.66	1.56	3.54
Cyprus	0.59	0.98	0.11	0.03	0.16	9.52
Egypt	0.92	1.16	0.67	0.36	0.64	3.52
Iran	0.66	0.68	0.04	2.61	1.71	2.72
Israel	1.04	0.76	1.69	0.51	0.87	0.12
Jordan	0.10	0.07	0.15	0.12	1.26	12.34
Kuwait	0.84	0.39	0.68	3.95	2.38	0.32
Lebanon	0.54	0.71	0.36	0.19	0.24	16.47
Libya	1.32	2.33	0.00	0.01	0.03	1.22
Morocco	1.10	1.66	0.27	0.56	0.48	1.60
Oman	0.34	0.03	0.11	2.84	3.62	4.79
Qatar	0.77	0.03	0.16	7.00	1.82	2.31
Saudi Arabia	0.82	0.47	0.82	2.84	1.88	2.77
Syria	0.95	1.58	0.16	0.05	0.09	6.59
Tunisia	1.20	2.09	0.04	0.04	0.14	3.26
Turkey	1.00	1.42	0.54	0.15	0.16	3.48
UAE	0.63	0.13	0.11	5.21	1.86	3.53
Yemen Rep.	0.18	0.06	0.28	0.57	4.34	1.54
All above	0.85	0.76	0.56	2.27	1.39	2.52

Note: Trade Intensity Index (T) is defined as: $T_{ij} = (x_{ij} / X_{it}) / (x_{wj} / X_{wt})$ where x_{ij} and x_{wj} are the value of country's (i) exports and region's exports to world (j), X_{it} is the country's total exports and X_{wt} are the total world exports. An index of more (less) than unity indicates trade flows that is larger (smaller) than expected given the partner's importance in world trade.

Source: Computations based on IMF Direction of Trade Statistics Yearbook 2001.

Table 5: Regional Export Shares and Weight in GDP, 2000

Country	Value of exports to Arab countries (\$ mill)	Share in total Arab trade (%)	Exports to Arab countries as a share of total exports (%)	Exports to Arab countries as a share of GDP (%)
Algeria	224	1.2	1.1	0.4
Bahrain	554	3.0	9.7	7.0
Egypt	544	2.9	9.7	0.6
Iran	2,117	11.3	7.5	2.0
Jordan	642	3.4	33.8	7.7
Kuwait	154	0.8	0.9	0.4
Lebanon	323	1.7	45.2	2.0
Libya	425	2.3	3.3	1.4
Morocco	360	1.9	4.4	1.1
Oman	1,386	7.4	13.1	7.0
Qatar	731	3.9	6.3	5.1
Saudi Arabia	5,680	30.3	7.6	3.3
Syria	900	4.8	18.1	5.3
Tunisia	535	2.9	8.9	2.7
UAE	3,981	21.3	9.7	8.3
Yemen Rep.	172	0.9	4.2	2.0
All Above Countries	18,728	100.0	7.4	2.7

Note: Regional trade refers to intra-Arab trade.

Source: IMF, Direction of Trade Statistics Yearbook, 2001 and World Bank, World Development Indicators, 2001.

Appendix: Trends in Bilateral Trade, 1960-2000

The body of the paper describes the *current* pattern of trade between countries in the Middle East. It is interesting to complete this picture by examining whether this situation has always existed, and what has been happening over time. A comparison of intra-regional bilateral trade flows over the last 35 five years suggests that there has been a significant decline in the relative importance in intra-regional trade since the early 1960s, but that there has been a pick-up in the last decade. A matrix of bilateral imports is reported in Appendix Table 1, with data aggregated according to the natural resource-intensity of trading partners. Table 2 does the same for exports. The region here is defined as all countries—not just Arab nations.

The data reveal two different types of evolution in imports from Arab economies. On the one hand, countries that are not oil-rich witnessed a decline or stability of the share of their regional trade until 1985, followed by a reversal since then, but generally not large enough to counterbalance the previous decline. On the other hand, oil-rich countries tend to increase trade with other Arab countries—an evolution which may reveal an income effect (oil-rich countries may have been induced to diversify their purchases because of lower oil prices, and to turn towards less expensive local sellers).

In the early 1960s, Lebanon and Jordan imported about 60 percent of all non-oil imports from the region. By 1997 this had dropped to the 10-15 percent range. Note that many countries register an increase in the intra-regional share after 1985. Increases are substantial for Syria, Iraq, Oman, Saudi Arabia, Libya and Kuwait. The regional breakdown of exports also suggests the long-term trend is down—most countries exported less in 1997 in relative terms to the region than in the early 1960s (Table 2). The exceptions with respect to non-oil trade that show a recovery in the last 10-15 years include Egypt, Syria, Saudi Arabia, Algeria, Libya and Kuwait. In the case of Syria, Egypt and Lebanon, the increase involves non-oil economies, while for Saudi Arabia the increase is in oil-rich countries (suggesting again growth of intra-industry trade in oil-related products).

Appendix Table 1: Intra-regional import pattern (percentages), 1964-97

	Natural resource-poor countries				Intermediate countries				Oil-rich countries				Total regional			
	1964	1978	1985	1997	1964	1978	1985	1997	1964	1978	1985	1997	1964	1978	1985	1997
Intra-trade as a percentage of total trade (oil included)																
Israel	0.9	0.1	0.2	1.3	0.9	0.0	0.0	0.1	0.1	0.1	0.0	0.0	1.9	0.3	0.2	1.4
Turkey	1.3	2.2	1.0	0.8	1.2	0.9	0.2	0.9	9.3	23.5	31.1	7.6	11.8	26.6	32.4	9.3
Lebanon	3.9	1.4	5.5	3.6	2.6	1.6	1.0	1.1	18.2	12.7	0.8	7.7	24.7	15.6	7.3	12.4
Morocco	0.0	1.1	0.4	1.3	0.4	0.7	0.0	0.3	2.3	8.0	21.5	10.8	2.8	9.8	21.9	12.3
Tunisia	0.2	1.9	1.2	1.8	0.5	0.1	0.4	0.6	5.6	5.3	7.4	5.0	6.3	7.3	9.0	7.4
Jordan	7.5	6.7	4.2	4.6	2.3	1.9	0.5	1.3	12.9	15.4	25.8	21.2	22.6	24.0	30.5	27.1
Egypt	0.5	2.0	1.1	2.0	0.0	0.2	0.2	0.2	5.2	1.9	2.0	4.6	5.7	4.2	3.2	6.8
Bahrain	0.0	0.3	0.6	1.1	0.0	0.0	0.1	0.8	85.7	45.8	48.1	11.7	85.7	46.1	48.8	13.6
Syria	6.6	4.1	2.5	6.8	2.6	3.0	0.6	2.2	8.8	9.6	27.2	5.6	17.9	16.7	30.2	14.6
Oman	0.0	0.5	0.1	0.5	0.0	2.9	0.5	1.0	98.1	16.5	22.4	26.7	98.1	19.9	23.0	28.1
UAE	0.0	1.0	1.7	1.1	0.0	1.4	4.1	0.4	93.3	2.8	4.4	6.3	93.3	5.2	10.1	7.8
Iraq	2.8	1.8	11.7	5.6	1.4	0.9	2.2	15.3	1.8	0.7	0.1	3.1	5.9	3.4	14.0	24.0
Iran	1.1	1.5	11.6	3.1	0.0	0.7	0.0	0.1	3.5	1.0	0.8	2.0	4.6	3.2	12.4	5.2
Yemen	0.0	0.8	0.3	4.2	2.8	0.7	0.4	2.3	76.0	23.4	0.6	7.5	78.9	24.9	1.3	14.0
Saudi Arabia	6.2	1.8	1.8	10.6	5.7	0.8	1.2	0.1	8.0	1.4	1.9	23.3	19.9	4.1	5.0	34.0
Qatar	1.3	1.0	1.5	0.4	0.0	0.7	1.1	0.9	4.6	4.3	5.6	6.4	5.9	6.0	8.2	7.7
Algeria	2.6	0.3	2.3	3.9	0.2	0.1	0.1	0.5	0.2	0.2	0.4	3.4	3.0	0.7	2.8	7.8
Libya	1.4	3.1	4.5	9.5	0.7	0.1	0.0	2.7	0.9	0.2	0.1	1.0	3.0	3.4	4.6	13.3
Kuwait	2.8	2.0	2.2	2.5	1.3	1.0	0.6	1.9	5.4	1.6	0.1	11.4	9.6	4.6	3.0	15.8
Yemen, DR	0.3	0.0	0.0	--	1.0	4.1	0.5	--	40.8	15.0	2.8	--	42.1	19.1	3.3	--
Intra-trade as a percentage of total trade (oil excluded)																
Israel	0.1	0.1	0.2	1.4	1.7	0.0	0.0	0.1	0.1	0.2	0.0	0.0	1.9	0.3	0.2	1.5
Turkey	1.8	1.2	1.5	0.8	0.3	0.4	0.3	0.3	0.4	0.3	1.0	1.9	2.4	1.9	2.8	3.0
Lebanon	11.4	1.6	5.3	3.9	7.4	1.9	0.5	1.2	41.3	2.1	0.3	4.2	60.2	5.6	6.1	9.3
Morocco	0.0	1.2	0.5	1.5	0.4	0.8	0.1	0.3	0.5	0.1	0.4	3.0	1.0	2.2	0.9	4.8
Tunisia	0.4	2.0	1.1	1.5	0.7	0.1	0.4	0.6	2.5	0.2	1.9	1.9	3.6	2.3	3.4	4.0
Jordan	24.8	7.5	5.4	5.4	8.9	2.1	0.7	1.5	33.4	6.5	5.8	8.7	67.1	16.1	11.9	15.6
Egypt	0.6	2.1	1.0	1.8	0.0	0.2	0.2	0.2	4.4	1.8	1.0	4.1	4.9	4.1	2.1	6.1
Bahrain	0.0	0.5	1.2	1.1	0.1	0.1	0.3	0.8	31.3	5.8	3.9	11.8	31.4	6.3	5.3	13.8
Syria	8.1	4.7	3.5	7.1	3.2	3.5	0.8	2.3	10.0	0.6	0.7	5.2	21.3	8.7	5.0	14.6
Oman	0.0	0.6	0.1	0.5	0.0	0.6	0.1	0.5	96.4	12.9	22.0	25.9	0.0	14.1	22.3	26.9
UAE	0.0	1.1	1.8	1.1	0.0	0.5	0.7	0.4	1.2	0.7	2.8	6.2	1.2	2.2	5.2	7.7
Iraq	1.3	1.8	11.8	5.6	0.7	0.9	2.2	15.3	0.8	0.7	0.1	3.1	2.8	3.4	14.1	24.0
Iran	0.6	1.5	12.3	3.2	0.0	0.5	0.0	0.1	1.2	0.8	0.4	2.0	1.9	2.8	12.7	5.3
Yemen	0.0	0.8	0.3	4.2	15.5	0.6	0.4	1.6	77.0	22.1	0.6	7.5	92.5	23.5	1.4	13.4
Saudi Arabia	1.6	1.8	1.9	10.9	1.5	0.8	1.2	0.1	2.1	1.4	1.9	23.8	5.2	4.1	4.9	34.7
Qatar	0.3	1.0	1.5	0.4	0.0	0.7	1.1	0.9	0.7	4.3	5.5	6.4	1.0	6.0	8.1	7.7
Algeria	2.5	0.3	2.3	4.0	0.2	0.1	0.1	0.5	0.2	0.1	0.4	2.6	2.9	0.5	2.8	7.1
Libya	0.7	3.1	4.6	9.5	0.3	0.1	0.0	2.7	0.3	0.2	0.1	1.0	1.2	3.4	4.7	13.3
Kuwait	1.0	2.0	2.2	2.5	0.5	1.0	0.6	1.9	1.9	1.6	0.1	11.1	3.4	4.6	3.0	15.5
Yemen, DR	0.2	0.1	0.0	--	0.6	0.1	0.6	--	10.8	1.7	0.0	--	11.6	1.9	0.7	--

Source: Author's calculations based on UN COMTRADE database.

Appendix Table 2 Intra-regional export pattern, 1964-97

	Natural resource-poor countries				Intermediate countries				Oil-rich countries				Total regional			
	1964	1978	1985	1997	1964	1978	1985	1997	1964	1978	1985	1997	1964	1978	1985	1997
Intra-trade as a percentage of total trade (oil included)																
Israel	1.9	1.8	0.6	1.1	0.0	0.0	0.2	0.4	1.5	2.8	0.0	1.3	3.3	4.7	0.8	2.8
Turkey	5.8	4.1	2.3	3.2	0.6	5.9	2.4	1.3	1.3	12.6	56.7	7.3	7.7	22.6	61.4	11.8
Lebanon	2.0	2.3	1.2	6.8	15.5	14.1	12.4	7.6	76.5	69.8	50.6	16.2	94.0	86.2	64.3	30.6
Morocco	0.1	1.1	3.4	1.5	0.3	0.2	0.1	0.2	2.9	1.8	6.0	2.8	3.3	3.1	9.5	4.4
Tunisia	0.1	1.3	1.8	2.0	1.0	0.1	0.5	0.5	7.2	7.5	7.2	6.6	8.2	8.9	9.5	9.1
Jordan	25.0	5.5	2.6	9.8	0.1	4.9	1.2	3.4	57.3	65.5	50.1	42.7	82.5	75.9	53.9	55.9
Egypt	3.4	3.5	0.6	9.0	0.6	1.3	0.3	0.6	3.7	8.0	2.3	6.4	7.7	12.9	3.2	15.9
Bahrain	21.3	0.0	0.3	1.2	0.4	0.0	0.4	1.3	33.5	16.9	27.4	5.1	55.2	16.9	28.1	7.7
Syria	29.6	5.6	2.5	22.9	6.4	6.6	1.5	3.0	13.3	12.9	7.4	11.2	49.2	25.2	11.4	37.2
Oman	0.0	0.0	0.0	0.0	0.0	0.5	0.2	0.3	10.6	0.4	1.0	14.8	10.6	0.9	1.2	15.1
UAE	0.0	0.0	0.5	0.2	0.5	0.3	0.2	0.3	19.1	2.2	5.5	6.7	19.6	2.5	6.3	7.2
Iraq	3.6	3.8	11.5	5.3	0.3	0.2	1.8	15.9	5.8	1.6	0.2	0.0	9.6	5.7	13.5	21.1
Iran	1.7	2.3	9.1	3.8	0.1	0.1	0.0	0.1	6.8	0.6	5.8	0.7	8.6	2.9	14.9	4.5
Yemen	0.0	0.0	0.0	0.0	1.0	0.4	0.1	0.5	55.1	35.4	12.9	0.3	56.1	35.7	13.0	0.8
Saudi Arabia	2.5	0.7	2.6	2.7	4.5	2.7	6.3	1.3	1.3	0.9	0.5	3.2	8.3	4.4	9.4	7.2
Qatar	9.9	0.0	0.1	0.3	4.0	0.2	0.3	0.3	6.2	1.0	3.7	0.7	20.2	1.2	4.2	1.3
Algeria	1.3	0.0	2.3	6.4	0.3	0.0	0.0	0.0	0.2	0.0	0.1	1.9	1.9	0.1	2.5	8.3
Libya	0.7	2.6	5.9	8.4	1.0	0.0	0.0	0.7	0.2	0.1	2.8	0.4	2.0	2.8	8.6	9.5
Kuwait	0.2	0.3	1.6	1.5	1.7	0.5	0.9	0.2	4.8	3.3	3.1	1.7	6.7	4.1	5.7	3.4
Yemen, DR	0.5	0.0	0.0	--	0.3	0.1	0.0	--	9.8	59.4	0.8	--	10.6	59.5	0.8	--
Intra-trade as a share of total non-oil trade																
Israel	2.2	0.2	0.6	1.1	0.0	0.0	0.1	0.3	1.8	3.0	0.0	1.4	3.9	3.2	0.7	2.7
Turkey	4.3	4.1	2.7	3.2	0.5	5.9	3.0	1.3	1.3	12.6	69.6	7.3	6.1	22.6	75.2	11.8
Lebanon	1.0	1.6	1.2	6.9	8.3	14.2	12.4	7.7	49.7	70.5	50.6	16.4	58.9	86.3	64.3	31.0
Morocco	0.1	1.0	3.1	1.3	0.2	0.2	0.1	0.2	2.4	1.8	6.1	2.8	2.7	3.0	9.3	4.2
Tunisia	0.0	1.9	2.6	2.0	0.7	0.1	0.7	0.6	6.4	11.0	10.4	7.2	7.2	13.1	13.6	9.8
Jordan	17.4	5.5	2.8	9.8	0.1	4.9	1.3	3.4	40.2	65.5	54.5	42.7	57.7	75.9	58.6	55.9
Egypt	5.4	5.7	1.6	6.0	1.1	3.5	1.2	1.1	6.1	19.3	10.7	11.8	12.6	28.5	13.6	19.0
Bahrain	0.0	0.0	1.1	2.0	0.6	0.0	1.4	2.0	74.4	33.6	36.2	6.5	75.0	33.7	38.6	10.5
Syria	55.1	3.6	4.3	28.7	10.5	19.5	6.5	10.4	25.7	38.5	31.8	31.5	91.3	61.6	42.6	70.6
Oman	0.0	0.0	0.0	0.0	0.0	11.3	4.2	0.3	70.5	10.1	30.0	15.0	70.5	21.4	34.2	15.3
UAE	0.0	0.0	0.4	0.6	0.0	9.6	2.4	1.1	26.7	59.7	59.4	29.3	26.7	69.2	62.2	31.0
Iraq	7.9	1.0	2.1	0.5	2.8	17.0	18.0	27.0	36.6	11.5	11.5	0.1	47.4	29.6	31.6	27.5
Iran	1.6	0.8	2.6	3.4	0.2	1.1	0.9	0.5	8.4	8.4	15.4	4.5	10.2	10.2	18.9	8.4
Yemen	0.0	0.0	0.0	0.7	1.3	0.4	0.2	7.9	40.2	39.8	40.6	6.9	41.4	40.2	40.8	15.4
Saudi Arabia	19.4	0.6	2.5	3.8	56.6	10.9	5.6	8.9	9.7	33.4	5.0	24.0	85.7	44.8	13.1	36.7
Qatar	1.5	0.0	1.4	1.5	0.0	5.6	3.7	2.5	62.1	25.0	41.9	6.3	63.6	30.6	47.1	10.3
Algeria	1.4	0.6	6.2	16.9	0.3	0.4	0.0	0.1	0.3	1.0	0.1	9.7	1.9	2.0	6.3	26.7
Libya	1.2	1.7	14.2	16.9	1.8	5.1	0.1	10.6	11.6	1.5	1.1	3.7	14.6	8.3	15.3	31.3
Kuwait	4.1	5.5	0.3	5.3	25.4	11.9	7.2	4.0	57.1	56.7	35.9	41.5	86.5	74.1	43.4	50.8
Yemen, DR	1.0	0.0	0.0	--	0.8	0.2	0.1	--	32.9	83.7	6.6	--	34.7	83.8	6.7	--

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