8

Global Engagement

Previous chapters have established that the Middle East and North Africa (MENA) region is a relative underachiever with respect to trade and investment. The issue is how to strengthen their performance in these dimensions to contribute to accelerated growth, labor absorption, and rising standards of living in the context of institutions and policies that are not particularly strong. One possibility would be to use external anchors such as the World Trade Organization (WTO) or preferential trade agreements to promote internal reforms, reinforce credibility, and lock in commitments. Such a strategy has clear attractions.

Yet historically Arab policymakers have hesitated in seizing these opportunities, and even today public opinion in the region exhibits ambivalence toward deeper integration with the outside world, exhibiting in the words of one observer, "widespread recognition of the need for change to more market-oriented economies without necessarily buying into the full logic of globalization" (AbiNader 2003, 2).

The comparison with Eastern Europe reinforces the notion that cultural orientation and historical experience matter and that political trauma may be a prerequisite for abrupt reform, a lesson undoubtedly not lost on the long-lived political regimes of the region. Moreover given the public's ambivalent attitudes toward external economic engagement, unlike the case of Eastern Europe, it is not at all clear that successor regimes would be liberal and not populist, whether Islamist or not.

Membership in Multilateral Institutions

We return to the comparison of MENA and Eastern Europe. Table 8.1 reports the accession dates and status of Arab and Eastern European countries

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Table 8.1 GATT/WTO and Bretton Woods accession status, as of 2005

Country	GATT/WTO	World Bank	IMF Article VIII
Middle East			
Normally endowed			
Egypt	1970	1945	—
Jordan	2000	1952	1995
Lebanon	Observer	1947	1993
Morocco	1987	1958	1993
Syria	—	1947	—
Tunisia	1990	1958	1993
Yemen	Observer	1969	1996
Resource-abundant			
Algeria	Observer	1963	1997
Bahrain	1995	1972	1973
Iraq	Observer	1945	—
Kuwait	1963	1962	1963
Libya	Observer	1958	2003
Oman	2000	1971	1974
Qatar	1994	1972	1973
Saudi Arabia	2005	1957	1961
United Arab Emirates	1996	1972	1974
Central Europe			
Czech Republic	1948[b]	1945[c]	1995
Hungary	1973	1982	1996
Poland	1967	1946[d]	1995
Slovakia	1948[b]	1945[c]	1995
Baltic Republics			
Estonia	1999	1992	1994
Latvia	1999	1992	1994
Lithuania	2001	1992	1994
Former Soviet Union			
Belarus	Observer	1992	2001
Russia	Observer	1992	1996
Ukraine	Observer	1992	1996
Former Yugoslavia			
Bosnia	1966[a]	1945[a]	—
Croatia	1966[a]	1945[a]	1995
Macedonia	1966[a]	1945[a]	1998
Serbia and Montenegro	1966[a]	1945[a]	2002
Slovenia	1966[a]	1945[a]	1995

(table continues next page)

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Table 8.1 GATT/WTO and Bretton Woods accession status, as of 2005 *(continued)*

Country	GATT/WTO	World Bank	IMF Article VIII
Eastern Europe			
Albania	2000	1991	—
Bulgaria	1996	1990	1998
Romania	1971	1972	1998

GATT/WTO = General Agreement on Tariffs and Trade/World Trade Organization
IMF = International Monetary Fund

a. Joined as Yugoslavia.
b. Joined as Czechoslovakia.
c. Withdrew in 1954; rejoined in 1990.
d. Withdrew in 1950; rejoined in 1986.

Sources: IMF Annual Report, 2004; WTO and World Bank Web sites, www.wto.org and www.worldbank.org.

to the main global multilateral economic institutions—the General Agreement on Tariffs and Trade (GATT) and its successor the WTO, the World Bank, and the International Monetary Fund (IMF). (In the case of the Fund, the date listed is when the country acceded to Article VIII on currency convertibility, which originally indicated that the funds in that currency could be used for IMF lending activities but more broadly signaled an irreversible commitment to forgo capital controls on current account transactions.)

All of the Arab economies are members of the Bretton Woods institutions, and in some cases, involvement with the Bank began in the preindependence period. The incentives for membership were straightforward: The Bank was a source of development finance and technical advice, and additionally it was distinct from the colonial power. Quite naturally, the more populous resource-scarce Arab countries tended to join these institutions earlier on, with the more financially stable resource-abundant countries accepting IMF Article VIII obligations more readily.

The real difference across the two regions is with respect to the GATT/WTO. While nonmembership is the exception in Eastern Europe, limited to some former members of the Soviet Union, almost half of the Arab countries are not members. It is notable that there is a correlation between the countries that are in the WTO (and have thus bound themselves to a globally recognized enforceable intellectual property rights protection regime) and the countries that ranked most highly on technology absorption measures in table 6.3.[1]

1. Bernard Hoekman and Jayanta Roy (2000) provide a MENA-centric introduction to the WTO.

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For oil producers such as Algeria, Iraq, and Libya, their lack of interest in membership is not particularly surprising: Under the mercantilist logic that dominates trade negotiations, there is little incentive for them to join the WTO—no country imposes tariffs on oil. For these resource-abundant countries the advantages of membership are in leveraging internal institutional modernization and reform by committing themselves to internationally enforceable agreements. Militarily weaker oil producers have a second, strategic reason for joining international organizations: As relatively small countries they make potentially easy prey for their larger neighbors (for example, the Iraqi invasion of Kuwait), hence it is in their interests to embed themselves in the global institutions and to try and bind their fortunes with those of larger extraregional powers. In the case of Saudi Arabia, these considerations were reinforced by concerns that WTO rules would clash with local interpretations of *sharia* prohibiting the importation of pork, the establishment of cinemas, and the availability of certain financial instruments such as insurance deemed un-Islamic.

What is striking is that with the exception of Egypt, which has been active in a global coalition of developing countries within the WTO known as the Group of 20, the resource-scarce Arab countries such as Jordan, Morocco, and Tunisia have joined the WTO relatively recently or not at all. This is not to say that they have been entirely absent—after all, the agreement bringing the WTO into existence in 1993 was signed in Morocco, and the current round of negotiations was launched in Qatar. Yet even in the case of Egypt, its legally bound tariff rates are so far above the actual applied rates that its WTO commitments do not impose any real policy constraints in this dimension. This lack of enthusiasm for the binding trade commitment at least in part may reflect a fundamental political logic: In regimes where the creation, extraction, and channeling of policy-derived rents is a core component of regime maintenance, open borders and binding trade agreements actually undermine the political economy of regime survival. The general impression is that the Arab countries have embraced GATT/WTO late or not at all. From a historical standpoint, the contrast with the Central European countries, which despite membership in the Council of Mutual Economic Assistance and Soviet domination during the Cold War were members of the GATT, as were Yugoslavia and Romania, is remarkable. What is relevant is that the Central Europeans saw the international system as a mechanism for leveraging domestic reforms and reintegrating themselves into world markets, despite the constraints imposed by the Soviet Union. To cite but one example, Harold James (1996) provides an eye-opening account of formal and informal Central European contacts with the IMF beginning in the 1950s following de-Stalinization and running through the 1960s and 1970s. He quotes an internal IMF memorandum recounting a 1968 meeting between a representative of the Fund and a Polish representative to GATT in which the Pole explained, "There were some in authority in Poland who were aware that they were

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paying a high price in continuing to trade with Soviet Russia. . . . He thought that the Fund would do a good service if it produced a kind of critique of the economic policies of the socialist countries. Such an appraisal would be seriously studied and would serve to point out to those in power that their policies were out of date and not in the long-term interests of their countries" (James 1996, 559). He goes on to document the Fund's growing alarm at the political element in the Central Europeans' economic reform plans and the dawning recognition that their proponents were quite consciously aiming at the dissolution of the Soviet Union's European empire.[2]

The Central Europeans continually pushed the envelope of Soviet tolerance with Hungary joining the Bretton Woods institutions in 1982, and Poland rejoining after a 36-year interregnum in 1986. Romania and Yugoslavia had been in the institutions for some time. After the collapse of the Eastern Bloc in 1989, Czechoslovakia rejoined the institutions in 1990, accompanied in short order by Bulgaria (1990), Albania (1991), and the newly independent Baltic republics (1992).

In sum, a significant share of the Central European elite regarded themselves as part of the West and the period of Soviet domination as aberrant. Even during the Cold War they participated in the GATT and in some cases the Bretton Woods institutions. When the external constraints were removed, the Eastern Europeans moved with alacrity to join (or rejoin) these organizations to anchor liberal policy reforms. In contrast, it took Tunisia 30 years to join the WTO, beginning with provisional accession to the GATT in 1959, an application for full accession in 1980, and final approval of the entry accession protocol in 1990. Saudi Arabia began negotiations in 1990, joining only in December 2005.

Given differences in cultural orientation and historical experience the Middle East as a whole evinces greater ambivalence toward the West in general and these Western-dominated institutions in particular. Perhaps this hesitation reflects the underlying attitudes of the population. As reported in table 7.3, the average Arab response to the question of whether the international economic institutions are good is 38 percent, compared with 58 percent in Eastern Europe or 65 percent in Central Europe. A World Bank report speaks of a pervasive "deep pessimism about the region's trading potential" and a consequent "lack of commitment of leadership in governments of the region" to reform (World Bank 2003a, 38, 22). The issue is whether there has been sufficient convergence in values and interests such that the Arab countries can make better use of the opportunities afforded by the international system or whether there are al-

2. As further evidence of Poland's westward gaze, James later quotes Tadeusz Mazowiecki, the prime minister in Poland's first post-Communist government, as remarking without irony that "I am looking for my Ludwig Ehrhard!" referring to the architect of West Germany's postwar liberalization and revival (James 1996, 568).

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ternative mechanisms more compatible with local interests and attitudes that can play a similar role of reinforcing internal reform.

Put in terms of interest group politics, the Eastern European countries made a conscious decision to destroy the economic practices that had underpinned the Communist political regimes. In contrast, the Arab countries as a group have not made such a decisive break with the constraints on rent channeling, which is part of the political survival strategy of a number of these regimes.

Role of Preferential Arrangements

In essence international trade agreements can benefit a country in two ways. One is through efficiency gains, in the form of either the traditional static efficiency improvements associated with resource reallocation according to comparative advantage and/or "dynamic" gains provided by greater scale economies, induced investment, and learning to become more efficient in order to meet international competition. The other source of potential gains is more subtle and difficult to document or evaluate, but these come from improvement in the business climate through direct improvements in commercial practices and dispute resolution plus reduced uncertainty associated with enhanced credibility and irreversibility achieved through binding national policies to enforce international agreements. In principle, countries can reap the benefits of direct efficiency gains and enhancements in business climate through both multilateral agreements such as the WTO and preferential arrangements such as free trade areas.

In any trade agreement, the magnitude of the conventional improvements in economic efficiency is determined by the size and economic complementarity of the agreement partners and the extent of reduction in existing barriers to trade. In this respect multilateral and preferential liberalization differ in one important way—in the case of preferential liberalization, under certain conditions the reallocation of trade away from efficient third-party trade partners and toward relatively inefficient preferred partners (called trade diversion) may be so large that a country could actually make itself worse off (as well as making third parties worse off). For this reason, economists generally regard multilateral agreements as superior to preferential agreements.

The problem with multilateral agreements is that the larger number of participants makes negotiating liberalization more complex and time consuming. As a consequence there is some tendency for these agreements to reflect a kind of lowest common denominator consensus, with respect to both the degree of liberalization and its scope across sectors and issue areas. In particular, while the WTO system has made considerable progress in removing border barriers to trade, especially tariffs that are particularly amenable to negotiated mathematical formulas for their reduction, the

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global organization has been less successful in addressing "behind the border" issues such as competition and tax policies, which are increasingly important in determining trade flows but are more difficult to negotiate and impinge directly on policies heretofore treated as purely internal matters.

One understandable response has been for countries to form the economic equivalents of "coalitions of the willing" and enter into preferential arrangements with like-minded countries that go beyond the global standards embodied in the WTO with respect to the elimination of border barriers as well as pursuit of transnational agreements on "new issues." Noneconomic political or diplomatic motivations often play prominently in the formation of these groups. The extent of conventional benefits under these agreements is driven by the size and complementarity of the partner country and the magnitude of the preexisting trade barriers; the nontraditional benefits are a function of the credibility derived from precommitting to liberal policies with a larger, more powerful partner and success in transforming trade commitments into broader reforms. For the Arab countries, two sets of potential partners are relevant: themselves and the United States and/or the European Union.

Intra-Arab Agreements

The Arab countries have a long history of entering into preferential arrangements among themselves, beginning with a 1953 treaty to organize transit trade among Arab economies, followed in 1964 by the establishment of the Arab Common Market, which failed.[3] Yet such initiatives, implying greater openness and competition, ran counter to the political imperatives of patronage, political control, and rent extraction on which a number of the region's political regimes relied, as manifested in the legacies of widespread industrial support policies, import substitution, and promotion of state enterprises.

Since then, the interest in preferential schemes within the Arab world has waxed and waned; the region is currently experiencing a renewal in interest in regional and subregional preferences, with the Arab Free Trade Area (AFTA), also known as the Pan-Arab Free Trade Area (PAFTA) or Greater Arab Free Trade Area (GAFTA), the most prominent. In 1998, 18 of the 22 members of the Arab League sanctioned the creation of a pan-Arab free trade area running from Iraq in the east to Morocco in the west (see appendix 8A). The original target for eliminating tariffs by 2008 was brought forward, and tariffs on intra-Arab trade were eliminated on January 1, 2005. The commitments cover only merchandise trade, not services or investment, and according to Robert Z. Lawrence (2006), nontariff barriers remain problematic.

3. See Zarrouk (2000b) for a history of these and other Middle Eastern integration initiatives.

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Table 8.2 Middle East's total trade shares, 2004 (percent)

Country	United States	European Union	Middle East	Rest of the world	Exports to Middle East/GDP
Algeria	16	57	3	25	1
Egypt	12	38	8	41	2
Iraq	40	20	5	35	n.a.
Jordan	13	17	31	40	13
Kuwait	13	19	5	63	1
Lebanon	6	45	15	35	2
Libya	1	75	5	18	2
Morocco	4	65	6	25	1
Oman	4	13	4	79	2
Saudi Arabia	15	20	4	60	2
Syria	3	37	12	48	6
Tunisia	2	75	7	15	3
Yemen	3	13	13	71	3

n.a. = not available

Note: Middle East includes Algeria, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Morocco, Oman, Saudi Arabia, Syria, Tunisia, and Yemen.

Sources: International Monetary Fund, *Direction of Trade Statistics*, July 2005, and *World Economic Outlook* database, April 2005.

In 2004 foreign ministers of Egypt, Jordan, Morocco, and Tunisia signed an embryonic subregional free trade agreement, the Agadir Agreement, allowing for accession by any Arab country. The smaller number of members, the greater potential cohesiveness of interests, and the relatively reformist nature of the governments suggest that this subregional agreement may convey greater prospects for successful implementation and elaboration. A critical aspect of the agreement is the adoption of pan-European rules of origin, enabling cumulation of local content and perhaps facilitating the development of horizontal specialization and cross-border supply networks in industrial production that have facilitated development in East Asia.[4]

Even if implemented, given the low intensity of intraregional trade reported in the last column of table 8.2, there is little reason to expect that GAFTA would have a large impact, at least through the traditional resource reallocation channel, though admittedly, Ali A. Bolbol and Ayten M. Fatheldin (2005) find evidence of growing intraregional trade intensity that they attribute to the preferential agreement. Yet even if this is the case, there is some reason to believe that the agreement could reduce wel-

4. The Agadir Agreement is to establish the Mediterranean Arab Free Trade Area (MAFTA), not to be confused with the Bush administration proposal for a Middle East Free Trade Area (MEFTA). See Lawrence (2006) for further discussion of the Agadir Agreement.

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fare for some of its members.[5] Trade with the United States and the European Union exceeds intraregional trade for every economy except Jordan, which imports oil from Saudi Arabia and where Iraq reconstruction-related exports have boomed in recent years. The only way that analysts have been able to generate large welfare gains is to posit substantial liberalization in the services sector through the elimination of implicit nontariff barriers, even though these are not part of the agreement.

In any event, skepticism about implementation is warranted. Historically intra-Arab regional initiatives, long on ambition and short on implementation, have had a negligible impact on trade flows.[6] The reasons are multiple: With the aforementioned exception of Jordan and Syria with its pronounced, though perhaps eroding, ties to Lebanon, in no country do intraregional exports account for more than 3 percent of GDP—in strictly economic terms, there is little reason to take each other seriously (table 8.2).

Furthermore, it is unlikely that the major oil producers have any interest in committing themselves to preferential trade with their relatively inefficient neighbors, when they can import from the most efficient global producers. Rather than tie themselves to their poorer relations, their interest is in binding themselves politically to powerful oil-consuming nations, who can act as their security guarantors in relation to covetous neighbors (for example, Kuwait 1990). To this list of political impediments one can add personal rivalries among competing authoritarian leaders and questionable institutional capacity in some states. Egypt, for example, has already announced that it is delaying the implementation of its GAFTA commitments because of concerns that the rules of origin are too liberal and are not being properly enforced by other member states (Hoekman and Konan 2005). Lastly, the weakness of the global trade system in exerting policy discipline on preferential agreements paradoxically may have encouraged frivolous diplomatic schemes, which arguably crowded out the implementation of more modest though potentially constructive trade-facilitation initiatives.

As noted earlier, preferential agreements can potentially harm third parties through trade diversion, and as a consequence the WTO agreement contains a provision (Article XXIV of the GATT) that constrains the use of preferential trade arrangements. These requirements in essence discourage countries from entering into tailor-made partial liberalizations that would be most likely to harm third parties. In particular, Article XXIV

5. Hoekman and Konan (2005), using a computable general equilibrium model to assess alternative trade liberalization scenarios, find that Egypt would actually experience a slight decrease in welfare in a pan-Arab free trade area. Konan (2003) indicates that the same perverse result would apply to Tunisia as well.

6. A series of studies using gravity models to analyze trade flows have failed to uncover any positive impact of these schemes. See Al-Atrash and Yousef (2000); Nugent (2002); and Miniesy, Nugent, and Yousef (2004). One exception is Rock-Antoine Mehanna (n.d.), who finds that the Gulf Cooperation Council (GCC) has modestly boosted trade.

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stipulates that the agreement must be comprehensive (i.e., it must cover "substantially all sectors"), must eliminate barriers within the preference area over a reasonable time horizon, cannot involve raising existing barriers to third parties, and specifies a procedure through which other signatories are notified of the agreement.

Article XXIV discipline is weak in general and even weaker with respect to the Middle East. It is weak in general because many of the key terms are vague, and there is no history for challenging or litigating preferential trade arrangements under Article XXIV. Just the opposite—the process of forming the European Economic Community in the 1950s and 1960s almost surely violated GATT strictures but for diplomatic reasons was never challenged. Furthermore, in the case of the Middle East as shown in table 8.1, most of the Arab countries have joined the WTO only relatively recently if at all. As a consequence, none of the multiple preferential trade arrangements among the Arab countries were ever registered with the GATT/WTO, and the organization has exerted no discipline on their formulation or implementation.

Looking forward, agreements among Arab countries are unlikely to constitute good precommitment mechanisms due to weak institutional capacity within the member states and a lack of ability to enforce noncompliance by signatories.

Against these doubts one could set the possibilities of unique benefits. In light of the skepticism about globalization expressed in public opinion polls, intra-Arab agreements may be more acceptable politically than agreements with countries outside the region, and in fact a poll of Middle Eastern firms found that intra-Arab agreements were perceived as the most beneficial (Zarrouk 2003). And it is at least arguable that for reasons of proximity and cultural affinity, Middle Eastern neighbors could exert policy surveillance more effectively than global institutions based elsewhere. Also to be considered is a sequencing argument that it may be preferable to expose one's firms to regional competition before developed-country competition.

One exception to these generally desultory results has been the Gulf Cooperation Council (GCC) comprising Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. With a greater commonality of interests and one dominant state to lead the way, the GCC formed a customs union in 2003 and established as a goal a currency union in 2011.[7] However the conclusion by Bahrain and Oman of bilateral free trade agreements with the United States has complicated the administration of the customs union, if not potentially undermining the project. Similarly, the currency union initiative has encountered rough sailing with member states unable to agree on the form of a centralized monetary authority, its location, or even the name of the currency. Now talk is of some looser form

7. See Lawrence (2006) for more details on the customs union aspect.

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of monetary cooperation short of a full currency union. Some if not all of the members appear to be violating fiscal convergence criteria, as well.

This analysis suggests that while intra-Arab initiatives may not be a bad idea, one should have modest expectations about their ultimate impact. The same does not necessarily hold with respect to preferential agreements with the United States and European Union.

Club Med

From the perspective of the Middle East, Europe is a large, rich, complementary, and geographically proximate trade partner. For these reasons, most Arab countries trade intensively with the European Union, and only in the case of Iraq, for perhaps transitory reasons, does trade with the United States exceed that with Europe (table 8.2). Hence it is natural to begin any discussion of preferential trade with Europe, the Middle East's "natural" trade partner.

Preferential trade between Europe and the Arab Mediterranean states began in 1972 with the European Union's Global Mediterranean Policy to promote trade preferences, financial aid, and technical cooperation.[8] The European Union went on to conclude bilateral agreements with its Mediterranean partners between 1973 and 1980. The most recent agreement reached in Barcelona in 1995 initiated movement toward free trade in industrial products by 2012, as well as expanding cooperation in finance, technical assistance, education, and political and security issues. The Arab countries at that time had an incentive to update the agreements before the Eastern Europeans joined the European Union and the Western Europeans lost interest or were overwhelmed with their own adjustment issues. The European Union has subsequently encouraged regional integration through the Agadir process, for example by providing small amounts of funding and technical assistance, as well as an initiative to incorporate the Agadir rules of origin into the Euro-Med agreement.

However, the economic importance of these agreements is subject to dispute. As Bernard Hoekman and Patrick Messerlin (2002) observe, commitments under these agreements do not go much beyond existing WTO commitments. Eighty percent of the Mediterranean countries' agricultural exports to the European Union are granted tariff preferences, but they are still subject to nontariff barriers and other distortions associated with the Common Agricultural Policy (Péridy 2005). Existing Euro-Med agreements permit incorporation of services—however, none of the Mediterranean countries have followed up. At the same time that they are gain-

8. The Arab economies that have concluded preferential agreements with the European Union are Algeria, Morocco, Tunisia, Egypt, Lebanon, Jordan, Syria, and the Palestinian Authority territories. The European Union has a separate forum of negotiation for a free trade agreement with the GCC countries, but progress has been very limited.

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ing preferential access of a sort in the European Union, the Mediterranean partners are obligated to a phased elimination of barriers on European industrial imports. Hoekman and Denise Konan (2005) estimate that the resulting trade diversion might actually reduce welfare in Egypt. Comparable estimates are not available for other Mediterranean countries.

Moreover, these preferences cannot be viewed in isolation: At the same time it extended preferences to the Middle East, the European Union was in the process of negotiating accession with Central and Eastern European countries, potentially eroding the Middle Eastern countries' effective preference margins. Conversely, as will be discussed below, some Arab countries have concluded preferential agreements with the United States—effectively reducing the preferences granted to European exporters.

Econometric modeling suggests that the Euro-Med preferences have had a positive impact on bilateral trade but that the effectiveness of the preference scheme is eroding. Nicolas Péridy (2005) estimates that at their peak, the agreements boosted bilateral trade by nearly 30 percent in the mid-1980s but that the effect steadily declined over the ensuing decade, and by the mid-1990s (the end of his sample period) the effect had declined to 12 percent and was falling. This decline could be ascribed to continued restrictions on agricultural trade, multilateral liberalization undertaken in the context of the Uruguay Round, including the phaseout of the Multi-Fiber Arrangement (a global network of product-specific bilateral textile and apparel import quotas), which eroded Mediterranean preference margins, and EU accession agreements with Eastern European countries starting in the early 1990s. This latter argument receives explicit support from the work of Anna Ferragina, Giorgia Giovannetti, and Francesco Pastore (2004), who compare the behavior of the Mediterranean and Eastern European countries to preferential trade opportunities in the EU market. They find Mediterranean-EU trade lower than expected on the basis of gravity models, and with the exception of Tunisia, this gap appears to have widened between 1995 and 2002. Bolbol and Fatheldin (2005) and Ludvig Söderling (2005) obtain similar results. Ferragina, Giovannetti, and Pastore obtain the opposite result with respect to Eastern Europe, which exhibited a marked narrowing of the gap between potential and actual trade over this period.

Arab textile and apparel exports to the European Union have been negatively affected, though not completely eliminated, by the complete phaseout of the Multi-Fiber Arrangement in 2005 (World Bank 2006c).[9] This is important insofar as textiles and apparel loom large in the export bundle of Tunisia and Morocco, the two Arab countries that have achieved the

9. A possible exception was exports from GCC countries, which were basically a product of the quota system and might disappear completely under a more liberal regime (Someya, Shunnar, and Srinivasan 2002). In any event, most of the employment in these operations went to workers from outside the region, mostly from South Asia.

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greatest success penetrating European markets outside the petroleum sector. Though even in this case, the European Union's subsequent restrictions on Chinese exports effectively increased Arab preferences.

Given the seasonality and constantly changing nature of fashion, timely delivery is relatively important in textile and apparel trade, and there is some evidence that production is increasingly located near the countries of final demand (Evans and Harrigan 2005). As a consequence, the Middle East's geographical proximity to the European Union could potentially confer competitive advantage vis-à-vis rivals such as India and China in this important sector. Dan Magder (2005) explores this possibility using a formal supply chain model of apparel trade. His findings indicate that if logistical issues could be resolved, geographical proximity could be a source of competitive advantage for the Middle East as a production location, especially in niche markets such as summer fashion, where fast turnaround times have significant effects on retailer profitability.

Of course, the advantages of geographic proximity are not limited to textiles and apparel. Under improved circumstances one would hope that this advantage could be exploited across a whole range of light manufactures, with Middle East–based facilities, for example, becoming suppliers of parts in the global sourcing decisions of the large integrated automobile assemblers, as has occurred in Turkey. Allen Dennis (2006) uses a computable general equilibrium model to simulate alternative scenarios and concludes that in the context of EU-MENA agreements, the indirect reductions in transaction costs associated with improvements in trade facilitation would actually generate larger welfare improvements for the Middle Eastern countries than the elimination of border measures per se.

Preferential Trade Arrangements with the United States

From the perspective of the Middle East, the United States is similar to the European Union in that it represents a large, rich, complementary, though distant, potential trade partner. For most Arab countries, trade with the European Union is a multiple of trade with the United States. However, the United States is far more strategically important than trade figures alone would indicate.

Moreover the United States differs from the European Union in that "behind the border" issues—including environmental protection and labor rights—rank prominently on its negotiating agenda. Furthermore, unlike the Euro-Med agreements that tend to be couched in vague language, the template for American bilateral agreements is a highly specific and enforceable legal document. A crude indicator of this difference is that the texts of the US free trade agreements with Jordan and Morocco are more than four and ten times longer respectively than their equivalent Euro-Med accession agreements. For these reasons a preferential trade arrange-

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ment with the United States is likely to amount to a much more consequential commitment than the Euro-Med agreement.

The basic lesson coming out of the existing literature, which uses computable general equilibrium models to simulate alternative trade liberalization packages, is that the real gains from liberalization stem from liberalization of services trade and behind-the-border regulatory impediments to trade, at least for the typically endowed Arab economies.[10] As discussed earlier in this book, these problems appear to be pervasive in the non–oil based economies, particularly in Egypt, though there have been improvements of late. Recent research also suggests that US multinational corporations significantly increase technology transfer to countries strengthening their intellectual property rights regimes, a result that seems to find support in the case of Jordan, the Arab country with which the United States has its longest-standing preferential trade arrangement (Branstetter, Fisman, and Foley 2005). Similarly, Bolbol and Fatheldin (2005) find that the agreement has significantly boosted Jordan's trade with the United States in marked contrast to the Euro-Med agreement, which they find has had little if any impact on Jordan's trade.[11] The upshot is that for the Arab countries, the long-run payoffs to the deeper, more intrusive agreements with the United States may exceed the shallower, less demanding association agreements with the European Union. Of course, the potential risks are higher as well.[12]

Thus far the United States has concluded free trade agreements with Jordan (2001), Morocco (2004), Bahrain (2005), and Oman (2005); has begun negotiations with the United Arab Emirates; floated the possibility of additional agreements with others including Egypt and Tunisia; and announced the goal of creating a Middle East free trade agreement (MEFTA) by 2013.[13] In addition to the free trade agreements, the United States has

10. See Konan (2003), Galal and Lawrence (2004), and Hoekman and Konan (2005) and sources cited therein.

11. The rapid increase in exports to the United States has generated employment for not only Jordanians but also imported workers including Bangladeshis (Steven Greenhouse and Michael Barbaro, "An Ugly Side of Free Trade: Sweatshops in Jordan," *New York Times*, May 3, 2006, C1). If this is indeed the case, generating employment growth for local residents is much more difficult than the calculations carried out in chapter 4 indicate. In the Jordanian case, much of the investment in labor-intensive sectors was undertaken by multinational firms in order to benefit from the trade agreements. For unclear reasons, Jordanian nationals did not take up a considerable number of the jobs created.

12. From a pure negotiating standpoint, having accumulated considerable experience in negotiating free trade agreements, US negotiators are more seasoned. However, given the stakes, and the greater political centrality of these negotiations to the Arab governments, they are likely to commit more senior people.

13. See Lawrence (2006) for an analysis of this initiative. Tamara Cofman Wittes and Sarah E. Yerkes (2006) discuss its diplomatic context. Thomas Friedman ("New Signs on the Arab Street," *New York Times*, March 13, 2005) points out the domestic political difficulties in Egypt.

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concluded qualified industrial zone agreements with the Palestinian Authority, Jordan, and Egypt.[14] (See appendix 8B for detailed discussions of individual agreements.)[15] These provide for preferential access to the US market for goods qualifying by meeting a local-content requirement specified in terms of US, Israeli, and the third-county's input content, even beyond what might be available through a free trade agreement, for example providing for accelerated tariff elimination or quota relaxation for products where the tariff phaseout may last up to 10 years.

"Deep integration" free trade agreements are a potentially useful mechanism for leveraging and locking in domestic reforms. As the discussion in chapter 4 made clear, informal barriers to trade such as monopoly public-sector service providers and problematic customs administration and attendant corruption significantly hamper cross-border integration, and US-style "deep integration" agreements may be useful in reforming these practices in a way that the "shallow integration" initiative of the EuroMed almost surely cannot.

Yet they are not a panacea. Even proponents of this strategy admit that they require complementary changes in policies, institutions, and practices to be fully successful (Kardoosh and al Khoury 2005, Lawrence 2006). As Jean AbiNader (2003, 5) has observed, "preferential trade agreements cannot remake legal and educational systems, enhance work habits, protect environments, encourage human rights and respect for minorities, and all the other collateral benefits without shifts in how Arab governments perceive their leadership and management functions. But they can be helpful and maybe that's sufficient for defining a workable template for low-risk options that move Arab regimes with more confidence to face the severe challenges of the coming decades."

Conclusion

In the realm of trade policy, Arab countries have made progress, and it would be wrong to portray the region's stance as stagnant or unchanging. The countries are undertaking unilateral reforms and increasingly binding themselves with the strictures of the WTO. Moreover, in contrast to past quixotic efforts at regional integration, under competitive pressure from

14. See Kardoosh and al Khoury (2005) for an excellent overview of qualified industrial zones.

15. Among the Middle Eastern countries, the United States has also concluded trade and investment framework agreements (TIFAs) with Algeria, Egypt, Kuwait, Qatar, Saudi Arabia, Tunisia, and Yemen. It also has concluded a qualified industrial zone agreement with Turkey and has bilateral investment treaties with Bahrain, Egypt, Jordan, Morocco, and Tunisia. Libya and Syria are the only Arab countries with which the United States does not have some sort of bilateral economic agreement.

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the world economy, some Arab countries are addressing regional integration with renewed seriousness, while others have been drawn into the preferential trade arrangement game with the European Union and/or the United States, powerful partners capable of demanding adherence to agreements. The issue is whether these efforts are sufficient given the demographic imperative the region faces.

In addition to their potential anchor for broader reforms, trade agreements have direct impacts, and this chapter has also reviewed evidence on the prospective effects of preferential agreements under consideration as well as those that have recently come into force. But the quantitative estimates of the payoffs assume a supply response, generated by either domestic firms or foreign investors. The issue is whether the assumption is correct that domestic and foreign firms will invest and increase production as an improving economic climate takes hold. But what happens if one throws a party and no one comes?

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Appendix 8A
Select Regional Organizations

The Middle East has a long history of preferential trade arrangements and organizations. Among the more prominent are the following:

African Economic Community (AEC). Established in 1991, went into force in 1994, with the goal of creating an eventual continentwide economic and monetary union in 2028. This goal is to be accomplished through the gradual integration of five subregional groups of which one is the Arab Maghreb Union. Middle East and North Africa (MENA) members include Algeria, Djibouti, Egypt, Libya, and Tunisia.

Arab Maghreb Union (AMU). A Maghreb Customs Union was formed in the 1960s but for the most part was not implemented. In 1989 Algeria, Libya, Mauritania, Morocco, and Tunisia formed the AMU according to its founding treaty "to work gradually towards the realization of the freedom of movement of people, goods, services and capital," as a precursor to a free trade agreement in 1992; a common market, the North African Common Market in 2000; and eventually a monetary union known as the Maghreb Economic Space. Some progress was made on sectoral issues, but in 1993 members agreed to postpone further discussion of integration issues. Dormant, the AMU does not maintain formal relations with the AEC, despite being designated as one of the five pillars of that organization. See Brenton, Baroncelli, and Malouche (2006) for discussion of current preferential arrangements within the Maghreb.

Arab Common Market. Through the Arab League and its subgroup, the Council on Arab Economic Unity, the Arab Common Market was established in 1965 with Egypt, Iraq, Jordan, and Syria as founding members and Libya, Mauritania, and Yemen joining later. Needless to say the goal of establishing a common market was not reached, though preferential tariff cuts were undertaken. In 1989 a subset of its members, Egypt, Iraq, Jordan, and (then) North Yemen established the Arab Cooperation Council (ACC) with the goal of intensifying the pursuit of a common market.

Arab Free Trade Area (AFTA), also known as the Pan-Arab Free Trade Area (PAFTA) or Greater Arab Free Trade Area (GAFTA). In 1998 18 of the 22 members of the Arab League agreed to the creation of a Pan-Arab Free Trade Area running from Iraq in the east to Morocco in the west (see Zarrouk 2000b for an overview). Membership includes all six of the members of the Gulf Cooperation Council (GCC), three of the five members of the AMU, eight other countries, and the Palestinian Authority. This is the only preferential arrangement in which Yemen currently participates. Al-

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geria is not a member. The original target for eliminating tariffs by 2008 was brought forward, and tariffs on intra-Arab trade were eliminated on January 1, 2005. The commitments cover only merchandise trade, not services or investment, and according to Robert Z. Lawrence (2006), nontariff barriers remain problematic. A similar Arab Common Market scheme was ratified by the Arab League in 1964 but failed.

Gulf Cooperation Council (GCC). Established in 1981, the GCC signed a preferential trade arrangement that led to the creation of a free trade agreement in agricultural and industrial products (though not petroleum products) and free movement of factors of production. The GCC originally envisioned forming a customs union by 1986, but progress on reducing internal barriers and establishing a common external tariff proceeded slowly. However, the customs union was eventually established in 2003, with a common external tariff set at 5 percent. Implementation of the customs union has been complicated by the conclusion of bilateral free trade agreements between Bahrain and Oman with the United States. The GCC also established as a goal a currency union by 2011, but is now backing away from this commitment, at least on this timetable. Members are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. Yemen has been permitted to begin participating in some activities as an initial step toward eventual membership.

Common Market for Eastern and Southern Africa (Comesa). Another of the five pillars of the AEC, Comesa was established in 1993 as a successor to the Preferential Trade Area for Eastern and Southern Africa, and the Comesa Free Trade Area was launched in 2000. As its name implies, the organization's notional goals involve the establishment of a common market and eventual economic union. Among the MENA countries, Egypt and Djibouti are members.

Intergovernmental Authority on Development (IGAD). Established in 1996, IGAD is a Horn of Africa subset of Comesa. Djibouti is a member. It is not a pillar of the AEC.

Other Preferential Arrangements. Over the past 40 years, Arab governments have entered into a variety of preferential arrangements—for example, as part of the Non-Aligned Movement, Egypt (then the United Arab Republic) entered into the Trade Expansion and Cooperation Agreement with India and Yugoslavia, which came into force in 1968, and after several renewals expired in 1983. In June 2005 the Organization of the Islamic Conference, of which all the Arab countries are members, announced a preferential scheme among its members to go into effect at the end of 2005. Appendix table 8A.1 lists preferential trade arrangements currently in force or expected to enter into force soon.

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Table 8A.1 **Participation in preferential trade arrangements**

Country	Name of agreement	Type of agreement	Year went into force	WTO notification status[a]
Algeria	African Economic Community	Customs union	1994	
	EC-Algeria	Association free trade agreement	1976	Report adopted
	EC-Algeria (updated)	Association free trade agreement		
Bahrain	Gulf Cooperation Council	Preferential arrangement		Notified 1984, no examination requested
	United States–Bahrain	Bilateral free trade agreement	2006	Examination not requested
	Arab Free Trade Area	Free trade agreement		
Djibouti	African Economic Community	Customs union	1994	
	Common Market for Eastern and Southern Africa	Preferential arrangement	1994	Examination not requested
Egypt	African Economic Community	Customs union	1994	
	Common Market for Eastern and Southern Africa	Preferential arrangement	1994	Examination not requested
	EC-Egypt	Association free trade agreement	1977	
	EC-Egypt (updated)	Association free trade agreement	2004	Factual examination not started
	Egypt-Jordan	Bilateral free trade agreement		
	Agadir Agreement			
	Arab Free Trade Area	Free trade agreement		
Jordan	EC-Jordan	Association free trade agreeement	2002	Under factual examination
	EFTA-Jordan	Association free trade agreement	2002	Under factual examination
	Egypt-Jordan	Bilateral free trade agreement		
	United States–Jordan	Bilateral free trade agreement	2001	Under factual examination
	Agadir Agreement			
	Arab Free Trade Area			

(table continues next page)

Table 8A.1 Participation in preferential trade arrangements *(continued)*

Country	Name of agreement	Type of agreement	Year went into force	WTO notification status[a]
Kuwait	Gulf Cooperation Council	Preferential arrangement		
	Arab Free Trade Area	Free trade agreement		
Lebanon	EC-Lebanon	Association free trade agreement	1977	
	EC-Lebanon (updated)	Association free trade agreement	2003	Factual examination not started
	Arab Free Trade Area	Free trade agreement		
Libya	African Economic Community	Customs union	1994	
	Arab Free Trade Area	Free trade agreement		
Morocco	EC-Morocco	Association free trade agreement	2000	Under factual examination
	EFTA-Morocco	Association free trade agreement	1999	Factual examination concluded
	United States–Morocco	Bilateral free trade agreement	2006	Factual examination concluded
	Agadir Agreement			
	Arab Free Trade Area	Free trade agreement		
	Turkey-Morocco	Free trade agreement	2006	Factual examination concluded
Oman	Gulf Cooperation Council	Preferential arrangement		
	Arab Free Trade Area	Free trade agreement		
	US-Oman	Free trade agreement	2006	
Palestinian Authority	EFTA–Palestinian Authority	Association free trade agreement	1999	Factual examination not started
	EC–Palestinian Authority	Association free trade agreement	1997	Factual examination not started
	Arab Free Trade Area	Free trade agreement		
	Turkey–Palestinian Authority	Free trade agreement	2005	Factual examination not started

Qatar	Gulf Cooperation Council	Preferential arrangement		
	Arab Free Trade Area	Free trade agreement		
Saudi Arabia	Gulf Cooperation Council	Preferential arrangement		
	Arab Free Trade Area	Free trade agreement		
Syria	EC-Syria	Association free trade agreement	1977	Report adopted
	Arab Free Trade Area	Free trade agreement		
Tunisia	African Economic Community	Customs union	1994	
	EC-Tunisia	Association free trade agreement	1998	Factual examination concluded
	Agadir Agreement			
	Arab Free Trade Area	Free trade agreement		
	EFTA-Tunisia	Free trade agreement	2005	Factual examination not started
	Turkey-Tunisia	Free trade agreement	2005	Factual examination not started
United Arab Emirates	Gulf Cooperation Council	Preferential arrangement		
	Arab Free Trade Area	Free trade agreement		

EC = European Community
EFTA = European Free Trade Association

a. The WTO does not have a record on all agreements. Most trade deals, especially with respect to Arab countries, are never notified to the WTO.

Sources: World Trade Organization, Regional Trade Agreements Gateway, www.wto.org; Tuck School of Business at Dartmouth, Center for International Business, Trade Agreements Database and Archive; Office of the United States Trade Representative, www.ustr.gov.

Appendix 8B
US Preferential Trade Arrangements with Select Arab Countries

This appendix summarizes existing US preferential trade arrangements with Jordan and Morocco and the prospective one with Egypt.[16]

Jordan

From a US perspective, the free trade agreement (FTA) with Jordan was undertaken for a variety of motives. The Clinton administration wanted to reward Jordan for supporting reconciliation between the Palestinian Authority and Israel through the Oslo peace process and King Hussein's personal involvement in the failed Camp David negotiations. Furthermore, the US-Israel FTA had created trade discrimination against Jordan and the Palestinian Authority territories. The US-Jordan FTA could be regarded as a mechanism for redressing the adverse impact on Jordan of the US-Israel FTA, a repayment for diplomatic service, and a means of deepening the bonds between Jordan and the United States. From an American exporter's perspective, it could also be interpreted as leveling the playing field with respect to preferential access that EU competitors would receive through Jordan's Euro-Med agreement. At the time of the negotiation of the FTA, Jordan was unique among the Euro-Med partners in exporting more to the United States than to the European Union.

The FTA covers trade in goods and services, intellectual property rights (IPRs), environmental protection, labor standards, electronic commerce, safeguard measures, and dispute settlement and establishes a binational committee to supervise implementation. The FTA is in addition to the preexisting preferences that Jordan already received in the US market through the generalized system of preferences (GSP) and the qualified industrial zone (QIZ) program, which remain in place.

Unlike the Euro-Mediterranean Partnership agreement, which simply makes reference to existing World Trade Organization (WTO) commitments in services, the US FTA requires additional liberalization, on the basis of existing commitments under the General Agreement on Trade in Services. Under the FTA, Jordan committed to amending its laws and regulations on services trade over a three-year period. Most importantly it revised its basic investment law, which now grants US firms national treatment in most sectors, as well as laws and regulations on intellectual property. These changes encouraged a surge in foreign direct investment

16. The United States has also concluded FTAs with Bahrain and Oman. See Lawrence (2006) for discussion of these agreements.

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(FDI), much of it going into manufacturing in the QIZs. However, the reforms also encouraged investment in the tourism, transportation, financial services, and health sectors among others. Improved IPR protection has contributed to the growth of the Jordanian pharmaceutical industry and retail trade of copyrighted products such as DVDs and supports Jordan's emerging software industry.[17]

Thirteen QIZs have been established in Jordan since 1998.[18] They are particularly important in the textile and apparel sector, where initial levels of US protection are high and the phaseout of protection under the FTA is slow, up to 10 years for some products. Exports to the United States are likely to exceed $1 billion in 2005, accounting for two-thirds or more of Jordanian exports to the United States. Employment in the QIZs is approximately 40,000, with Jordanians accounting for roughly 26,000. As noted earlier, many employees are from South Asia including Bangladesh. Seventy percent of the Jordanian employees are women, and a majority of these women were previously not in the labor force (World Bank 2004d). Investment in the QIZs has reached $85 million to $100 million, much of it by Asian textile and apparel firms. There have been widespread reports of labor abuse by these firms, particularly with regard to treatment of imported South Asian workers.[19] There is very little participation by non-Jordanian Arab investors (Kardoosh and al Khoury 2005).

However, Marwan Kardoosh and Riad al Khoury (2005) report that this investment has been associated with little technological transfer or backward linkages to the economy. They argue that this is due primarily to the lack of technological capacity on the part of indigenous firms, which for the most part are not capable of supplying inputs of sufficient quality, volume, and timeliness to the QIZ investors. Kardoosh and al Khoury also point to the difficulty of linking local vocational training programs to the needs of QIZ investors and thus encouraging the hiring of more local workers.[20]

From a regional perspective, Jeffrey B. Nugent and Fahyre De Alencar Loiola (2003) argue that the expansion of textile and apparel production

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17. For further details, see Lord (2001); Rosen (2004); and Hale (2004).

18. In addition to the QIZs, Jordan has a special economic zone at the port of Aqaba. A trade facilitation agreement with Israel originally signed in 1995 was deepened in 2005 in the context of the two countries' Euro-Med agreements with the European Union.

19. Steven Greenhouse and Michael Barbaro, "An Ugly Side of Free Trade: Sweatshops in Jordan," *New York Times*, May 3, 2006, C1.

20. Kardoosh and al Khoury (2005) report other disincentives to hiring locals: They are perceived as less efficient than their foreign counterparts, regarded as possibly reluctant to accept some types of work as being below their social status, and in the case of women, less willing to accept overtime as well as subject to broader familial concerns about their activities outside the home.

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in the Jordanian QIZs has amounted to the transfer of quota-constrained textile and apparel production from the United Arab Emirates to Jordan—i.e., a trade-diverting reallocation of regional production, not a net expansion. (This argument ignores the fact that UAE-based textile and apparel production is itself the product of the distortionary Multi-Fiber Arrangement regime and that the relocation of production to Jordan might actually be a move toward global free trade equilibrium but this is, of course, no consolation to UAE workers.) More worrisome is the claim by Kardoosh and al Khoury that the growth of the Jordanian QIZs has come at the expense of the Palestinian Authority territories, though given the existing political situation, it is unclear whether Israeli outsourcing to the West Bank would have continued even if the Jordanian QIZs had not existed. Similar trade diversion arguments have been made with respect to Egypt, but a careful analysis of the data suggests that significant diversion has not transpired (Magder 2005, box 1).

Despite the idiosyncratic connection to Israel and the peace process, one might argue that the US FTA with Jordan might have a demonstration effect with respect to other Arab countries. Some evidence indicates that this indeed has been the case.

Morocco

Following the conclusion of the Jordan FTA, the United States negotiated agreements with Morocco and Bahrain. In economic terms, Morocco would appear to be an even less likely partner for an FTA than Jordan. Again, US motivation would appear to be primarily political: to bind more closely to the United States another diplomatically moderate Arab regime.[21]

From the standpoint of Morocco, the benefits of the FTA as conventionally understood are likely to be small: Trade intensity with the United States is low (table 8.2), and roughly 60 percent of Moroccan exports already entered the United States duty free due to the absence of any normal trade relations (most-favored nation) tariff, GSP, or some other provision (USITC 2004). Presumably Morocco's motivation resides in the perception that the gains through the nontraditional channels of leveraging internal reform and locking in its credibility are relatively large.

The US-Morocco FTA covers merchandise trade, services (including specific provisions regarding financial services, telecommunications, electronic commerce, and intellectual property rights), investment, government procurement, safeguards, labor, environment, transparency, dispute

21. Ahmed Galal and Robert Z. Lawrence (2004) observe that the 1787 treaty of peace and friendship between Morocco and the United States, renegotiated in 1836, is the longest unbroken treaty relationship in the history of the United States.

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settlement, and US technical assistance to Morocco with respect to customs administration.[22]

A number of studies using computable general equilibrium (CGE) models have attempted to assess the prospective impact of the agreement; these models focus on merchandise trade, and given the basic outlines of the pre-FTA status quo—low trade and a general absence of tariff barriers to Moroccan exports to the United States outside textiles and apparel and agriculture—the results that these models obtain are predictably small: The central estimate of the US International Trade Commission's analysis is a $119 million one-time increase in US welfare (USITC 2004). Other studies cited by the USITC reach similar modest results. The results for Morocco are similarly underwhelming. John Gilbert (2003) actually obtains the results that the agreement would be slightly welfare-reducing for Morocco: The loss of tariff revenue due to a diversion of imports from tariff-paying EU producers to duty-free American suppliers would outweigh the modest efficiency gains, though this result is misleading—under the Euro-Med agreement the tariffs on EU imports would have been eventually eliminated anyway.

Yet this class of models is notorious for greatly overestimating the impact of terms-of-trade effects (thus attributing too much impact to tariff changes) while ignoring issues that are not amenable to CGE modeling but may be quite important in reality. In the case of the US-Morocco FTA these concerns cut both ways. First, in all likelihood, the models do not capture well the impact of relaxations of quantitative barriers on Moroccan exports to the US market or the complicated rules of origin in textiles and apparel that encourage the sourcing of relatively high-cost textiles from the United States—and potentially negate the gains offered by US market opening. But more important than the inability to capture the impact of nontariff provisions on merchandise trade, the models ignore the services sector where much of the action is: Services account for 45 percent of the Moroccan economy and are arguably subject to greater policy-induced distortions than merchandise trade is. Finally there are process issues such as IPR, government procurement, and transparency, where improvements conceivably could have substantial impact on Moroccan welfare, if not US trade.

Moroccan welfare will also be affected by costs of implementation and, depending on one's welfare criterion, the distribution of benefits. Morocco may reap considerable long-run gains from progress on the less traditional "behind the border issues," but one estimate puts the one-time costs creating the necessary administrative capacity at $40 million to $48 million (Galal and Lawrence 2004). With respect to distribution there are concerns that liberalization of bulk grain imports may depress farm incomes and

22. The United States has also provided Morocco a small amount of aid to improve labor standards, including issues relating to child labor.

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contribute to inequality. The fact of the matter is that no one has a good grasp of the ultimate impact of what are in reality complex agreements.

Egypt

If the agreement with Morocco is regarded as having a small impact, because of both the low level of US-Morocco economic integration and Morocco's peripheral place in the Arab world, the same cannot be said about a prospective US FTA with Egypt. Because of Egypt's economic size and centrality to any pan-Arab integration scheme, and Arab cultural and political life more generally, a US-Egypt agreement would probably represent a kind of tipping point with respect to economic integration between MENA and the United States.

Because such an agreement is prospective in nature, any evaluation is by definition provisional and speculative. But given the characteristics of other US FTAs one can be confident that this would be a "deep" agreement, addressing services, investment, and a range of behind-the-border issues in addition to the traditional elimination of border barriers. Bernard Hoekman and Denise Konan (2005) find that while elimination of border impediments would deliver modest gains to Egypt, the real opportunities are in the removal of nontariff barriers in the services sector, with the elimination of these impediments to trade yielding an improvement in welfare 10 times that of the abolition of tariffs alone.[23] Nevertheless, these estimated static welfare gains are small—less than 2 percent of GDP. The issue is how big the nontraditional welfare gains might be.

There are reasons to believe that Egypt could exploit a "deep integration" FTA as a mechanism to support its own internal reform efforts; a cabinet reshuffle in July 2004 increased the influence of a younger generation of more liberal technocrats. Under their leadership Egypt has pursued a number of economic reforms including a rationalization and liberalization of the trade regime and customs administration, an overhaul of the tax code, and a substantial effort to begin privatizing its extensive network of state-owned enterprises. Under these conditions the FTA could

23. The Hoekman and Konan model has some unusual characteristics that exaggerate the impact of services liberalization. The implied tariff on transportation is 50 percent, meaning that elimination of this nontariff barrier amounts to a large improvement in transportation efficiency, which in turn generates a roughly 50 percent expansion of the tourism sector (which is treated as pure exportable). The expansion of tourism accounts for the single largest increase in sectoral output and almost half of the increase in exports. While Dan Magder's (2005) case study of the Egyptian apparel sector suggests that it might not be an exaggeration to characterize the logistical problems in Egypt's transportation sector as amounting to a 50 percent tax on exports, a $1 billion increase in tourism revenues would seem to require a sweeping reorganization of the transportation and communications sectors—and absence of terrorism.

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help lock in reforms that the Egyptian government is already undertaking unilaterally.[24] Presumably the reduction in uncertainty and risk would translate into increased private-sector investment from both local and foreign sources. The existing Euro-Med agreement, which covers neither services nor the right of establishment, cannot play this role.

At the same time it is unlikely that US negotiating demands would be limited solely to Egyptian reforms already in train. While there is no reason to believe that such US demands would necessarily be against Egyptian interests, there are risks in "deep integration" scenarios. These include harmonization to inappropriate standards or without proper time for adjustment or building complementary institutional capacity.

Recent US FTAs such as those concluded with Morocco, Australia, and Central America probably present the best guide to what US negotiating demands would be. These would include protracted phaseouts of protection in sensitive agricultural sectors, US content requirements in apparel, a "negative list" approach in services under which the right of establishment in any sector not specifically exempted is approved, enhanced regulatory transparency including anticorruption provisions particularly with respect to government procurement, enhanced IPR protection particularly with regard to pharmaceuticals, which in the past has been a point of contention between the United States and Egypt in other contexts, and finally labor and environmental considerations.

US demands with respect to agriculture and textile and apparel trade would presumably erode though not eliminate the conventional trade gains that Egypt might capture in these sectors. The IPR issue is a subtle one and depending on how the rules were written could benefit or harm Egypt or, more accurately, harm certain Egyptian interests while benefiting others. The nascent software sector and high-technology sector more generally, which could particularly gain from increased regional integration, including with Israel, would probably be beneficiaries. Pharmaceuticals are a different story, however, and the Egyptian negotiators would be well advised to proceed cautiously in this area.[25]

Given Egypt's low scores on some of the regulatory indicators discussed in chapter 4, the potential gains with respect to process issues such as the right of establishment, transparency, government procurement, and regulatory reform could be large. Reforms in these areas could be particularly important in leveling the playing field for private-sector entrants in competition with existing or newly privatized public-sector entities pos-

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24. See Galal and Lawrence (2004) and Magder (2005) for details. The former argue that past Egyptian reforms have been more successful when anchored to external agreements through the World Bank, International Monetary Fund, or WTO.

25. The Egyptian negotiators probably did not win themselves any sympathy points when at the 2003 WTO ministerial meeting in Cancún they pushed the inclusion of Viagra on the WTO's list of "essential medicines."

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sessing the advantages of incumbency and long-standing political ties to the government.

While the potential gains are speculative in nature, the potential drawbacks against which they should be weighed do not appear large. Egypt already risks exposing itself to welfare-reducing trade diversion through the Euro-Med agreement and the Greater Arab Free Trade Area, if implemented. Indeed, with the United States beginning to conclude FTAs with other Middle Eastern countries, Egypt risks being left behind. An FTA with the United States might actually represent a move toward a less distortionary free trade equilibrium.

The real downside risk is the flip side of the potential gain—the limitation on sovereignty represented by a binding agreement on a range of issues and practices not currently covered by external agreements. Here one has to trust the ability of the Egyptian negotiators to come back with an agreement that on net benefits Egyptian interests.

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