

ERF Policy Research Report

Deeper Integration of Goods, Services, Capital and Labor Markets:

A Policy Research Agenda for the MENA Region

Bernard Hoekman

Khalid Sekkat

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Preface

The Economic Research Forum (ERF) is undertaking a broad initiative to develop and deepen research on a number of policy relevant and high priority areas for the development of the Arab World. The Research Initiative for Arab Development (RIAD) is supported by a number of major international donors and will be implemented over many years.

This report aims at providing ERF with a sound basis for selecting and designing a research program over the next 3-5 years for one of the major themes of the initiative - regional integration in the Arab region. The report was initially prepared for a workshop on “Regional Integration in the Arab Region,” held in Cairo in November 2008. At the workshop authors received valuable comments from attendees, which have been integrated into this policy research report.

The report addresses the subject by first providing a summary review of existing knowledge about regional integration. Regional integration is considered in a broad sense both with respect to markets, that is goods, services, labor and capital; and in terms of geographical coverage, that is preferential agreements between Arab countries or with non-Arab countries and openness without any preferential treatment.

Secondly, it goes on to identify the knowledge gaps on regional integration in the region. These gaps are assessed both in terms of policy-relevance and according to international best practice.

Finally, the report proposes a number of directions and priorities for a future policy-relevant research program.

The authors wish to thank Catherine Mikhail for very helpful assistance, as well as workshop attendees for their valuable feedback and comments. Also, they stress that the views expressed are personal and should not be attributed to the World Bank.

Bernard Hoekman
The World Bank

Khalid Sekkat
Economic Research Forum

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Introduction

Recognition of the link between openness to trade and economic prosperity has led most nations to become more and more engaged in international trade, and the world economy to become increasingly integrated. Government policies have supported this process, through trade and investment (FDI) liberalization. Much of this has been done unilaterally, but many governments have also sought to use preferential integration agreements (PTA) as a policy instrument to spur “natural” market integration. While there is huge heterogeneity on this front, market forces have been the dominant factor behind market integration in many (most) parts of the world. It is often observed that in the region that has been most successful at harnessing trade for growth, that is East Asia, intra-regional trade was driven not by PTAs, but by firms responding to global opportunities. Formal efforts to conclude PTAs lagged actual integration of product markets by decades. Low Most Favored Nation (MFN) protection for inputs and capital goods and a focus on producing for the world market drove the emergence of production networks which endogenously generated both specialization and de facto regional integration/cooperation. Similar forces played a major role in the transition economies of Central Europe; although in those countries the prospect of accession to the European Union (EU) played a major role in reducing the perceived risk of investment and in ensuring market access to a major market.

The focus of this paper is on the MENA region. Countries in the region can be divided fairly naturally into three types of economies: relatively natural resource-poor, labor rich countries, where less than one third of exports comprise natural resources; labor scarce oil exporters, where more

than two thirds of exports consist of natural resources—mostly fuels; and an intermediate group of labor abundant countries where exports of fuels and ores constitute between one and two-thirds of total exports. They also split into 3 sub-regions: the Maghreb, the Mashreq and the Arabian Peninsula (The Gulf Cooperation Council, GCC, countries plus Yemen).

The region is characterized by limited integration of product markets, but capital and labor flows are significant and may have greater potential than traditional trade in (manufactured) products to equalize factor prices.¹ The paper discusses the prospects of, and payoffs from, deeper integration of the countries belonging to the Arab World (League of Arab States) in the World economy.

This paper is based on the premise that any consideration of a possible research program that focuses on intra-Arab integration of product and factor markets must take into account both the prevailing patchwork of agreements and the fact that this patchwork already extends to/includes non-Arab partners. It must also recognize that the rest of the world is actively pursuing “regionalization” as well and that this is a phenomenon that is often driven as much, if not more, by markets than by governments. For example, rising oil prices and security and environmental concerns are factors that are inducing firms to source closer to their final markets.

We view regional integration as one instrument among others. We do not presuppose its superiority in terms of any objective, for example, to promote efficiency, reduce risk/volatility, capture economies of scale or as a stepping stone towards political integration. A corollary of this view is that one must consider explicitly whether or not other instruments may be more effective.

The rest of the paper is organized in 4 chapters. Chapter 1 offers a broad overview of integration agreements around the World and their economic and political motivations. Chapter 2 discusses the main distinct features of the Arab countries regarding goods, labor and capital markets integration. Chapter 3 presents the state of research on goods, labor and capital markets integration pertaining to Arab countries. Building on the results of the preceding chapters, chapter 4 highlights the main gap of knowledge about Arab integration and suggests a policy relevant research agenda for the future.

Economic Integration

1.1 A world tour

Reciprocal trade agreements are a prominent part of the global trade policy landscape. As of mid 2008 over 380 PTAs had been notified to the GATT/WTO, of which some 200 PTAs remain in force.² Of these, customs unions account for less than 10 percent. Many involve contiguous countries but many do not. The EC has been the “market leader” in the PTA business. European countries account for more than half of all PTAs notified to the WTO and that were still in force in 2008. The major regional grouping in Europe is the European Union, with 27 members in 2008. Other European PTAs include the European Free Trade Association (EFTA), (Iceland, Lichtenstein, Norway and Switzerland) and the Central European Free Trade Agreement.

The US became a proponent of PTAs in the 1980s, starting with agreements with Israel in 1985 and Canada in 1988, followed in 1992 by the North American Free Trade Agreement (NAFTA) with Canada and Mexico. Since the mid 1990s, the US has concluded PTAs with Australia, Bahrain, Chile, four Central American countries (El Salvador, Guatemala, Honduras, and Nicaragua) and the Dominican Republic (DR-CAFTA), Jordan, Morocco, and Singapore. As of mid 2008, PTAs with Peru and Oman had been ratified but were pending implementation, while PTAs with Colombia, Panama, and South Korea were awaiting approval by the Congress.

Virtually all OECD nations are now a member of one or more PTAs. The long-standing exception among OECD countries used to be Japan. This changed starting in 2000, with a PTA with Singapore. Since then, Japan has concluded bilateral deals with other trading partners in Asia (Malaysia, Indonesia, the Philippines, and Thailand)

as well as Chile and Mexico. An agreement with ASEAN was signed in April 2008, and talks are ongoing with Australia, India, Switzerland, and Vietnam. Preferential trade agreements are also a central feature of the trade policy strategy of many countries in Latin America, Africa and Asia (e.g. World Bank, 2005; and Schiff and Winters, 2003).

Regional integration is a central element of the trade strategies that are being pursued by many Arab countries, and has been for decades. Efforts to integrate regionally were started probably earlier than in any other developing region in the world. All countries in the region have concluded numerous bilateral agreements to reduce trade barriers on a preferential basis. Most of these have not had much of an economic impact. For a variety of reasons discussed in the literature – discussed below—progress has been very slow, with frequent reversals. Examples are the 1957 Arab Economic Unity agreement, the 1964 attempt by Egypt, Iraq, Jordan, and Syria to form an Arab Common Market, and the 1989 Arab Maghreb Union involving Algeria, Libya, Mauritania, Morocco and Tunisia (Sekkat, 1996; Testas, 1999). Until the late 1990s, the exception to the rule was the 1981 Gulf Cooperation Council. Even there, it took more than 2 decades for members to agree on a common external tariff, the minimum necessary condition for the realization of the customs union objective (Legrenzi, 2003).

Regional trade integration was given a new stimulus in the mid to late 1990s, driven not so much by Arab countries themselves but by the EU. Most Arab countries around the Mediterranean signed free trade agreements with the European Community (EC) that aimed at the elimination of tariffs on trade in goods with the EC with the exception of agriculture. Following the launch

of the Barcelona process and bilateral Association Agreements with Mediterranean countries that called for freeing bilateral trade in manufactures, members of the Arab League revitalized their long-standing but stalled integration efforts by creating a Pan-Arab Free Trade Agreement (PAFTA) in 1998 with the objective of removing tariffs on intra-Arab trade by January 2005.³ Contrary to past experience, this objective was mostly achieved. With the elimination of tariffs between signatories,⁴ non-tariff measures (NTMs) are the main obstacle hampering both intra-Arab trade and trade with the EU and the US in those instances where countries have FTAs with these major traders.

Both PAFTA and the FTAs with the EU are traditional agreements that are limited to merchandise trade and only free trade in manufactures. Trade in agricultural products remains hampered by tariffs, quotas, seasonal restrictions and a variety of NTMs. The same is true for the 2004 Agadir agreement setting an FTA between Egypt, Jordan, Morocco and Tunisia (Wippel, 2005; Péridy, 2005a). No extant agreement implies the creation of a common market for services, investment and other factor flows, or the establishment of common institutions to address regulatory policies. The GCC has gone furthest in the direction of converging on common norms in some regulatory/policy areas and in integrating both factor and product markets. Currently, GCC nationals can move freely among the member countries, and there is a waiver of visa requirements for expatriates with valid visas in other Gulf countries. Member states have slowly expanded a positive list of permissible areas for cross-country FDI activities for GCC nationals, including retail and wholesale trade, and restrictions on stock and property ownership by GCC citizens have gradually been relaxed (Alabdulrazzaq and Srinivasan, 2006; Dar and Presley, 2001; Legrenzi, 2003). The revised GCC treaty of 2001 calls for the creation of a common market by 2007, and a single currency by 2010. The Economic and Social Council of the Arab League has called for the establishment of a customs union among PAFTA members by 2016.

A number of countries (e.g. Morocco, Tunisia and Egypt) are now engaged in negotiations with the EU to liberalize investment and services flows. Some (e.g., Jordan and Morocco) have already concluded an agreement with the US that does this. A

distinct feature of the agreements that have been signed by these countries with the US is that they cover services and investment while other PTAs involving countries in the region do not.

The status quo is a patchwork of (overlapping) trade agreements that has emerged in part endogenously as a response to specific agreements. For instance, PAFTA and the Agadir agreement are arguably partial political and economic⁵ responses to the Euro-Med initiative (Figure 1). At the same time the rest of the world is moving faster: the EU now has 27 members; ASEAN countries are deepening their integration and are more advanced in inclusion of services and mutual recognition of standards; and countries such as Chile and Mexico have gone far towards realization of free trade with major trading powers and neighboring states through a strategy of “regional promiscuity”, that is negotiating PTAs with any willing partner. This strategy has proven to be beneficial and feasible because MFN rates of protection were lowered substantially. Actually, these countries pursued an open trade regime and used PTAs to improve access to export markets.

1.2 Potential benefits of integration

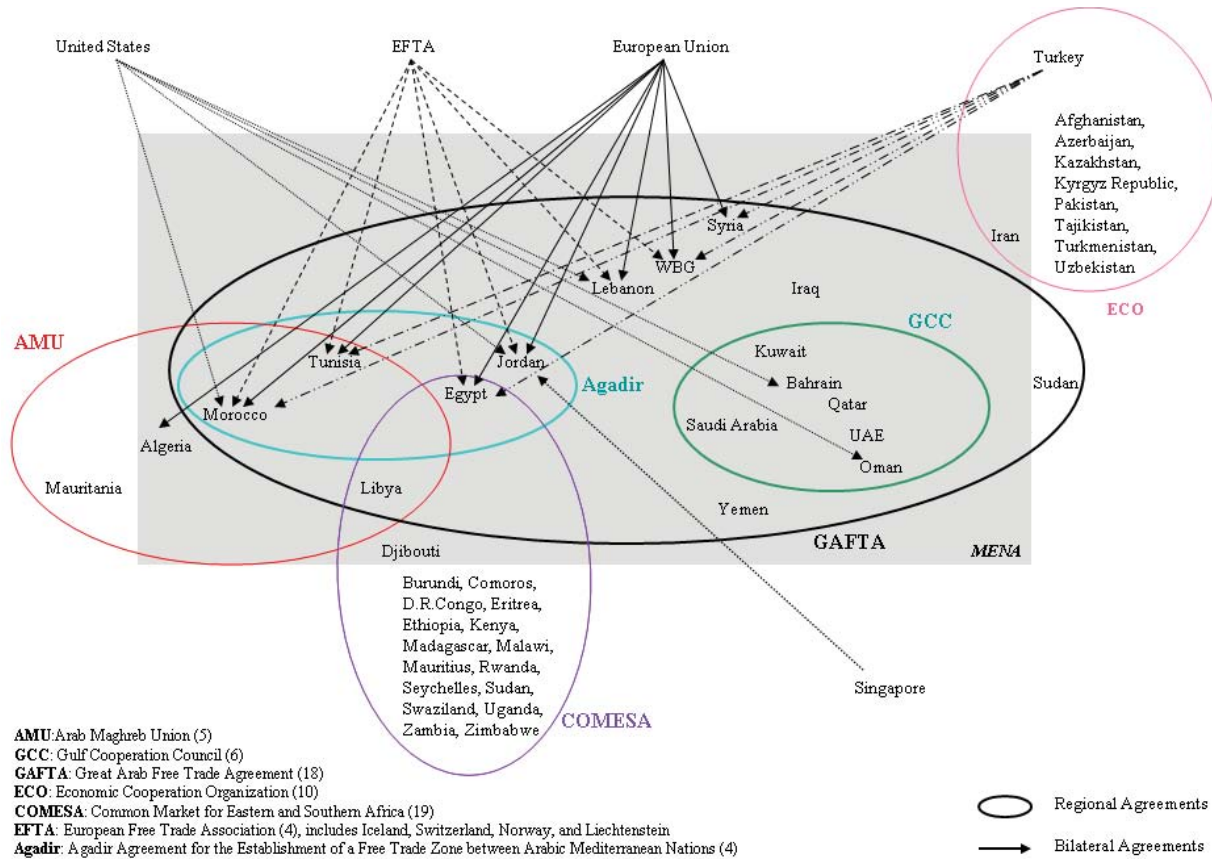
Our view of regional integration as an instrument among others to foster Arab growth and development, implies the corollary that one must consider explicitly whether other instruments may be more effective. Thus, the general question “why go preferential?” must be asked.

Economic arguments

Economists frequently cite two major arguments for trade agreements: improving market access for exporters (the terms of trade argument) and credibility (time consistency).

The WTO does not offer free trade. A FTA with a major trading partner does and on a preferential basis. Such preferred access is the more valuable the larger the partner market and the higher the barriers the partner maintains on imports from competing suppliers. It may be easier to get for a country if it is small and, thus, not perceived as much of a threat by import-competing firms in the partner country. Moreover, as tariffs fall, because of unilateral decisions or trade agreements, the relative importance of NTMs as barriers to trade and market integration rises. PTAs may offer better instruments than the WTO for traders to get govern-

Figure 1.
Trade agreements in the MENA region



Note: Only major agreements are depicted.
 Source: World Bank (2008).

ments to deal with market segmenting non-tariff policies that prevent the benefits of tariff removal from being fully realized. That is, a PTA may offer deeper integration of a form that is not on offer in the WTO. More generally, a PTA may allow integration of markets that are not covered by the WTO: in particular capital and labor markets, as well as regulatory areas where cooperation results in greater internalization of the benefits of policy reforms.

PTAs may also have a defensive rationale, as in the so-called domino effect (Baldwin, 1995): as major trading powers create trade blocs, incentives for excluded countries to seek similar trading relationships increase, because the costs of being a nonmember rise. Exclusion from a major PTA market, or confronting higher barriers and costs than do 'insiders', can change the political

economy equilibrium in the excluded country. Exporters get greater incentives to mobilize and put pressure on their governments to seek accession or negotiate a PTA with the large blocs.

Trade agreements may be used by governments as a commitment device and a mechanism to overcome political economy constraints (Bagwell and Staiger, 2002; Ethier, 2007; Maggi and Rodriguez-Clare, 1998, 2008). The agreements can change expectations and lobbying behavior of firms and interest groups. The theoretical (and practical) arguments for using trade agreements as a commitment device depend on there being a credible enforcement mechanism. In the WTO context this may not exist for small countries that cannot affect the terms of trade and are too small to make it worthwhile to bring to the WTO court. PTAs may offer much stronger enforcement mechanisms, es-

pecially if private interests have direct access to courts or other tribunals and mechanisms. Some PTAs have supranational enforcement mechanisms, the EU being the primary example, which can reduce uncertainty regarding implementation of the agreement. Enforcement is obviously also relevant for the market access incentives to negotiate a PTA: if seen as more effective, there is less uncertainty associated with the PTA than there is with the WTO. This is especially the case if the available remedies are stronger. PTAs may also allow more credible commitments to be made if proximity of member countries reduces monitoring costs. Similarity with partners (in terms of per capita income, culture, institutions, etc.) also reduces implementation costs.

An additional economic argument, although less frequently cited, concerns the role of PTA in facilitating cooperation. Some problems or issues may be shared by only a limited number of (often neighboring) countries, and therefore call for cooperation that is limited to the countries that will benefit from cooperation. Regional infrastructure such as bridges, railways and roads, power pools and electricity grid interconnection are examples of such "club goods". Interest in cooperation may extend to a willingness to engage in provision of financial transfers to support the delivery of regional public goods or achieve other objectives such as regional economic development.

Political arguments

Political scientists add that integration of markets or cooperation on joint projects may be an instrument to reduce the probability of conflicts by creating linkages and mechanisms for communication and raising the perceived costs of breaking off cooperation. This function of regional integration could be particularly important in the MENA region given a history of political tensions and conflict among neighboring Arab states.

In addition to these rationales there may be "non-economic" foreign policy and national security objectives driving PTAs. Indeed, these often predominate in public discussion and debates, with any economic costs being argued to be the cost of achieving the non-economic objectives. More ambitious forms of cooperation may extend to seeking to create a larger political entity; less ambitious forms may revolve around agreements to cooperate on joint infrastructure or on specific

policy areas (e.g., labor markets; movement of workers). The collapse of Soviet hegemony allowed the countries of Eastern Europe and the Baltic to embrace democracy and market-based economic systems. Accession to the EU was seen by them as a tool to counter Russia's aspirations of a regional power, cement the transition to a market economy and revive the common European cultural heritage.

In sum, PTAs can augment the WTO in important ways, including the prospect of better access to export markets than can be obtained from the WTO (as in PAFTA, and the EU/US PTAs, which provide duty-free access for merchandise to the signatory markets) and/or the prospect of better access and deeper commitments in areas not covered by the WTO or in a less comprehensive way (e.g., services, labor, investment, other regulation). But it is important to recognize that there is much that can also be done through the WTO if governments want to use trade agreements as an instrument to pursue market integration objectives.

Table 1.
Intra-MENA trade agreements and investment treaties

	Algeria	Bahrain	Djibouti	Egypt	Iraq	Iran	Jordan	Kuwait	Lebanon	Libya	Morocco	Oman	Qatar	KSA	Syria	Tunisia	UAE	WBG	Yemen
Algeria	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Bahrain	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Djibouti	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Egypt	BIT, TA	BIT	BIT**	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Iraq	-	BIT**	-	FTA	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Iran	BIT, TA	BIT	-	BIT**	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Jordan	BIT, TA	BIT, FTA	-	BIT, FTA	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Kuwait	BIT, TA	-	-	BIT, TA	BIT, TA	-	BIT**, FTA	-	-	-	-	-	-	-	-	-	-	-	-
Lebanon	TA	FTA*, BIT	-	TA, BIT,	FTA	BIT	TA, FTABIT	TA, BIT	-	-	-	-	-	-	-	-	-	-	-
Libya	-	-	-	BIT, TA	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Morocco	TA	BIT	-	BIT, FTA	BIT, TA	BIT, FTA	BIT, FTA	BIT, TA	BIT, TA	-	-	-	-	-	-	-	-	-	-
Oman	BIT	-	-	BIT	-	BIT	-	BIT*	-	-	-	-	-	-	-	-	-	-	-
Qatar	TA	-	-	BIT**	-	BIT, TA	-	FA	-	-	-	-	-	-	-	-	-	-	-
KSA	-	-	-	BIT	-	-	-	TA	-	-	-	-	-	-	-	-	-	-	-
Syria	BIT**, TA	TA, BIT	-	BIT, TA	BIT**, TA	BIT, FTA	BIT, FTA	BIT, TA	BIT, TA	-	-	-	BIT**, BIT**, TA	TA	-	-	-	-	-
Tunisia	BIT**, TA	-	-	BIT, FTA	-	BIT	BIT, FTA	BIT, TA	BIT**, FTA	-	-	-	-	-	TA	-	-	-	-
UAE	BIT	-	-	BIT	-	-	FTA	BIT**	TA, BIT	-	-	-	-	-	BIT, TA*	-	-	-	-
WBG	-	-	-	TA, BIT	-	-	TA	-	-	-	-	-	-	-	-	FA	-	-	-
Yemen	BIT**, TA	BIT**, BIT**	-	BIT	-	BIT	BIT	BIT**	FA, BIT	-	-	-	-	-	BIT, FA*	-	-	-	-

Notes: Framework Agreements (FA) call for cooperation, and exchange of information and expertise. Free Trade Agreements (FTA) involve broad tariff reductions on a preferential basis. Trade Agreements (TA) are less demanding than FTAs, but more concrete than a FA. A TA could, for example, include tariff reductions, special exemptions, or creation of a free trade zone. Bilateral Investment Treaties (BIT) provide investor protection. Double Taxation Treaties (DTT) avoid the multiple imposition of taxes by partner countries. * = Not Ratified; ** = Not enforced; in italic = status unknown.

Source: World Bank (2008).

Distinct Features of Arab Integration

A distinct feature of the MENA is that most countries have made (very) limited commitments in the WTO. Others are not (yet) WTO members: Iran, Iraq, Lebanon, Libya, Syria, and Yemen. The reason for non-membership is to a large extent a reflection of foreign policy considerations and concerns on the part of some WTO members. In this context a regional strategy may be the only feasible instrument of cooperation available to the countries concerned. But even if WTO membership is not available, consideration of a PTA strategy needs to consider the pros and cons of agreements with non-Arab partners. This is especially important since the rest of the world, including emerging markets, are a major trading partner for some Arab countries.

While the achievements related to the elimination of import tariffs and other border barriers are limited, other types of agreements have often been concluded by governments in the region. Particularly frequent have been “positive list” trade agreements under which specific lists of products are liberalized, with a tariff preference being granted to signatories. However, by construction such agreements usually do not liberalize trade in products that are produced domestically. Moreover, many bilateral investment treaties (BITs) have also been concluded between MENA countries and between them and non-Arab source countries (Table 1). Regarding labor market, less attention has been paid by governments in the region to defining a formal cooperative framework to support cross-border movement of workers. As discussed below, national policies in labor scarce countries have often been either very welcoming or very restrictive, with great variance over time.

Political objectives have played a prominent role in MENA regionalism but in a different way

than in the EU. Very often the PTAs appear to have represented convenient “displacement activity” for governments, providing an opportunity for photos and the appearance of strengthening relationships with partner countries. However, not much, if anything, has been done to liberalize trade and encourage economic specialization, restructuring and adjustment. As a result there is not much of an economic payoff. The activity may help achieve short-term goals but has no economic foundations on which to build. This implies in turn that the processes do little to sustain cooperation and achieve longer-term foreign policy objectives (such as sustaining peaceful relations).⁶

2.1 Trade

As far as trade policy is concerned, the region is among the most restrictive in the world. Much of this reflects non-tariff policies – the uniform tariff equivalent of all tariffs (ad valorem and specific) is around 12% on average, rising to 24% if NTMs are included (Table 2). Although the GCC countries have low, uniform MFN tariffs for manufactures, protection is higher for agriculture. The highest levels of MFN protection are in the Maghreb countries, for both manufactures and agriculture. In Egypt, Jordan and Lebanon tariffs have been reduced substantially in recent years but NTMs remain prevalent, resulting in trade restrictiveness levels that are more than double those prevailing in the GCC. There is both a substantial tariff and non-tariff agenda in most Arab countries.

The Arab region suffers also from a small product market, limited complementarity and large product overlaps. The economic size of the Arab region is limited. Arab countries that are members of the PAFTA represent a little less than Spain’s GDP. Only one Arab country (Egypt) has more

Table 2.
Overall and tariff-only trade restrictiveness indices (2007)

Region (dev. countries only)	Total Trade	Agriculture	Manufacturing
East Asia and Pacific	12.5%	34.5%	10.6%
	<i>4.9%</i>	<i>8.3%</i>	<i>4.7%</i>
Europe and Central Asia	11.3%	41.1%	8.5%
	<i>5.0%</i>	<i>13.0%</i>	<i>4.4%</i>
Latin America and Caribbean	13.9%	34.1%	12.1%
	<i>8.0%</i>	<i>13.3%</i>	<i>7.2%</i>
Middle East and North Africa	24.2%	52.5%	19.3%
	<i>11.7%</i>	<i>18.7%</i>	<i>10.5%</i>
GCC*	12.2%	33.3%	6.1%
	<i>6.0%</i>	<i>10.6%</i>	<i>4.6%</i>
Maghreb	34.1%	73.8%	28.8%
	<i>18.2%</i>	<i>30.5%</i>	<i>16.8%</i>
Egypt, Jordan, Lebanon	22.3%	44.0%	18.6%
	<i>6.7%</i>	<i>9.9%</i>	<i>6.2%</i>
South Asia	17.5%	45.5%	15.3%
	<i>13.0%</i>	<i>20.8%</i>	<i>12.8%</i>
Sub-Saharan Africa	19.3%	28.9%	20.9%
	<i>11.8%</i>	<i>14.9%</i>	<i>11.4%</i>

Notes: * No data for Kuwait for TTRI; no data for Kuwait, Bahrain, Qatar and United Arab Emirates for the OTRI.
Source: Kee et al (2008); OTRI (i.e., including NTMs) in bold; TTRI in italics.

than 60 million inhabitants. One implication of the ‘smallness’ of many of the countries in the region is that to achieve efficiency, exploit economies of scale, and ensure firms/consumers have access to inputs/products at world prices/quality, they need to be open. Regionalism is a potential mechanism to increase the effective size of markets, but the fact that most economies are “small” implies that there is no natural “hub” or anchor country – as is the case for Mexico and Central America (the US) – nor is there a subset of “equals” (large countries) that have an interest in cooperation (internalizing terms of trade externalities) – as was the case in the EU (Hoekman and Messerlin, 2003).

Many Arab countries are also relatively similar to each other and compete more with each other for the same export markets. 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\$1,000 (Yemen) to over US\$25,000 (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.

Various indicators of product concentration in trade have been calculated in the literature, including the number of distinct product categories exported, measured at the different levels of desegregation and the Herfindhal-Hirschmann index.⁷ Oil-rich countries have concentration indices that are much higher than those of natural resource poor countries. 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, while the number of product categories exported increased substantially in some oil exporters, e.g., in Qatar. Compared to emerging markets and European transition economies the region has a narrow industrial base.

In a number of countries, especially Egypt, Morocco and Tunisia there has been a significant diversification of the export base. This in turn has led to an increase in intra-industry trade (IIT), but the conclusion of Havrylyshyn and Kunzel (2000) that this type of trade is limited in the region remains true today. IIT of Arab countries is far below the ratios registered by Asian comparators, which have IIT indices in the 0.60 range.⁸ Among Arab countries, Tunisia has the highest share of IIT (40 percent), followed by Morocco and the UAE. The magnitude of IIT has been growing rapidly in a number of other countries, however, including Egypt and Jordan. Related to low levels of IIT, there is generally a high ratio of imports to exports of components, indicating that manufacturing is often still assembly-type activities directed at domestic markets as opposed to integration into global supply chains. The only country in the region with a significant share of components in its total exports is Tunisia (10 percent).

Devlin and Page (2001) show that since the late 1980s there has been a trend of increasing trade intensity among Mashreq countries as well as in Mashreq exports directed to Maghreb countries. Furthermore, there is a higher concentration in non-traditional exports such as processed agricultural products and basic manufactures in non-oil

goods traded regionally than in exports directed to the EU and to the rest of the world. Moreover, using intra-industry trade (IIT) as an indicator, trade among Arab countries demonstrated significant levels of competitiveness compared with their trade with the EU, with some exceptions in exports of Morocco and Tunisia showing higher levels of competitiveness in exports directed to EU than in intra-Arab trade.

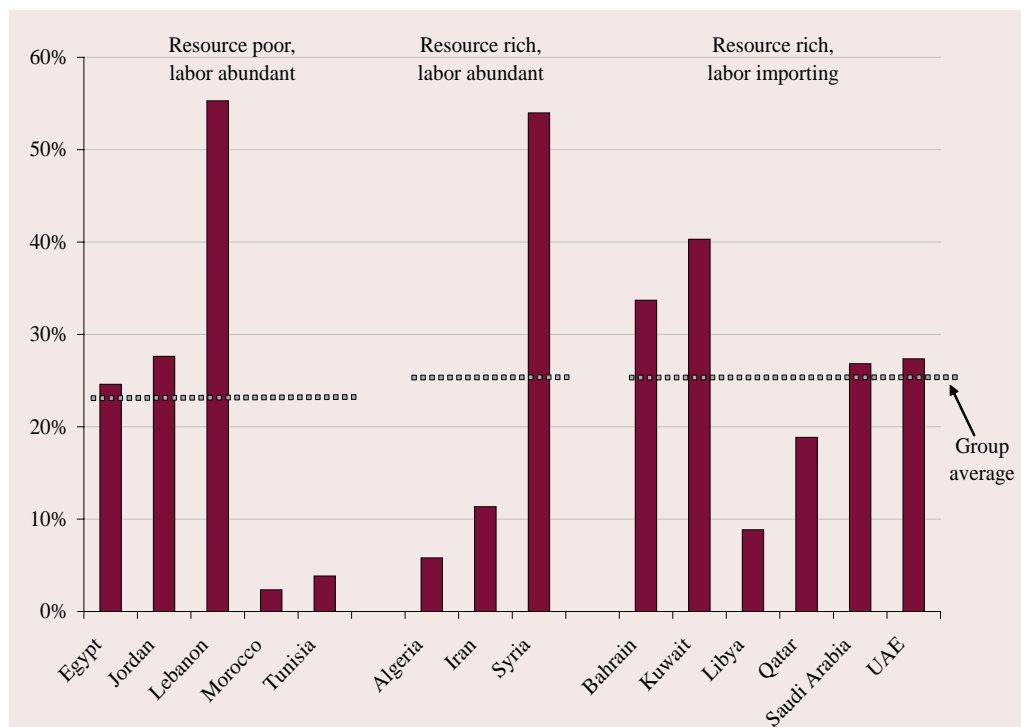
Zarrouk (2001) undertook a comparative analysis of dynamic exports of the Arab countries. He concluded that for most Arab countries the number of dynamic products is higher in intra-regional trade than in exports to the EU suggesting that rising opportunities for intra-regional trade in processing activities have expanded. His findings showed also that the dynamic Arab products maintain differentiated export niches in intra-regional trade suggesting a greater room for developing export capacity and enhancing the success of regional trade agreement.

The geographical pattern of exports of Arab countries mirrors the product structure, that is, the importance of oil results in most trade being with the rest of the world. In the late 1990s/early 2000s the set of countries that tend to trade substantially with other Arab countries (20 percent or more of total exports) was limited to Jordan, Lebanon and Syria. For most Arab countries, regional exports accounted for less than 10 percent of total exports. This continues to be the case. However, if the focus is limited to non-oil-related trade the ratio rises substantially for many countries. About one-quarter of total non-oil exports go to other Arab countries (Figure 2). For Lebanon and Syria, regional markets account for more than half of non-oil exports; the GCC countries are in the 25-40 percent range; while the Maghreb countries trade very little with the rest of the region—exports going predominantly to the EU.

2.2 Labor

During the last two decades, the labor force has grown very rapidly in MENA countries, greatly exceeding employment growth. This has led to stagnant or rising unemployment levels and associated economic and social challenges. Although fertility rates have been in decline, the population aged 20-29 will increase by some 4-5 million annually in the coming years and plateau around 2015. Some 75 million new jobs will need to be created

Figure 2.
Intra-MENA share of total non-oil merchandise exports, 2006



Source: World Bank (2008).

by 2020 to absorb the new entrants into the labor market (Johansson and Silva-Jauregui, 2004).

Migration has historically played an important role in absorbing a part of Arab labor forces. Workers from Egypt, Jordan and Yemen were actively recruited for employment within oil exporting Gulf countries—in 1990 some 700,000 Egyptians were working in Iraq and over 800,000 Yemenis were employed in Saudi Arabia and the Gulf. In turn, Syrian workers moved into Lebanon and Egyptian workers to Jordan. By the early 1980s, over four million expatriate workers were employed in the oil exporting Gulf countries. Non-nationals made up nearly 70 percent of the workforce and a quarter of total population within the Gulf. By some estimates, roughly 10 percent of Egypt's and 15 percent of Yemen's labor force was employed in other Arab countries. As a result of the oil windfall, real wages and standards of living rose throughout the region, and poverty rates fell substantially.

There is also a number of MENA workers settling in non-Arab countries. Accurate and complete data on the destination of workers, which

can help in assessing the degree of intra-Arab labor markets integration, are still lacking. One exception is the recent data base constructed at the University of Sussex (2007) which provides 4 matrices of migration around the world by origin and destination. The 4 matrices differ in their degree of reliability and completeness with the most reliable being based on the officially reported stocks of migrants by host countries. This matrix is, however, highly incomplete. To construct the 3 other matrices the team use various assumptions which make the matrices more complete but less reliable. Table 3 reports the shares of migrants to Arab countries in total migrants based on the less complete/more reliable and on the more complete/less reliable matrices. The focus is on the most important sender countries. Irrespective of the matrix used, the figures suggest that the labor market in Mashreq is highly integrated while the one of the Maghreb is not.

However, migration to other Arab countries makes workers vulnerable to the oil price movements. Arab labor markets have witnessed two profound transformations in recent decades: (i)

integration driven and financed by the oil boom in the 1970s; and (ii) in the 1990s, fragmentation following the decline in oil income and the Gulf conflicts.⁹

In the 1980s and early 1990s net outflows of Arab workers to the oil-exporting countries fell sharply, driven by lower oil prices and the effects of the 1991 Gulf War. As a result the former worker remittances to non-oil exports in the region dropped and an economic slowdown was transmitted throughout the region. The latter gave rise to a shift in sourcing away from traditional Arab suppliers of workers towards South Asia. Regional conflicts have resulted in labor markets that are increasingly nationalized. Notwithstanding these shocks, workers' remittances were over US\$ 15 billion in 2006, much larger than net FDI flows and net official flows (World Bank, Global Development Finance, 2008). Remittances exceed 15 percent of GDP in Jordan and Lebanon (Maimbo and Ratha, 2005).

2.3 Capital

The MENA region has long been the world's smallest region in terms of recipient of foreign capital. The ratio of foreign capital inflows to GDP was on average around 1% for the MENA during 2000 while it was around 3% in SSA and 4% in Latin America. Although the ratio is increasing to reach around 3% in 2006, it is still below that of SSA. These figures suggest that the region is failing to integrate in the World's capital market.

This section examines the issues and challenges surrounding the question of capital inflows to the region. We first examine whether a closer look at the data confirms the region's low integration in the World's capital market. We then review the literature on the impacts of capital inflows on economic performance to see whether the region is in trouble. Finally, we examine the determinants of capital inflows to LDCs to highlight what the region should do if needed.

Here, we focus on private capital flows. The latter could be broken into FDI flows, portfolio equity flows and debt flows. Figure 1 presents the evolution of total private capital inflows to LDCs between 1998 and 2006. It shows that after a slight decrease in 2002, following the 11 September 2001 attacks, the flows are steadily increasing. Hence the results pertaining to the evolution of the ratio of foreign capital inflows to GDP in MENA might

rather reflect a more general wave than the region's specific performance.

To go deeper, Figure 2 presents the split of private capital inflows into the 3 components. It constitutes the largest component followed by debt flows. Portfolio equity flows are rather marginal. Appendix A shows that a similar picture holds for inflows to the MENA. Hence, in what follows we will focus on the 2 main components.

Figure 3 presents the breakdown of total capital inflows by region of the World. It shows that the share of the MENA is very small and almost unchanged over the period. East Asia and Pacific is gaining ground at the "expense" of Latin America and the Caribbean.

Beside its importance in total private flows, FDI attracted most of the economic research regarding capital flows to LDCs. This stems from the fact that (see Gibson et al, 2006 for a recent survey) FDI flows are usually seen as longer-term and hence result from long-term decisions about the productive capabilities of the country whereas other flows can be more speculative in nature. Figure 4 shows that the ratio of FDI to GDP is increasing in the MENA. However, as mentioned above this does not mean a particular performance of this region. Beside the effect of the wave of capital inflows, the ratio might increase because the region is growing slower than the others.

Table 3.
Share of migrants to Arab countries in total migrants (in %)

Origin Countries	Share 1	Share 2
Yemen	98.94	82.03
Egypt	94.25	71.39
Jordan	92.08	83.72
Syrian Arab Republic	74.65	49.13
Iraq	52.93	54.24
Lebanon	45.36	20.03
Tunisia	15.90	10.16
Algeria	2.61	7.06
Morocco	2.27	8.73

Note: Share 1 = less complete/more reliable; Share 2 = more complete/less reliable matrices
Source: Global Migrant Origin Database, Updated March 2007

Figure 3.
Total net capital flows to developing countries

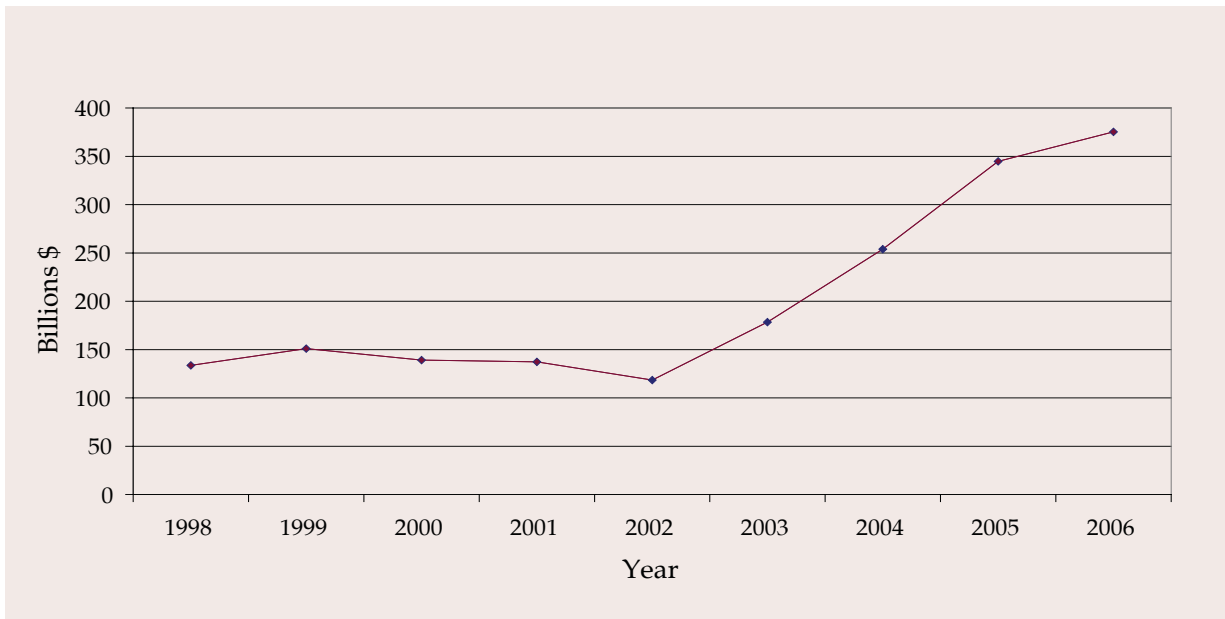


Figure 4.
Net capital inflows by type: World

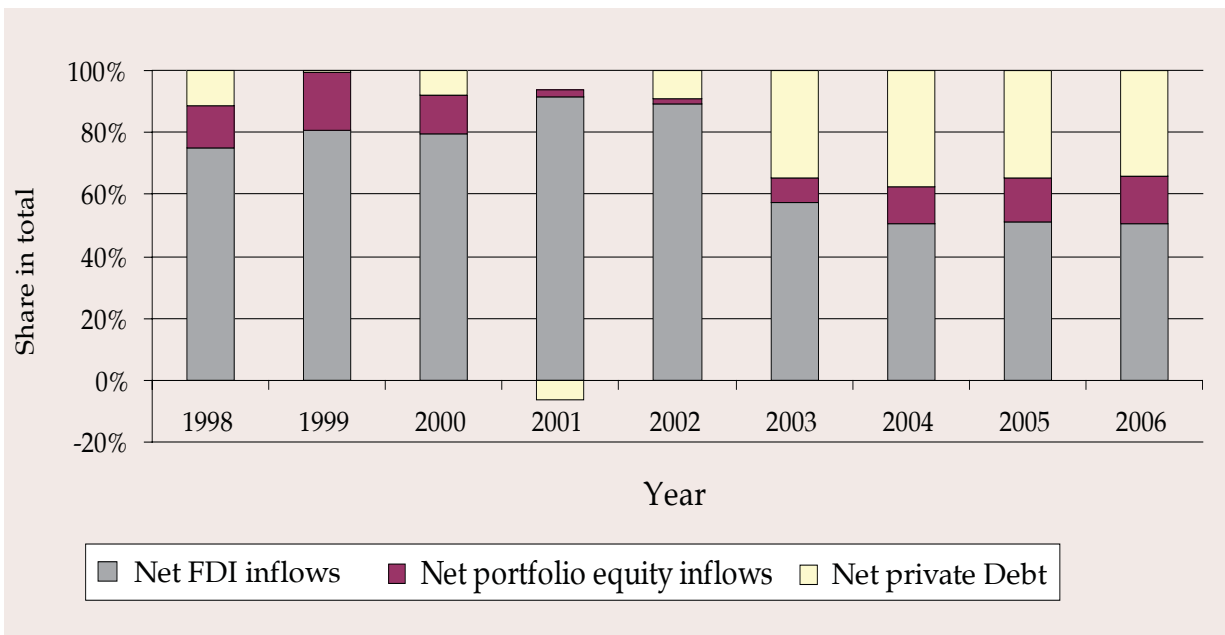


Figure 5.
Breakdown of total capital inflows by recipient

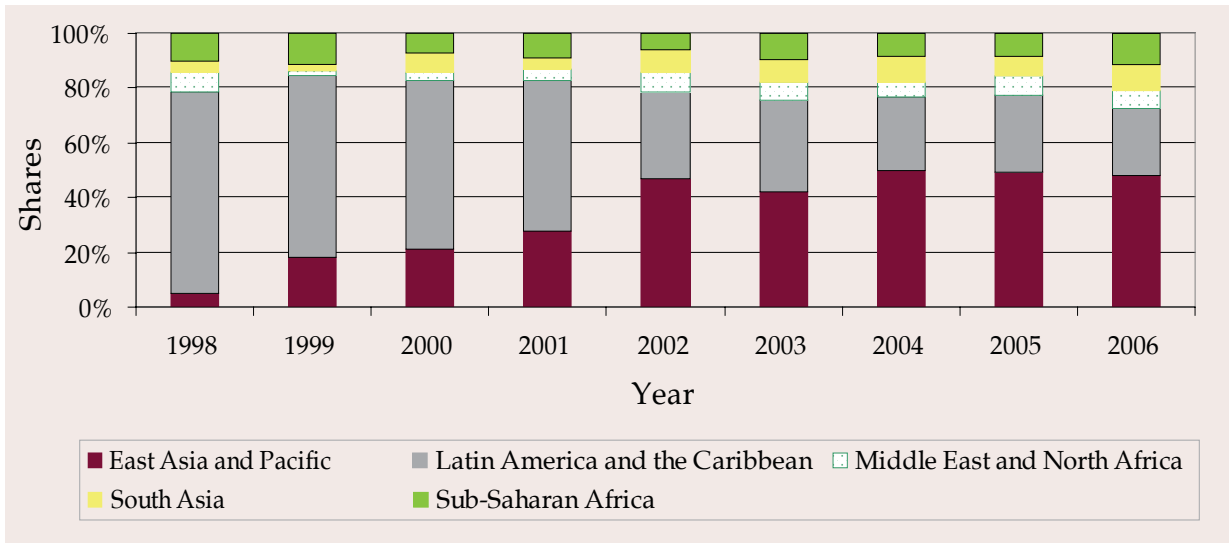
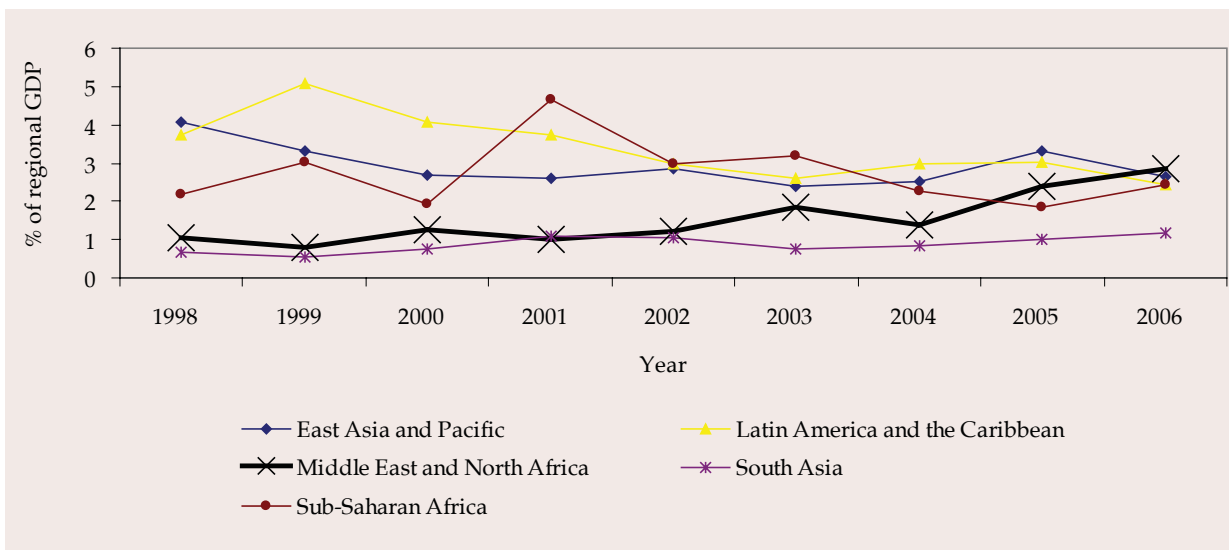


Figure 6.
FDI inflows by region



Research on Arab Trade Migration and Capital Flows

3.1 Research on Arab Trade

Much of the research on Arab (non-)integration has been driven by the four following questions: Is the level of intra-Arab trade 'too low'? Are there obstacles to expanding such trade? What are the gains from such expansion e.g. regional integration? How can regional integration be made to work?

Is the level of intra-Arab trade 'too low'?

Yeats and Ng (2000) calculate an index of the intensity of regional trade to determine if the value of trade between two countries is above or below what would be expected on the basis of their importance in world trade.¹⁰ They conclude that intra-Arab trade flows are not consistently lower than what should be expected and that the share of some countries' (e.g., Egypt) exports to the region is much larger than what would be expected.

Such intensity indices do not control for factors such as GDP and trade costs as determinants of trade flows. The basic workhorse tool that tends to be used to assess the effects of PTAs is the gravity model. This framework has been very effective in explaining trade volumes between country pairs and is consistent with what economic theory predicts are the determinants of trade. In a nutshell it postulates that trade between two countries is a function of their size, their wealth, their distance from each other, whether they are contiguous and speak the same language, and policy variables. The latter include the existence of a PTA. Much of the literature on this subject is summarized by Schiff and Winters (2003).¹¹

Gravity model regressions on non-oil trade for the period 1970-98 suggest that in the 1970s, being located in the MENA 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. Al-Atrash and Youssef (2000) concluded that while intra-regional trade in the Maghreb and among the GCC states was less than predicted this was not true for the Mashreq countries. Most studies using gravity techniques have generally concluded that overall intra-regional trade is "too low", in part as a result of the strong EU bias of the Maghreb (e.g., Achy, 2006; Bolbol and Fatheldin 2005, 2006; Miniesy, Nugent and Youssef, 2004; Peridy, 2005a; Nugent and Youssef 2005, and Söderling, 2005). Bolbol and Fatheldin (2005, 2006) are representative in showing that the Eastern Maghreb countries have little trade or FDI with Mashreq countries – in effect, the pattern of FDI paralleling trade flows, which are directed towards the EU.¹²

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.

This remains an interesting research issue because if (i) intra-Arab trade is not less than what would be expected given fundamentals; and (ii) economies that sell a large share of their exports to the region account for only small shares of total intra-Arab trade, the political economy of Arab integration based on preferential merchandise trade liberalization is not propitious (Hoekman and

Messerlin, 2003). Conversely, if there is significant scope to expand trade among Arab countries, the political economy would be such that groups can be identified that have a stake in a more integrated Arab market.

Are there obstacles to expanding intra-Arab trade?

Trade costs are high in many Arab countries, reflecting government policies and regulations that result in limited competition. Starting in the late 1990s analysis began to point to the negative effects of public monopolies in ports and port services and poor infrastructure for loading and storing goods on the costs for handling and shipping containers in many MENA countries. Similar findings pertained to air transportation, professional services, fixed line telecommunications and utilities (see e.g., contributions in Hoekman and Zarrouk 2000 and Hoekman and Kheir el Din, 2000, and Achy, Boughzala, Kheir-El-Din and Togan, 2005; Rosotto, Sekkat and Varoudakis, 2005). 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).

A major source of real trade costs and anti-export bias are non-tariff costs of trade. Zarrouk (2003), based on a private sector survey in eight Arab countries, estimated that the cost of getting goods across borders averaged 10 percent of the value of goods shipped. Next to bureaucratic red tape, customs clearance procedures were the most important source of non-tariff trading costs, with the average company spending 95 man-days per year resolving problems with customs and other government authorities. Excessive delays resulted from lengthy processes of clearance and inspection, the number of documents and signatures needed to process a trade transaction, and the frequency of problems with customs and other government authorities.¹³

More recent data point to the same general conclusion. Sources of new data include the World Bank's Doing Business report and Logistics Performance Index, as well as investment climate assessments. As discussed below, the Zarrouk survey and these new sources of data can be used to

get a better understanding of the relative importance of sources of real trade costs, and to monitor the effects that PTAs have on lowering them over time, including on trade flows. Dennis (2006) is an example of a paper that attempts to do so using a CGE model (GTAP). He uses the Zarrouk (2003) survey data as a measure of trade costs and finds that removing these generates more than double the welfare gains than the removal of tariffs would do.

Méon and Sekkat (2004) argue that the quality of institutions limits MENA countries integration into the global economy. They focused on the impact of a broad index of political risk as well as indices of specific aspects of governance (corruption, government effectiveness and the rule of law) on manufactured exports and FDI inflows. A variety of econometric approaches all provide strong support for the hypothesis that poorly performing institutions reduce both trade and FDI flows. They conclude that institutional improvements deserve greater attention and should complement a focus on standard trade and FDI policy liberalization.

The basic issue here is to identify what exactly needs to be done – to identify the policy handles than can/should be the subject of PTAs. Kheir el Din and Ghoneim (2005) argue that absence of effective regional institutions is the main impediment to intra-regional trade. This is a matter that goes back to the issue of implementation of PTAs – what type of institutional mechanisms or bodies are needed to push forward a PTA? And how can political support for these mechanisms be created?

PAFTA is a traditional (or a shallow) PTA, limited to merchandise trade and that could do more to lower non-tariff, behind-the-border policies that generate the observed trade costs. The potential for more intra-trade may be significant if these costs can be reduced. Another implication for research is to look at past efforts elsewhere in the world to lower real trade costs to obtain a better estimate of the effects of doing so. It should be stressed that the gains from reducing trade costs will be highest where trade (potential) is the greatest. Dennis (2006) concludes—paralleling most of the CGE literature (see below) – that the gains from lowering trade costs in MENA countries associated with trade flows with the EU are much greater than those directed towards the MENA region.

The recent non-MENA centric literature on regional integration has been inspired not just by the question of levels of trade, but also methodological issues and an interest in assessing the importance of real trade costs and product differentiation. Feenstra and Ma (2007) is illustrative, in focusing on the importance of real trade costs and basing the analysis on more recent theory that stresses the importance of heterogeneity of firms (product variety) and the impact of fixed costs on contesting export markets. They use a sample of countries for the 1988-2005 period, and find that port efficiency of importing countries contributes significantly to the extensive margin of exports for the partner country, and that the exporter's overall trade restrictiveness (measured by the OTRI) negatively impacts its own variety of exports.

Longo and Sekkat (2004) extended the gravity model to examine the impact of infrastructure availability, economic policy, and internal political tensions on intra-African (including African-Arab countries) trade. To highlight specific obstacles hampering such a trade, bilateral trade between Africa and developed countries is also analyzed. The results show that, besides traditional gravity variables, poor infrastructure, economic policy mismanagement, and internal political tensions have a negative impact on trade among African countries. Except for political tensions, the identified obstacles are specific to intra-African trade, since they have no impact on African trade with developed countries.

Harb (2007) uses a gravity model to assess the impact of ports infrastructures, internet diffusion, and administrative efficiency on intra-Arab trade. He also undertakes a series of simulations showing the potential increase in intra-Arab trade that would be achieved by national and regional strategies aimed at upgrading the three aforementioned factors. He notes that actions to reduce trade costs will reduce any eventual welfare-reducing effects induced by PAFTA (standard trade diversion). Port inefficiencies are found to be the main cost raising factor.

What are the gains from intra-Arab trade expansion?

Two approaches have been traditionally used: CGE modeling which focuses in general on ex ante evaluations and gravity models estimation which focuses in general on ex post evaluations.

Ex ante general equilibrium simulation studies

Much of the research to date on MENA has used CGE approaches, focusing on the potential effects of new or recently signed PTAs, including not just assessments of the impacts of preferential liberalization of goods trade, but also the effects of deeper integration. The basic finding is that shallow integration (preferential liberalization of goods trade) does little to improve welfare, whereas extending PTAs to cover services reforms and deeper integration that lowers real trade costs has the potential to generate large positive effects.

Contributions to this stream of the literature include contributions by a variety of authors to edited volumes (e.g., Galal and Hoekman (1997), Hoekman and Zarrouk (2000) and Dessus, Devlin and Safadi (2001)) and many papers (e.g., Bayar (2005), Bchir et al. (2007), Hoekman and Konan (2001, 2003, 2005), Konan (2003) and Konan and Maskus (2005)). Many of these studies assess and compare alternative regional trading arrangements. These types of studies generally conclude that PTAs that are limited to manufactures may be welfare reducing owing to trade diversionary impacts but whether positive or negative, will have small effects on welfare because initial (non-oil) trade flows are small.

These models allow the effects of integration on the consumer price index, a measure of the real exchange rate, average wages by skill level (depending on data), and owners of capital. A payoff of using these types of models is that insights are generated in impacts at the industry level and thus adjustment effects across sectors – expansion and contraction. In general, participating in more trade agreements reduces the negative effects of any individual PTA. Moreover, extending PTAs to include services and FDI reduces the expected inter-industry adjustment (Hoekman and Konan, 2001). But MFN liberalization is usually found to dominate, providing larger welfare payoffs than any of the bilateral agreements or their combination. And when PTAs are compared, the studies generally conclude that the greatest potential gains from preferential trade liberalization are associated with the largest markets (i.e., the EU for many of the Mediterranean MENA countries).

The CGE models are a useful (indeed, the only feasible) tool to assess agreements ex ante. But they have major limitations as a result of limited data on economic variables and the strong as-

sumptions that need to be made once the focus of attention extends beyond tariffs (e.g., what a given PTA can/will do in terms of changing the costs/quality of services inputs). Compared to the literature that focuses on other regions, MENA-centric research also lags somewhat in terms of the methodology employed. The recent non-MENA literature has included household survey data (e.g., work on Russia embeds information from some 50,000 households into the model and disaggregates by region within the country; incorporates heterogeneity of firms and product variety, and allows for FDI and trade in services (e.g., Jensen, Rutherford and Tarr; etc.). The reason for the lag is primarily due to the weakness of available data for the region.

Of these elements, only services have featured in MENA-centered studies. Some of the earliest models incorporating services reform scenarios were built to assess PTAs for countries in the region (e.g., Hoekman and Konan, 2001; Konan and Maskus, 2005). One area of convergence between the empirical research on the level of trade and operating costs and the CGE based papers incorporating services is that if PTAs are to have significant positive effects they must deal with the sources of the observed high trade and operating costs. Much of these policy areas revolve around services. Reforms in service-sector policies that would 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.

The studies conclude that most of the potential gains from policy reform are in the area of services and investment – with liberalization that drives down markups generating welfare increases that are 5 to 10 times what can be obtained from standard (preferential) liberalization of trade in goods.

There is much that could be done to improve CGE modeling of regional integration, but this is conditional on improving the underlying databases on policies, services trade, including stocks and flows of FDI by sector, and a better mapping of (assumed) policy reforms/trade cost reductions to what PTAs actually cover (or could cover).

Gravity models

An implication of the gravity studies is that

implementation of intra-regional liberalization should expand trade. As the length of time that has passed since tariffs were removed on intra-PAFTAD trade is short, there have been few ex post studies. A recent paper by Abedini and Peridy (2008) tries to do so. They incorporate both traditional determinants of international trade (GDP, distance, border effects) and variables that have not been used in the literature, such as expectations and sunk costs in a gravity analysis of PAFTA. They find that the agreement resulted in a gross increase in trade creation of approximately 20% in the 1988-2005 period. A problem with this conclusion is that PAFTA was only implemented gradually after 1998 (in initial steps of 10 percent, later accelerated to 20 percent a year to achieve full implementation in 2005). Thus, there is an attribution/identification problem here. Other events also need to be controlled for such as expansion of the EU, the exclusion of some agricultural products from PAFTA during much of the period (e.g. agriculture is the most dynamic import for Syria), and the gradual abolition of textile quotas under the WTO during the period.

Determining causality is a general difficulty for researchers in this area. In a world where countries and thus trade is growing one would expect more intra-PTA trade without a PTA as well. Matters are compounded by countries also undertaking unilateral liberalization at the same time or before they engage in PTAs (i.e. what then is driving increased intra-PTA trade?). This suggests that empirical evaluations of PTA impacts must compare outcomes to what would have happened if the PTA was absent (the counterfactual). This is very difficult if not impossible as the PTA exists after all. What can be done, however, is to control for other factors and variables that affect trade flows.

Perhaps surprisingly, there is no consensus in the general (i.e. non-MENA) trade literature on whether PTAs lead to more intra-PTA trade – some studies find a negative effect, and many have ambiguous conclusions. Baier and Bergstrand (2007) argue that the findings of much of the literature greatly understate the trade effects of PTAs because they ignore the political economy of trade policy, that is, why the PTA was negotiated in the first place. Researchers generally assume that the formation of a PTA is exogenous. In practice it is not likely to be (e.g. the level of trade can be ex-

pected to determine whether or not to join a PTA). Baier and Bergstrand (2007) argue that if account is taken of this endogeneity, the impact of PTAs on trade volumes with partner countries rises a lot, and the average PTA has a significant effect on intra-PTA trade: they estimate that on average a PTA doubles trade between two members after 10 years.

How to make integration work?

A key policy question that arises in the context of both the empirical and CGE literature discussed above is whether a given PTA actually addresses or could address the underlying causes of low intra-regional trade or identified set of distortions. In principle almost all of the excess costs and mark-ups that are modeled in the CGE papers can be reduced through unilateral action. Thus, what matters is if a PTA facilitates or assists governments to take the needed policy reforms. In the literature this issue is clearly recognized and authors note that to date there has not been much evidence that PTAs are designed to deliver the needed “pressure”, in part, because no PTAs have not yet included the needed areas and because they are not designed to ensure there are strong incentives for compliance and implementation. The exceptions are the more recent US FTAs.

Most of the focus in the economic literature as regards the design and operation of PTAs has centered on comparing Arab PTAs to the EU (e.g., Hoekman and Messerlin, 2003; Winters, 2003). Kheir-el-Din and Ghoneim (2005) assess the design of the PAFTA and related Arab League institutions and also compare it to the EU, concluding that a shift in the direction of supra-national institutions is needed to push forward Arab integration. The comparison with the EU is appropriate to some extent, especially given that many Arab countries are pursuing deeper integration with the EU. But presumably other types of integration schemes also have lessons to offer. More generally, there is a great need to have information on what is being/has been done. As discussed below this is a precondition for moving the research agenda on institutional design forward.

A number of studies have described the structure of GCC and the Arab League agreements. But with a few exceptions (e.g., Fawzy, 2003; Afifi, 2005) there appears to be very little explicit political economy analysis by economists that aims to

improve our understanding of why arrangements are designed the way they were, and, as important what can be learned from the experience to date in existing PTAs.

For example, as discussed in Alabdulrazzaq and Srinivasan (2007), in the GCC there are two levels of political oversight, a Supreme Council comprising the Heads of State and a Ministerial Council that meets quarterly. The latter spans a number of committees (Financial and Economic Cooperation, Education, Health, Labor and Social Affairs) that prepare studies and submit recommendations to the Supreme Council. The GCC Secretariat is responsible for the supporting meetings of these intergovernmental bodies with reports, including monitoring the implementation of decisions. A number of specialized agencies have been created for technical policy areas, including a GCC Standardization Organization, a commercial arbitration body, and a registry for patents. These bodies are headed by representatives of the member states, and have their own permanent technical staff. Very little effort has been made by economists to track and analyze what these various bodies have done, whether or not recommendations were implemented and if not, why not, etc. Absent, such analysis it is not possible to determine *ex post* what the effects of the PTA were. The attribution problem is impossible to resolve. But it is also impossible to use the experience of the GCC to inform how PAFTA might be structured as members move down the path of deeper integration.

The same conclusion applies to the EU and US agreements – there are very few studies of how these agreements operate (e.g., what the various committees and councils they establish actually do; whether and how decisions are implemented, how disputes are settled, etc). As argued by Hoekman (2007) this is a priority area for research on regional integration.

Summing up

In terms of the issues addressed, scientific quality, and policy relevance and impact of the extant research, the literature on MENA (intra-regional) trade is similar to what has been done elsewhere. The primary differences are explained by the lack of “serious” PTAs in the region until recently and the much weaker databases that researchers have to work with. Production, trade, investment

and employment data is often patchy if not non-existent for a number of countries in the region, including large economies such as Saudi Arabia. The same is true of data on policies, including the extent and manner in which PTAs have actually been implemented. The knowledge gap is by far the greatest on basic data needed to undertake empirical analysis.

A feature of the more rigorous research on MENA regional trade is that much of it has been generated by researchers employed by international institutions such as the IMF, AMF, API and World Bank. One implication is that too little attention has been devoted to political economy questions and analysis – the application of formal techniques to better understand and analyze the determinants and incidence of status quo policies. Examples of the types of questions that are not addressed in the literature are: who gains?; how large are the associated rents?; who pays?; and, what is the role of elites, the army, etc? Economists have also devoted little attention to assessing the extent to which PTAs were implemented. In part this is again a result of limited data and transparency of the PTAs that have been signed over the years between Arab countries. Even the most far-reaching arrangement to date (the GCC) generates little public information on what is done by the organization. This does not mean that the information cannot be obtained, but to do so would require a pro-active effort to collect it. This can only be done by Arab speakers who are independent of governments and international organizations. This would appear to be the type of activity that a network such as the ERF is well placed to do.

3.2 Research on Migration

For the last decades, the pace of international migration has accelerated. The number of international migrants increased from 154 to 175 million between 1990 and 2000 and is nearing 200 million in the recent years. A similar tendency is observed in the Arab world. Research on migration investigated the determinants and consequences, especially for countries of origin. Regarding determinants, Hatton and Williamson, (2002) pointed to the difference in income across countries, the share of population between 15 and 39 years old in the origin and host countries, the stock of immigrants and the extent of poverty in the country of origin.

As far as the consequences for the origin countries are concerned, generations of economists have argued that emigration; especially of the most talented workers (brain drain) is likely to reduce the average level of human capital of the labor force. In the 1960s the economic literature (for example, Grubel and Scott 1966, Johnson 1967) had a tendency to downplay the negative externalities imposed on those left behind (Grubel and Scott even termed them 'negligible') and insisted on the role of remittances, return migration and diaspora externalities.¹⁴

Remittances constitute an important channel through which migration may generate positive effects for source countries. Workers' remittances often make a significant contribution to GNP and are a major source of income in many developing countries. According to the recent *Global Economic Prospects of the World Bank (2006)*, recorded remittances to developing countries amounts to about \$US 150 billion in 2004, roughly the same amount as foreign direct investments and about three times as large as the official development aid.

Remittances have a strong impact on poverty and economic activity. They impinge on households' decisions in terms of labor supply, investment, education (Hanson and Woodruff, 2003, Cox Edwards and Ureta, 2003), migration, occupational choice, and fertility, with potentially important aggregated effects. This is especially the case in poor countries where capital market imperfections (liquidity constraints) reduce the set of options available to members of low-income classes.

Although the magnitude of return migration is badly known, the fact that migrants accumulate knowledge and financial capital in rich countries before spending the rest of their career in their origin country may generate beneficial effects on productivity and technology diffusion. Empirical results pertaining to different countries (e.g. Mesnard, 2004) confirm that low-skill workers migrate with the aim of accumulating enough savings so as to access self-employment and entrepreneurship.

A large sociological literature emphasizes the creation of migrants' networks that facilitate the movement of goods, factors, and ideas between the migrants' host and home countries. There are two types of network effects: networks that facili-

tate further migration, and networks that facilitate trade, FDI and technology diffusion. Massey, Goldring and Durand (1994) outline a cumulative theory of migration: the first migrants usually have enough resources to absorb the costs and risks of the trip, then family and friends draw on ties with these migrants to migrate at substantially reduced costs and risks. Another type of effect consists in the creation of business and trade networks; such a "Diaspora externality" has long been recognized in the sociological literature and, more recently, by economists in the field of international trade (Rauch and Trindade, 2002). In many instances indeed, and contrarily to what one would expect in a standard trade-theoretic framework, trade and migration appear to be complements rather than substitutes. Interestingly, such a complementarity has been shown to prevail mostly for trade in goods which are specific to the country of origin. In this case, ethnic networks help overcoming information problems linked to the very nature of the goods exchanged.

In Arab labor markets, migration has historically played an important role in Arab labor markets (Shafik, 1996). Arab labor markets have witnessed two profound transformations in recent decades: (i) integration driven and financed by the oil boom in the 1970s; and (ii) in the 1990s, fragmentation following the decline in oil income and the Gulf conflicts.¹⁵ As discussed by Youssef (2005), migration of people within the MENA region has been and is significant. During the oil boom of the 1970s and early 1980s, labor migration was a mechanism for addressing labor market shortages in oil exporters, pulling in workers from the Mashreq and Yemen.¹⁶ This had the effect of promoting Arab economic integration – generating the types of effects that otherwise would occur through greater trade integration (wage convergence, etc.).

Although the level of migration in MENA is high, migration is constrained and distorted by market failures (most visibly information asymmetry and imperfect contracts) and government failures (inefficient or non-existent national migration and labor policies) (World Bank, 2008). There has been no parallel to the PTAs discussed above for movement of workers – both short term and longer term. The scope for mutual gains from trade in labor is significant given that wage gaps within (and between) regions are very high and show large variation across countries and skill

levels.

McCormick and Wahba (2001) studied the linkages between overseas employment, savings and entrepreneurial activity on return to Egypt. They evidence supporting the hypotheses that both overseas savings, and the duration of stay overseas increase the probability of becoming an entrepreneur amongst literate returnees to Egypt. Amongst illiterate returnees, overseas savings alone increase the probability of becoming an entrepreneur. The results for literates suggest that skill acquisition overseas may matter more substantially than overcoming a savings constraint in explaining how overseas opportunities influence entrepreneurship on return. For illiterates, who usually accept menial positions overseas that offer little opportunity for learning, the opposite obtains.

Dustmann and Kirchkamp (2002) used data from a survey of Turkish immigrants to Germany. They show that more than half of the returning migrants are economically active after return, and most of them engage in entrepreneurial activities. We then develop a model where migrants decide simultaneously about the optimal migration duration, and their after-return activities. Guided by this model, we specify and estimate an empirical model, where the after-return activity, and the optimal migration duration are simultaneously chosen.

Mesnard (2004) studied return migration in Tunisia. She concluded that temporary migration has contributed to economic development of Tunisia through at least two channels. On one hand, transfers sent by migrants to their origin country represent a sizeable source of foreign currency and income for developing countries. This may be crucial for highly indebted countries and has often been recognized through policy measures aimed at attracting remittances. On the other hand, savings repatriated upon return under different types of goods allow poor workers to overcome credit constraints for investment into small projects.

A key question for policy – and research – is which markets such migration is best directed to, and, what type of migration should be supported by MENA governments – temporary or longer-term; skilled vs. unskilled, etc. The focus of much of the recent literature has been on outward migration to non-Arab countries, but history suggests that the creation of a common Arab labor market

would generate large movements and potentially large gains.

A major constraint in doing research in this area is absence of reliable and comparable data on flows and stocks. Statistics are scarce and of generally low quality – see Parsons et al. (2007).

3.3 Research on Capital Flows

The literature of interest to us addresses two questions regarding capital flows: What is the impact of capital inflows on the host country? What are the determinants of capital inflows to a given country?

Impact of capital inflows

Capital inflows represent additional resources a country needs to improve its economic performance. By increasing capital stock, capital inflows can increase a country's output and productivity through a more efficient use of existing resources and by absorbing unemployed resources. De Gregorio (1992) showed, in a panel of 12 Latin American countries, that FDI is about three times more efficient than domestic investment (UNCTAD, 1992; Blomstrom et al., 1992). Capital inflows can also act as a catalyst for local investment by complementing local resources and providing a signal of confidence in investment opportunities. Agosin and Mayer (2000), using a panel of 32 countries over the period 1970–96, found that FDI crowds-in domestic investment in Asia but crowds it out in Latin America. Finally, capital inflows can stimulate the development and dispersion of technological skills through transnational corporations' internal transfers and through linkages and spillovers among firms. Borensztein et al. (1998), focusing on 69 developing countries, supported the effect of FDI flows on economic growth through a "catch-up" process in the level of technology. They also revealed a strong complementarity between FDI and human capital. FDI has an overall positive effect but its magnitude depends on the stock of human capital available in the host country.

Regarding the MENA, Boukilia-Hassane and Zatla (2000) investigated the relationship between the stock of FDI an economy has received and its growth rate. They found a positive albeit not very significant effect of FDI on growth. When they enlarge the cross-section dimension of the panel to include 54 developing economies, the relation-

ship becomes highly significant. The authors interpret this as possible evidence of the existence of a threshold effect and of the importance of the level of human capital in affecting the effectiveness of FDI.

Haddad and Harrison (1993) examined the impact of foreign investment on firms in Morocco's manufacturing sector from 1985 through 1989. Comparisons of performance between domestic and foreign-owned firms reveal that, on average, foreign firms tend to be more export oriented and to pay higher wages. Much of the differential in outward orientation between domestic and foreign firms is due, however, to the fact that foreign firms tend to be relatively large. For the same size class, they find small differences in the outward orientation of foreign firms and domestic firms. Their results also show that firms with some foreign ownership exhibit higher levels of overall multi-factor productivity. However, the rate of growth of productivity is higher for their wholly domestically-owned counterparts. The results show that this is due in part to the distortionary effects of protection - foreign firms lag behind domestic firms in productivity growth in protected markets. Finally, direct foreign investment seems to contribute to knowledge transfer from foreign to domestic firms. Joint ventures exhibit higher levels of productivity than their domestic counterparts. Using a production-function approach, they also found that foreign presence is associated with increased productivity in wholly domestically-owned firms. Sectors with high levels of foreign investment have domestically-owned firms closer to the efficiency frontier. However, there is no significant relationship in the sample between higher productivity growth in domestic firms and greater foreign presence in the sector. Although domestic firms do exhibit faster productivity growth, it cannot be attributed to a higher foreign share.

Laureti and Postiglione (2005) examined the relationship between economic growth and capital inflows (including non-FDI capital inflows) for the eleven Mediterranean countries that participated at Barcelona Process. The results showed that FDI does not explain growth. The coefficient associated to portfolio equity flows exhibits a negative relation with growth.

Determinants of capital inflows

The determinants of capital inflows to a given

country are grouped into three categories: basic economic factors, trade and the exchange market policies and other aspects of the investment climate.

An early survey by Agarwal (1980) summarized the basic economic determinants of country attractiveness with respect to FDI: the difference in the rate of return on capital across countries, portfolio diversification strategy of investors and market size of the host country. The difference in the rate of return is dependent on incentives for foreign investors and supply of cheap labor. Empirical evidence shows that the effect of incentives provided by the host country on FDI is only marginal however. Agarwal explains this unexpected finding by the fact that incentives are generally accompanied by a set of restrictions and requirements. The supply of cheap labor appears as a more convincing explanation of FDI. Overall, empirical evidence on the relationship between inter-country differences in the rates of return and FDI does not provide any conclusive results. This ambiguous finding is due, according to Agarwal, to statistical and conceptual problems. Theoretically, FDI is a function of expected profits but available data are on reported profits. In addition, reported profits may not be similar to actual profits since transactions between the parent company and its affiliates are subject to intra-company pricing rather than to market pricing.

The portfolio diversification hypothesis stresses the fact that investors select their locations taking into account both the expected profits and the perceived risk. Portfolio diversification helps reducing the total risk as long as returns are highly correlated within the country and weakly correlated between the home and the host countries. The empirical evidence in favor of this hypothesis remains weak. Some authors attempted to understand why multi-national companies tend to contribute more to FDI than to portfolio investments, which are more likely to provide a better instrument for geographical diversification. They argued that this preference might be due either to the absence of organized security markets (the case of LDCs) or to presence of high inefficiencies on these markets when they exist.

Finally, FDI is considered to be a function of output or sales on the host market. Most empirical studies reviewed by Agarwal have lent support to the relationship between FDI and market size

of the host countries. This view is, however, challenged by Lucas (1993). Focusing on seven Asian countries (Indonesia, Malaysia, Philippines, Singapore, South Korea, Thailand and Taiwan) over the period 1960-87, he considered two measures of market size. One concerns the export market and the other concerns the domestic market. The results revealed a weak relationship between the size of domestic market and the volume of FDI and a high degree of responsiveness of FDI to incomes in major export markets. This may reflect the outward orientation of foreign firms located in this region. FDI inflows are also found to be more responsive to wages than to costs of capital including taxes.

Analyses of the role of economic policy in attracting FDI have historically been concerned with trade reforms. Blomstrom and Kokko (1997) examined the effects of trade liberalization on FDI. They showed that trade liberalization and a reduction in investment restrictions have different effects on FDI, depending on the host country's motives for wanting to engage in FDI. There is the tariff-jumping argument, in which trade and factor mobility are viewed as substitutes. The other view is that the major motive for FDI is the exploitation of intangible assets in the host country. Trade liberalization is likely to decrease intra-regional FDI flows if the tariff-jumping argument is valid, because exporting from the home country becomes more attractive than FDI as a way of serving the regional market. But if the motivation behind FDI is the exploitation of intangible assets, then a reduction in trade barriers can enable multinationals to operate more efficiently across international borders. This is especially the case for vertical FDI. The net impact of liberalization is therefore determined by the structure and motives for pre-existing investment.

On the empirical side, Hufbauer et al (1994) showed that trade liberalization of the host countries plays a significant and consistent role in the investment decisions of the United States and Japan. Belderbos (1997) analyzed data on Japanese firms in the electronic sector in order to reveal the link between FDI and protectionists measures, and in particular to determine whether such measures taken by the European Union and the United States have led to Japanese tariff-jumping FDI. The results show that anti-dumping actions in the European Union are highly threatening for Japa-

nese exports, and are likely to induce tariff-jumping FDI. Just the beginning of an anti-dumping action is enough to induce a Japanese firm to start investing without waiting for the outcome. Thus, trade barriers appear to increase FDI.

The relationship between FDI flows and exchange rate was examined by Froot and Stein (1991) who found that FDI inflows are negatively correlated with the value of the dollar. This implies that a depreciated currency can stimulate in buying control of productive corporate assets. Cushman (1985) focused on the effects of real exchange rate risk and expectations on FDI. The results show significant reductions in US direct investment associated with increases in the current real value of foreign exchange, and very strong reductions associated with the expected appreciation of real foreign exchange. Goldberg and Kolstad (1995) explore the implications of short-term exchange rate variability on FDI flows and support the hypothesis that volatility contributes to the internationalization of production.

Economists generally acknowledge the important role of infrastructure in stimulating growth and investment. Wheeler and Mody (1992) found that infrastructure quality is an important determinant of FDI inflows to LDCs. Labor costs and the existing foreign investment also play an important role. Their results also suggested that incentive variables to attract more FDI flows such as tax breaks or short run grants have only a limited effect because transfer pricing and deduction of foreign taxes provide alternative ways to reduce the amount of paid taxes.

Political risk is expected to have a negative effect on FDI flows through its impact on profit uncertainty. Root and Ahmed (1979) tested for the effect of economic, social and political variables on FDI. They found that four economic variables (per capita GDP, GDP growth rate, economic integration, importance of transport, commerce and communication), one social variable (degree of urbanization), and one political variable (the number of constitutional changes in government leadership) have an effect on FDI. Schneider and Frey (1985) reexamined the issue and concluded that both economic and political factors are crucial for FDI flows to LDCs. As far as economic factors are concerned, FDI reacts positively to per capita GNP and negatively to the balance of payments deficit. Growth of GNP and the workers' skill lev-

el are found to have weak effects on FDI decisions. Regarding political determinants, the amount of bilateral aid coming from Western countries has a strong positive effect on FDI flows, while the government's ideological position (right or left wing position) does not have any significant effect.

The role of institutions is crucial in terms of commitments to and enforcement of rules. Corruption is generally put at the heart of the non-enforcement of rules in LDCs. It is found to depress growth and domestic investment and to contribute to an unfair wealth distribution (Mauro, 1995). Wei (2000) carefully examined the relationship between FDI and corruption. He used three measures of corruption, all of which are based on surveys of international entrepreneurs. The estimation results showed the existence of a negative relationship between corruption level in the host country and inward foreign direct investment. Henisz (2000a) examined the effect of commitment to rules on growth and investment. He focused on the effect of frequent or arbitrary changes in taxation, regulation and other relevant economic policies. He found that commitment to rules has a statistically and economically significant impact on growth and that this result is robust to various specifications. Henisz (2000b) focused on the effects of political hazard and contractual hazard on investment decision of multinational corporations. The results confirm that firms are more likely to enter wealthier countries with large populations and credible political rules.

Focusing on the MENA, Gibson et al, 2006 examined the determinants of non-FDI capital inflows. The results suggest that sustained growth has a positive impact on net capital inflows whereas government deficits tend to encourage net outflows. Higher inflation reduces net inflows. The degree of financial development (as represented by M2/GDP) appears to affect capital flows negatively; that is, as the level of financial development rises, so there is a tendency for countries to experience net capital outflows. This is perhaps not surprising: with financial development comes an increasing sophistication on the part of investors which is likely to lead to their seeking to diversify their portfolios by investing abroad. Capital controls help to support net inflows or reduce net outflows reflecting the fact that most controls in this group of countries were directed at outflows. Finally, the results tend to support the view that

macroeconomic fundamentals are important determinants of net capital flows.

Sekkat and Veganzones (2007) confirmed the importance of the basic economic factors and sound macroeconomic policies as important determinants of FDI inflows to the MENA. They also assessed the importance of openness, infrastructure availability and sound economic and political conditions in increasing countries attractiveness with respect to FDI. The results show that these factors are particularly important. Moreover, the paper shows a much higher impact of the above determinants for FDI in the manufacturing sector. Knowing that export diversification is a major factor for sustained growth in the region, the last result suggests that the expected return from openness and other aspects of the investment climate could be much higher.

Rosotto et al. (2005) focused on the potential impact of opening up telecommunications to competition in MENA on the participation of the region in the World economy. The latter was assessed with respect to manufactured exports, participation in production network and attractiveness of FDI. The analysis confirms that, after controlling for the influence of other structural factors, better performance of telecommunications strengthens export performance in manufacturing including exports of intermediate products. Moreover, by facilitating linkages with transnational production networks and reducing the cost of doing business, better telecommunications sector performance is found to be a determinant of foreign direct investment inflows in developing countries.

Méon and Sekkat (2004) examined the extent to which institutions' functioning disables a greater participation of the MENA in the world economy. They focused on the impact on manufactured exports and FDI attractiveness and consider a broad index of political risk as well as indices targeted toward specific aspects of governance (corruption, government effectiveness and the rule of law). The results are robust to different econometric approaches and lend strong support to the hypothesis that the ill functioning of institutions may disable the participation of MENA countries in the world economy. They suggest that the impact of an improvement in the quality of institutions may result in a sensitive increase of FDI inflows and manufactured exports. That increase is comparable to the one resulting from liberalization poli-

cies. Hence, although institutional reforms can take time, they deserve the necessary efforts given their outcomes as compared to other reforms.

Finally, Lagoarde-Segot and Lucey (2006), assuming that the MENA's financial market development could help integrating the Region into the World market, assessed the degree of financial market development within the Region. They used bootstrap, probit and hierarchical cluster methodologies. The results suggest that in spite of intra-regional heterogeneity, the MENA region ranks favorably by comparison to Latin America and Eastern Europe. Overall, our results suggest that economic reforms have finally led to market emergence in the MENA region and that the necessary conditions are met to attract further portfolio flows in the area. The authors suggest that future research could examine the composition and performance of a MENA inclusive portfolio.

Conclusions and A Policy Research Agenda

The discussion in the previous sections shows where we stand in terms of knowledge about Arab integration. To conclude this paper, we present in this chapter a number of policy research questions relevant to Arab integration but still not dealt with in the literature.

Before discussing the research questions, it is worth emphasizing the importance of the collection of better data, both on economic variables (policies, performance and outcomes) and on the implementation of PTAs (both intra-Arab and those with non-Arab countries). Data are critical in order to assess impacts/incidence of PTAs and to provide guidance to policymakers on what is working and what is not. Dealing with this issue requires both a multi-year focus and a cross-country, network, approach to the design of research projects. It also requires and will benefit from an annual reporting exercise (e.g., “Monitoring MENA Integration”) that can serve as a focal point for engagement with policymakers and the economic press.

Data constraints are among the most important determinants of the gap between “best practice” research on regional integration and research in the region in terms of methodology and rigor. That said, PAFTA and the various EU/US PTAs have now been/are being implemented, so more can be done than in the past. Indeed, this is a propitious time to launch a research program as there is an opportunity to monitor and assess implementation in “real time”. In this respect the region can leapfrog the status quo in other regions where relatively little is known about implementation. “Best practice” here is probably Latin America, where the IDB and the OAS have been tracking PTA implementation. An implication is that it makes sense to bring in these organizations/staff into the effort here.

6.1 Scope of integration

In the past, the approach that has been taken by countries in the region has been very “traditional”: the focus has been on the negotiation, mainly with other Arab countries and with the EU, of trade agreements where the coverage has mostly been limited to goods. Initiatives have been made periodically to go beyond this to include factor markets but, with the exception of the GCC, these were never implemented. Although there are significant differences in factor endowments across MENA countries that should be a good basis for greater trade in goods, an alternative is for governments to focus on liberalizing trade in factors (labor and/or capital/investment).

Economic integration covers a large spectrum of possibilities along three dimensions: markets (good, services and factors), policies (including the adoption of common tariffs i.e. customs union) and partners. We address research questions related to markets in separate sections and focus here on partners and policies but it is important to note that there is this more basic strategic question of whether to continue with efforts to integrate product markets or instead to put much more emphasis on factor market integration.

Partners

An important question and priority area for research concerns the appropriate integration strategy for countries in the MENA region. Insofar as there are mutual gains from cooperation on policies and infrastructure that affects the costs of crossing borders, the appropriate partners are readily determined (i.e., adjacent countries). But matters are less clear-cut when it comes to trade policy and “behind the border” policies that affect trade in goods, services and factors. It is important that governments (and thus researchers) focus on

all potential partners, including a strategy that focuses on the world as a whole (i.e., a multilateral, non-discriminatory strategy).

Any assessment of options must start with the status quo and what has already been put in place by governments. PAFTA exists and the intention is to extend it to cover services and to move towards a customs union. The GCC is committed to create a common market. At the same time a number of MENA countries have signed FTAs with the EU and the US. But, what about other countries in the rest of the world? A significant share of trade is already with Asian countries, who are now active players in the PTA market. Does it make sense to prioritize intra-Arab integration efforts; to deepen existing FTAs to cover services and factors of production (labor, capital); or to focus attention on large emerging markets where barriers to trade and investment are significant?

The choice regarding the markets and policies dimensions will depend on the partner. Presumably for different country pairs/sets there will be a different ranking of the types of markets that should be prioritized in terms of liberalization. A similar question arises for the type of integration scheme that is most appropriate. If the assessment

is that the relative gains of integration of a specific factor market are greater than for integration of product markets it makes little sense to seek to establish a customs union or a FTA. It may be more appropriate then to seek to create a common labor market (as was done by the Nordic countries) or to create a temporary admission/work permit system (see below).

Some Arab countries have PTAs that involve other non-Arab countries and even cover some policy areas. For instance, the PTAs that involve the United States generally have the broadest coverage (Roy, Marchetti and Lim, 2007). Figures 7 and 8 illustrate the differences across PTAs in terms of coverage of services and investment. An important question is to what extent the specific commitments that are made go beyond the status quo ante and if so, whether (i) the PTA process helped promote domestic reforms, and (ii) did so in a manner that benefits all potential suppliers – including those in the rest of the world. That is, are reforms implemented on a MFN basis?

Border policies

The choice here concerns the adoption or not of common (trade, industrial, competition, etc.)

Figure 7.
Coverage of 17 investment provisions in selected PTAs

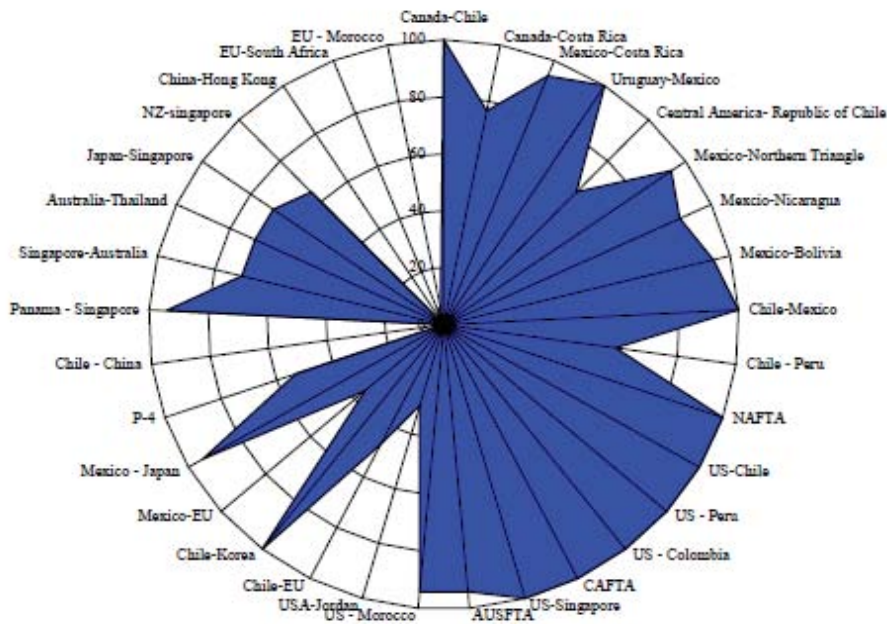
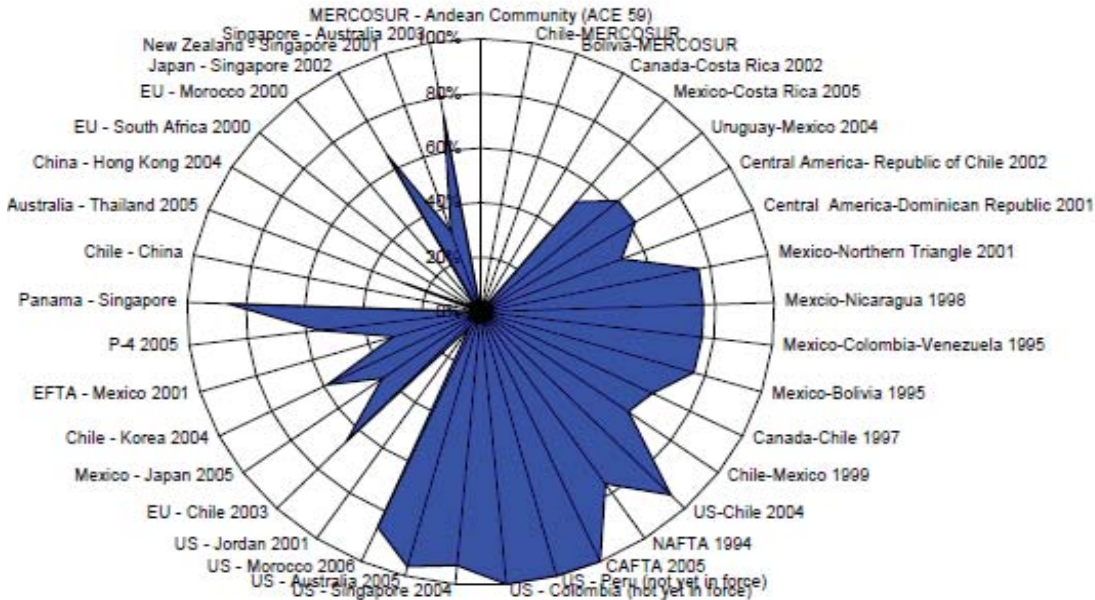


Figure 8.
Coverage of 29 services provisions in selected PTAs



Source: Estevadeordal, Shearer and Suominen 2007

policies. Regarding trade policy an important issue concerns the treatment of non-members. For instance, when integration is limited to a PTA without common external tariffs, the rules of origin (ROO) become a major determinant of the incentive regime confronting firms. In the region, even the GCC is not yet a full customs union with free circulation of goods. This implies that rules of origin continue to be imposed on intra-GCC trade flows. The basic rule that applies is a value added criterion of 40 percent, which is identical to the rule that is applied in principle under the PAFTA, although in practice individual PAFTA members apply varying rules for the same product. Under PAFTA the origin requirement is reduced to 20 percent if a good is produced in two Arab countries. Agreement on a more detailed set of rules of origin of the type found in EU and US PTAs has not proved possible. This not necessarily a bad thing: a value content rule is at least transparent, and allows PAFTA members to use the level of value added as a focal point for future efforts to reduce the trade restrictive effects of the ROO.

There is a large literature now estimating the

effects of rules of origin (e.g. Cadot et al., 2006). For example, Gasoriek et al. (2003) analyze the impact of rules of origin in the Euro-Med context, focusing in particular on the effect of allowing cumulation of intermediate inputs across EU partner countries, and show that the rules have a statistically significant impact in restricting trade. The EU has responded to pressure from EU firms to reduce the trade impeding effect of ROO by adopting more liberal cumulation rules. This is the Pan European Cumulation System (PECS) (Gasiorek et al., 2007).

What are the economic incentives of the ROO following from the PAFTA in comparison to those from the EU and US is an obvious area for research that is closely linked to the broader question of how to bring down real trade costs and what the impacts of these costs are on trade and the location of production and employment. The Inter-American Development Bank has developed a methodology and constructed a detailed database of ROO for the Latin American region and similar efforts are ongoing for other regions (Estevadeordal et al., 2007). The same could and

should be done for MENA.

The ROO is also important for trade and investment in services. Fink and Molinuevo (2007) and Fink and Jansen (2007) argue that the rules of origin that are contained in most recent PTAs are mostly liberal, in that PTA benefits extend to non-member firms that are established (have a commercial presence) and substantial business operations in a PTA member. Fink and his co-authors argue that such liberal rules of origin necessarily mean PTAs on services are multilateralizing in nature (i.e., do not give rise to potential trade diversion incentives). However, if there are significant policy-based barriers to entry in a market and thus significant rents, there are obvious incentives for firms in the PTA partners to seek to limit entry by non-PTA firms. Thus, as in the case of trade in goods it is not (only) the rule of origin that matters, but the level of prevailing market access barriers against ROW suppliers.

A way to cope with the problems related to the ROO is the adoption of a Customs Union (use common external tariffs). The PAFTA has stated it aims to establish a customs union. Experience suggests this will be difficult. In the region only the GCC has managed to agree on a CET. Although progress has been made towards establishing a mechanism for redistributing tariff revenues collected at GCC borders on goods to which the common external tariff is applied on the basis of final consumption within the GCC, there continue to be customs and border controls affecting intra-GCC flows of goods. In part this is because of the national divergences away from the common external tariff of 5 percent, and in part it reflects the fact that despite GCC efforts to adopt harmonized norms for goods, national conformity assessment procedures continue to apply.

One subject for research in this area revolves around the design of revenue allocation rules and implementation mechanisms. It could draw on the GCC experience and that of other customs unions such as SACU (which is currently experiencing tensions due in part to re-allocation of tariff revenues within the union).

The literature on regionalism suggests a number of reasons why there may be a bias for the external trade policy of a customs union to be more restrictive than under a FTA. Because there is no common external trade policy, member countries compete in their external trade policies. Industries

cannot lobby for area-wide protection. While import-competing firms in member countries may have an incentive to obtain such protection, each industry will have to approach its own government. The required coordination and cooperation may be more difficult to sustain than in a customs union where the centralization of trade policy requires firms to present a common front. In any particular instance, some member country governments will award protection, whereas others will not. If industries in member countries are all competing against third suppliers, protection by one member may benefit industries in other member states. Such free riding can result in less protection than in the absence of the FTA. This benefit may be offset by other aspects of FTAs, in particular the need for rules of origin, which may allow industries to limit the extent of intra-area liberalization and can be detrimental to nonmembers. However, Baldwin (2006a) has argued that changes in the political weight of different parties or in the relative importance of different costs will over time change the political economy so that groups that once sought to segment markets will begin to seek to integrate them.

Some evidence is beginning to emerge that supports these theoretical considerations on the likely dynamics of FTAs vs. customs unions. Estevadeordal et al. (2008) conclude that the preferential tariff reduction following PTA formation in Latin America promoted subsequent external tariff reduction for those PTAs that do not involve the formation of a customs union. Bohara et al. (2004), focusing on the impact of preferential trade flows from Brazil to Argentina, find that greater imports from Brazil led to lower MFN tariffs in Argentina, especially in sectors where trade diversion occurred as a result of Mercosur. As the potential for trade diversion is especially great for South-South PTAs (because developing countries tend to have relatively high external trade barriers) the associated costs provide a powerful force for multilateralisation: lowering external barriers to trade will reduce such costs. Work along these lines could be done for MENA PTAs, that is, tracking the incentives for governments to follow PTA liberalization with MFN liberalization.

Behind the border policies

The prospects for the “multilateralization” of PTA commitments in “behind the border” areas is

an important general area for research. They may be significant as in many cases regulation is quite naturally applied in a non-discriminatory fashion, treating domestic and all overseas suppliers or firms equally – where ‘domesticity’ is defined in terms of location of production/activity than nationality of ownership. This is quite different from tariffs and NTBs affecting trade in goods, where domestic/foreign and intra-foreign discrimination is generally the objective. From the perspective of achieving regulatory objectives, nationality often will (and should) not matter. That said, in practice it is certainly not inevitable that regulations are applied on a nationality-blind basis – insofar as protectionism is an objective of policymakers, regulation can be used to achieve it.

Even if regulatory changes are applied on an MFN basis, there remains the question of what norms to adopt and specifically in the context of PTAs, whether to adopt common norms or to converge to the norms of a specific partner. One model here is “hegemonic convergence”: a hegemonic economic power is essentially able to impose its own model on its partners, not necessarily coercively but by the force of its market size. This appears to be the path that Morocco and Tunisia are already on – convergence with the EU in many areas (as a result of deepening of existing FTAs; the European Neighborhood Policy, Mediterranean Union, etc.). Examples of the hegemonic model abound in ‘deep integration’. The US requires partners in BITs to conform to an identical template and imposes its preferred types and levels of intellectual property right protection provisions in its PTAs (Fink and Reichenmiller, 2005). Another example is the EU interest in extending its system of geographical indications through its PTAs.

An alternative outcome is “competition between rules” that is, acceptance by governments of policies as being equivalent. This has been an important feature of the EU model of integration of product markets, driven by the aggressive policy of the European Commission and European Court of Justice towards other limitations on the freedom of movement of goods such as product standards (where the principle of mutual recognition was applied). In services the political sensitivity of the convergence route is evident in the constrained liberalization of cross-border services espoused by the recent Services Directive in the EU and the difficulties that have affected efforts

by the EU and the US to make progress in moving towards accepting each other’s regulatory norms for specific services as being effectively ‘equivalent’. Research could focus both on the costs and benefits of these alternative “models” and the types of institutions and mechanisms that could help MENA countries take an informed view of what they can/should do in PTA negotiations when these address regulatory matters.

Policy areas that could be the focus of research include industrial policy and subsidies (state aids) and discriminatory procurement regimes – all policies regarding which there would need to be common disciplines if countries are to move towards deeper integration arrangements. A related policy area is the impact of export and special economic zones and the incentive regimes that have been put in place by different countries in terms of preferential treatment for investors and market access.

Yet another policy area that is relevant in this connection is competition law and policy. To date competition-related provisions in PTAs are limited to those with the EU and are confined to practices that have or may have an effect on trade, reflecting the EU’s focus on market integration and the view that removal of private barriers to entry and anti-competitive behavior is a necessary complement to the removal of border barriers and restrictions on state aids. The EU PTAs do not include explicit provisions for formal cooperation or information exchange (Holmes et. al., 2005). In practice the focus of EU competition law remains very Euro-centric – concerned only with EU welfare. There is in principle significant scope to design PTAs so as to strike a bargain that involves joint enforcement and “outsourcing” of competition disciplines to the jurisdiction with the greatest capacity in this area – the EU or US. Hoekman and Saggi (2007) argue that the exchange of market access concessions and/or transfers for enforcement of competition and disciplines on investment incentives and other state aids is feasible. How to structure such deals in practice and strengthen competition enforcement in the MENA region is an interesting area for research that could have significant payoffs.

6.2 Trade in goods

It would be useful to complete previous researches focusing on Arab trade along the line

of a deeper investigation of both obstacles to and outcomes of expanding such trade. Obstacles are mainly related to anti-export bias, real trade costs, safeguard clauses and lack of diversification. Outcomes include the traditional trade diversion and creation effects and the impacts on other aspects of integration (e.g. capital market).

Obstacles

The significant macro-economic reforms in the 1980s and 1990s only partly changed the economic incentives confronting firms. Both the tax incentive structure facing firms and the extent of border barriers (OTRI) continued to be a deterrent to both global and intra-regional trade and investment. For instance, in Egypt, firms continued facing an overvalued exchange rate, high tariff levels, high interest and high corporate tax rates. This means that trade liberalization did not go far enough to reverse decades of inward-looking import substituting industrialization strategies, and most MENA firms still did not find it attractive to export to other Arab countries or to the rest of the world (Galal and Fawzy, 2003).

Whether there is still a substantial anti-export bias is a question that could usefully be investigated. A recent global project on agricultural trade policy distortions suggests that the level of anti-agricultural bias has become less relative to manufactures (Anderson and Valenzuela, 2008).

In a similar vein research should exploit the new data being collected by Zarrouk on the “costs of crossing Arab borders” and the LPI and Doing Business databases to identify more specifically the relative importance of different sources of trade costs. Good examples of this type of analysis are Djankov, Freund and Cong (2006) and Sadikov (2007). This research can then inform the design of PTA disciplines and the potential areas for regional cooperation, recognizing that much of what may be required must be implemented by governments unilaterally. Dennis (2006) and Harb (2007) are examples of recent research in this area that focus on MENA. More work in this vein that explicitly ties into what can and what cannot be addressed via PTAs is needed.

Product standards are another source of real trade costs/restrictiveness. This is another area where there is only limited knowledge for MENA national regimes and the scope for regional cooperation (mutual recognition; harmonization to

international norms). For example, GCC members are in the process of unifying the standards and conformity assessment/certification systems. Some 2,700 standards have already been agreed by the GCC Standardization Organization, but enforcement to date is still on a country-by-country basis, that is, there is no mutual recognition and associated free circulation of goods. Much less is known about other PTAs, including the ones with the EU and US.

Types of relevant questions that could be explored include the following: What is the impact of existing national regimes in terms of trade costs (i.e., how high are the fixed and variable costs associated with different standards for different markets? How much scope is there for convergence towards/adoption of international norms? Does it make sense to move towards adoption of standards of major partner markets? What types of institutional, cooperative solutions relating to certification and conformity assessment of standards can be considered based on experience elsewhere?

Research that estimates and determines the effects of trade costs can help determine policy reforms that will promote greater diversification of Arab exports. Building on the theoretical insights by Melitz (2003), recent research has shown that lowering the fixed costs of contesting an export market is particularly important for smaller firms and new entrants – see for example, Chen and Mattoo (2008), Czubala, Shepherd and Wilson (2007); and Shepherd (2008).

Regional cooperation to reduce trade costs 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). This suggests one area for research is to design and create such “transparency mechanisms” in the region.

All PTAs have provisions allowing for the use of safeguard protection and instruments such as antidumping. Some countries in the region have become active users of antidumping (Egypt). There is increasing evidence that such instruments can play a useful role in dealing with political economy pressure for protection (Finger and Nogues, 2005). Research on the use of such instruments in the MENA context has been very limited. Given the importance of safeguards in other regions, both positive and normative focused research could help identify policies to support a process of deeper integration of Arab markets, both regionally and with the rest of the world.

Outcomes

More trade is not necessarily good from a welfare perspective. What matters is how much of what is observed is trade creation and how much is diversion? Not surprisingly empirical assessments of the impact of PTAs do not come to uniform conclusions. Much depends on the structure of before and after the formation of the PTA, on the pattern of comparative advantage, the size and composition of the PTA, etc. That said, many PTAs have been found to generate trade diversion (see Schiff and Winters (2003) and World Bank (2005) for surveys of the literature).

Very detailed analysis at the HS 6-digit level of desegregation (some 5,000 products) of the impact of the FTA between Canada and the US and the subsequent NAFTA by Romalis (2005) provides clear evidence of trade diversion. He shows that the greatest increases in US imports from Mexico occurred in items on which the US imposes the highest MFN tariffs, that is, those goods where NAFTA provides Mexico with the highest preferential tariff margins. A similar result obtains for Canada. While overall welfare effects of NAFTA for the US are small, one reason for this is the trade diversion, which results in higher prices of protected goods. Romalis (2005) also finds that volume effects are significant: NAFTA increases trade between Mexico and both Canada and the US by almost 25 percent. Thus, studies suggest that there may well be significant market access and terms of trade benefits for countries joining a PTA, as well as distributional effects – with consumers paying the costs of any trade diversion. Research of this type should also be undertaken for the case of PAFTA and the EU/US FTAs that

have been fully implemented.

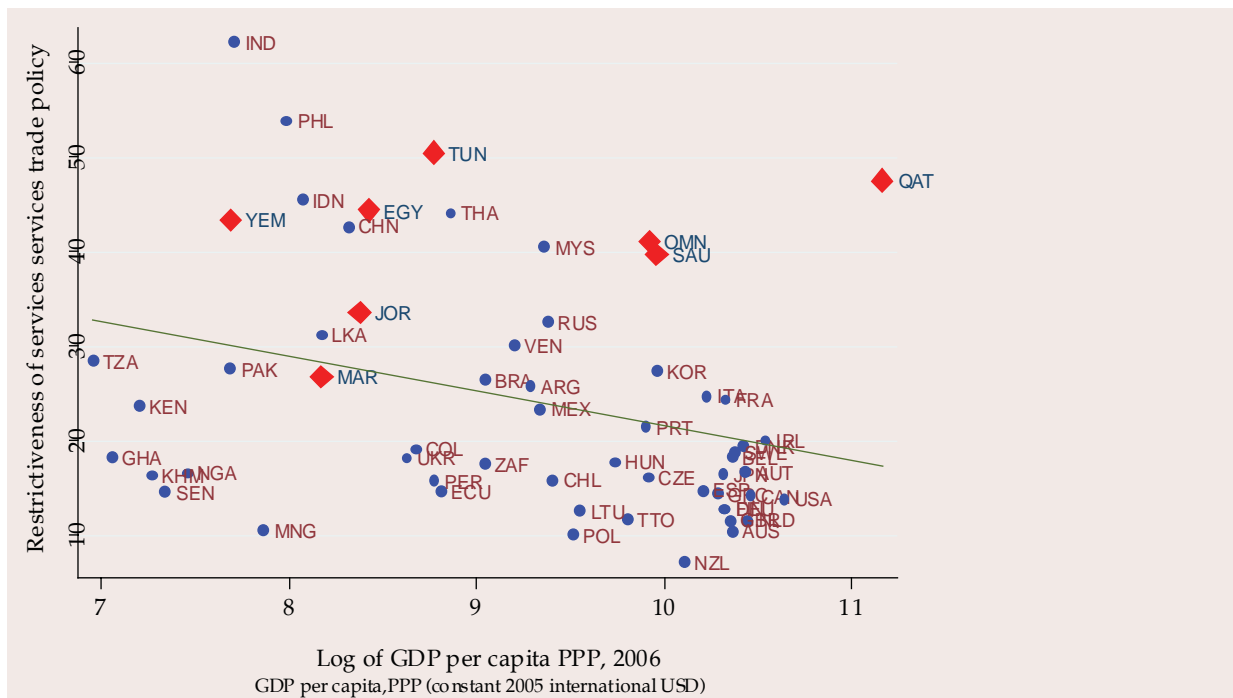
As noted above/below, assessments of welfare impacts of PTAs should also consider the impacts of reductions in real trade costs, the effects of greater FDI and more efficient and higher quality/lower cost services.

Clearly a narrow focus on merchandise trade is inadequate to assess the effects of PTAs. As, if not more important, are the impacts on investment and FDI, and the associated potential for the acquisition and diffusion of technology, and the extent and implications of the ‘deeper integration’ dimensions of PTAs. Many studies have found that ‘serious’ PTAs may encourage FDI inflows and that these in turn can generate positive productivity spillovers (Schiff and Winters, 2003). There is nothing automatic about such investment and spillover effects, however. The experience of some 20 developing countries between 1980 and 2000 illustrates that many PTAs have not led to significant new FDI inflows (World Bank, 2005). Conversely, Leshner and Miroudot (2007) conclude that investment provisions in PTAs do affect investment flows positively. No such work has been done for MENA.

Blanchard (2007) argues that FDI inflows attenuate the need to use PTAs to deal with terms of trade externalities. If firms are able to engage in FDI and do so, as more firms originating in any country-pair invest in each others markets, governments will have less incentive to manipulate tariffs and other policies in an effort to improve their terms of trade. The reason is that doing so, assuming it is feasible and effective, will benefit the foreign firms located in a host market as well as domestic firms. The greater the foreign (FDI) share, the lower the incentive of the government to use border policies, and the less need to use the reciprocity mechanism in trade negotiations. An implication is that the larger are two-way FDI stocks, the more inclined governments are likely to be to lock these in: there is little, if any, downside to doing so. Here also there is scope to explore this question empirically for MENA.

Research on the effects and impacts of BITs would also be useful. As noted above many countries have concluded BITs. Do they have an effect? Are there disputes? Egger and Pfaffermayr (2004) argue BITs have a significant impact on FDI – what is the case in MENA? What are the implications and what can be learned from the experience with

Figure 9
Restrictiveness of services trade policies, 2008



Source: Gootiz and Mattoo (2008).

BITs for the inclusion of investment disciplines in MENA PTAs?

6.3 Trade in services

More than 15 years ago Fischer (1993) argued that the region is already more integrated in terms of trade in services than trade in manufactures. As already discussed, research in this area should focus on better understanding and measuring the effects of current policies and the impacts of policy changes on prices and quality and variety of services available to firms and consumers, as well as net employment effects of policies/reforms. The limited tradability of services implies that FDI is an important avenue through which access to best practices and new services could be acquired. Given that many service activities are subject to investment restrictions (e.g., nationality requirements, restrictions on movement of personnel, limits on foreign equity shareholdings), 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. Although there has been a significant degree of reform since the late 1990s, a recent compilation of the policy regime pertaining to foreign supply of services suggests that Arab countries are among the most restrictive countries in the world (Figure 9). Levels of restrictiveness are particularly high for professional services (legal, accounting, etc.) and transport services (road, rail, maritime and air) (Figure 10).

Hoekman and Messerlin (2001, 2003) have argued that targeting service sector reforms could lower trade-related costs such as transport, logistics and other transaction costs as well as increase the variety of key inputs used by firms such as finance, telecommunications, etc. This may help counterbalancing competition pressures coming from trade liberalization. An expanding service sector will also generate employment opportunities for skilled and unskilled workers who are either unemployed or who are employed by government or by import-competing private manufacturing. Indeed, a political precondition for public

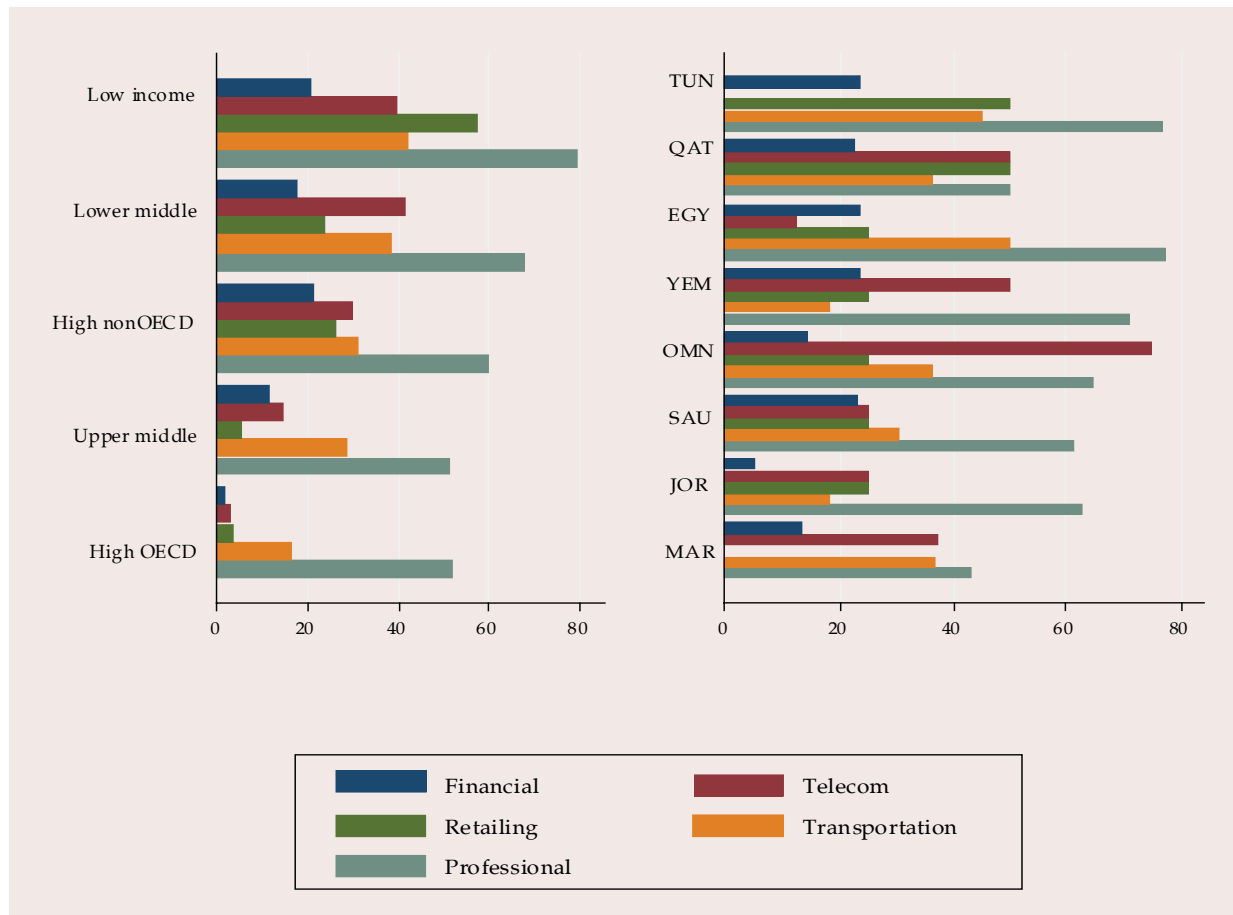
sector downsizing is that such alternative employment opportunities emerge. Fears of employment loss need to be addressed *ex ante* through the establishment of safety nets and transitional adjustment assistance, but what matters most is that employment opportunities are created elsewhere in the (regional) 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; whether it be services or goods-producing industries (Jensen, Rutherford and Tarr, 2008).

A central issue for research 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. A key question then is whether and how an Arab

integration-based effort to liberalize services can help to overcome national political constraints to reform. Economists often stress the potential role of PTAs as a mechanism to “lock-in” a reform path through pre-commitment to specific targets or outcomes. How can an Arab cooperation strategy help to address major political economy constraints that impede national (unilateral) reform?

One of these constraints 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

Figure 10. Restrictiveness of services policies: eight Arab countries



Source: Gootiiz and Mattoo (2008).

to pre-commit to actions aimed at reducing the role of the State. This implies the focus of analysis must be on government services as well as other services. Two interest groups play a major role in 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. What are the bureaucratic incentives confronting sectoral regulators? How high are the rents created by regulatory entry barriers? Who captures them? 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. How valid are these arguments in specific sectors/countries?

6.4 Movement of workers

The literature on migration concludes that the overall benefits from migration exceed the output loss and the cost of migrants' education incurred by home countries. The output loss in MENA countries is arguably small because of unemployment, migrants often are not highly educated and obtain training/skills while abroad, and the remittances sent back by migrants are a big positive for those who stay at home. Migration also reduces pressure in MENA labor markets. Research has shown that return migrants have new skills to apply and capital to invest (Fargues; 2006; Wahba, 2004; Ozden and Schiff, 2006).

Research questions here revolve around the design of formal cooperative frameworks to encourage and better manage (temporary) migration within the region and to non-Arab destinations. Concretely, research could focus on specific actions to increase the joint gains of freer movement of persons within the Arab world – through liberalization of temporary movement of services providers; mutual recognition of qualifications, credentials, and diplomas; greater competition in the provision of educational services within the

region to improve quality standards; the scope for cooperation among MENA countries with respect to international (extra-regional) labor movement (e.g., a common negotiating stance on labor movement issues in the WTO and with the EU); and the establishment of regional monitoring and transparency mechanisms to generate information on the functioning of MENA labor markets and cross-border flows of workers.

A more integrated MENA labor market requires that professional degrees and credentials be recognized throughout the region. To some extent this is already the case—e.g., the Convention on the Recognition of Studies, Diplomas and Degrees in Higher Education in the Arab States (adopted 1978; renewed in 2003) ensures that educational attainments are recognized. Moreover, the type of protectionist professional standards that are often found in industrialized countries and that aim to prevent foreign providers from contesting “their” market are less prevalent in Arab countries, reflecting initial weak bases of expertise in a wide variety of technical and professional fields.

Significant investments have been made by GCC countries to improve educational infrastructure, providing an opportunity to establish facilities within the GCC to provide specialized training to Arab workers, in partnership with either employment agencies and/or prospective employers to ensure that training is responsive to job/labor market requirements. Identifying one or more regional “hubs” for vocational and professional training could both exploit this existing capacity more fully and constitute a specific area in which other Arab countries and the GCC could cooperate to mutual advantage.

Given the sensitivity associated with the prospect of a large-scale expansion in migration to the labor scarce countries in and outside the region, in conjunction with continuing (indeed, rising) demand for foreign workers in these countries, suggests that research could also usefully focus on the design of cooperative arrangements that can partially substitute for longer-term movement of workers across borders and encourage more temporary two-way flows. Greater temporary labor inflows have a number of potential advantages: they will have little impact on the demographic profile of the host countries; generate fewer political costs/resistance while still addressing labor force needs in host countries; and attenuating brain drain losses as returnees bring back acquired

human and physical capital as well as transfers of remittances while they are employed abroad.

An obvious challenge is to ensure that temporary movement is indeed temporary. This is an area where research can have large payoffs: how can PTAs be designed to strengthen the incentives for temporariness both for employers and temporary entrants. Indeed, migrants may prefer staying in the host country if their income is higher than what they can earn in their home countries. Host country firms may also prefer to keep workers *ex post* due to turnover costs. The challenge is to design self-enforcing cooperation agreements that make temporary entry desirable to firms and workers *ex post*. The experience in a number of countries that have put in place successful temporary entry schemes point to the importance of cooperation between source and host country in enforcing the “rules of the game”. This suggests that the research focus should be on measures/actions that could be taken in PTAs to provide that MENA nationals will return once contracts expire. Possibilities are to increase the cost to host firms to retain workers by taxing them and/or by requiring them to deposit lump-sum payments into an escrow account that is refunded on return of workers.

While the importance of establishing temporary worker movement frameworks will vary across host countries depending on their willingness to accept longer-term residency of MENA nationals, a common concern across all host states relates to the skills and training of workers. Even if there were no restrictions on the movement of workers, labor market demand in labor scarce countries is increasingly shifting towards higher skilled labor. Even unskilled jobs increasingly require that workers are able to read, drive, operate electronic equipment, etc. This has potential implications for the design and delivery of vocational training and exploring options to encourage employment agencies to provide training to potential workers for specific types of contracts.

A final question: what is the relationship between trade and migration – are they complements or substitutes? Nassar and Ghoneim (2002) and Abdalla, Razgallah and Zarrouk (2007) make a start at addressing this question and conclude that they may be both: substitutes in the sense of pushing towards factor price equalization (wages) and complements in that more migration seems

to be associated with more bilateral trade. Much more can be done in this area.

6.5 Capital flows

The literature on capital flows splits into 2 branches: one focuses on their determinants and the other examines their impact. The available evidence suggests that capital inflows depend on traditional economic factors such as production costs and accessible markets (Agarwal, 1980 and Lucas, 1993), political and institutional risks (Schneider and Frey, 1985 and Wei, 2000) as well as on economic policy such as trade liberalization or exchange rate (Blomstrom and Kokko, 1997 and Goldberg and Kolstad, 1995). However, capital inflows seem not to depend much on incentives such as tax breaks or grants (Wheeler and Mody, 1992).

The available evidence on Arab countries is scarce. Research should assess the extent and evolution of capital flows to the region by origin (especially intra vs. extra Arab) type and industry. It should also analyze the determinants of capital flows to the region and whether the region is specific or not with respect to given determinants. Finally, examining the evolution of these determinants in the region and its reasons could help better target actions aiming at higher attractiveness of the region.

Regarding the impact of capital flows, the literature suggests that capital inflows might allow more efficient use of existing resources: e.g. De Gregorio (JDE, 1992), crowds-in domestic investment (Agosin and Mayer 2000) and stimulate the development and dispersion of technological skills provided adequate human capital is available (Borensztein et al., 1998). However, only few researches focused on Arab countries. We still know little about the type and destination (i.e. activity) of capital inflows that have, if any, a high impact on export diversification, technology dispersion, growth and poverty reduction in the region. Using bilateral sector data, one could investigate the impact of capital flows to the region on productivity, export, technology, employment and wages. At the same time, one or two case studies comparing the effectiveness of Free Processing Zones vs. more general incentives to attract capital (human capital, infrastructure etc.) should help better target policies.

6.6. Implementation

MENA countries have generally failed to seriously implement most PTAs. Fawzy (2003) argues that, on the political front, concerns over the distribution of gains from integration across and within countries, issues of national sovereignty, and the cost of adjustment resulting from increased competition, all constrained intra-MENA PTAs. Another limiting factor was a lack of mechanisms to compensate losers. On the economic front, Arab countries have not had sufficient incentives to integrate because of similar production structures sheltered by high levels of protection. Further, because they have had less hospitable investment environments, higher transaction costs and more restrictive entry rules than in comparator countries, intra-regional investment has also been limited.

The situation on the PTA front has now changed. There are a number of “serious” PTAs, including PAFTA, the GCC, and the FTAs with the EU and the US. Are they being implemented? What is the impact of implementation? Addressing these questions is clearly a priority area for any research effort on regionalism in MENA. However, it is important to start with a good understanding of the contents of the PTAs, that is, what do they require? What bodies have been established that are responsible for implementation? For example, although both investment and services trade are covered by the Common Market chapter of the 2001 GCC Economic Agreement (which requires that all GCC natural and legal persons be accorded the same treatment as nationals in any GCC country, without differentiation or discrimination) there are no specific disciplines or implementation bodies associated with the GCC treaty. Clearly mapping out what PTAs call for and whether they have created mechanisms to implement provisions is the first step. Monitoring what is done and assessing where possible the impacts of implementation on firms and households is the second step.

A major feature of PTAs in the region is that they are black boxes: very little is known by experts and the citizens who are affected. The research must be done in both a rigorous qualitative manner and through quantification of the impacts/incidence of specific PTAs. Significant value added could be created through a regular (annual) monitoring exercise in which each PTA

is assessed in terms of implementation and operation: what was done by the constituent governance bodies? What was on the agenda and what was decided? Were commitments implemented? Was there backsliding? An annual report that is widely disseminated to the press and discussed with stakeholders in the region could help raise the profile of/interest in the PTA agenda.

Political economy questions and sequencing of coverage

Increased internationalization of markets and technological advances put pressure on firms to seek greater efficiency through access to larger markets, foreign technologies and investment. PTAs can help realize these objectives if they provide cheaper access to intermediate inputs and facilitate the two-way cross border movement of intermediate goods for further processing. Nations that have formed successful PTAs in the post Second World War period have tended to have high levels of intra-industry trade, reflecting similar endowments and relatively high per capita income levels—e.g., the EU, EFTA, NAFTA and the Australia-New Zealand Closer Economic Relations (CER) agreement (Egger, Egger, and Greenaway, 2006).

The political opposition to liberalization that expands inter-industry trade may be stronger because industries that are less competitive than those abroad will generally be forced to contract substantially. In the case of intra-industry trade, adjustment is more at the firm- than at the industry level. Some firms in the industry will expand. High levels of intra-industry trade may generate pressures on PTA member governments to liberalize more generally to facilitate slicing up of production chains by national/regional firms. Over time, after removing border barriers on a preferential basis, the net benefits of a PTA may go to firms, especially if the rules of origin constrain (raise the costs of) global sourcing. This may lead firms to support external liberalization (Baldwin, 2006a, b).

Baldwin’s argument starts from the premise that at a given point in time, exporters see an interest in expanding access to locations where they can undertake parts of their product process. They could, therefore, put pressure on their government to negotiate a PTA. Another important part of the story is that the major players are the big markets

(e.g. the EU); so that one result of the process is a hub-and-spoke system of PTAs. This essentially consists of a set of bilateral trade agreements. Because a hub-and-spoke system involves separate agreements between the hub (e.g., the EU) and the spoke countries, there is scope to exclude “sensitive sectors” from the coverage of each bilateral agreement. Each spoke is likely to have comparative advantage in a somewhat different set of such sectors.

The political economy equilibrium that underpins hub-and-spoke ‘systems’ of PTAs began to break down as a result of technological change and increasing competition by China. Firms in Europe began to see an interest in further reducing the cost of production. One way this could be achieved was through reduction of the administrative costs of the hub-and-spoke system, in particular the associated rules of origin. One result was the adoption of the pan-European Cumulation System in 1997, under which any inputs sourced from any of the spokes or the EU member states counts for purposes of determining origin, and thus eligibility for duty-free treatment.

A precondition for this type of trade to increase in the MENA region or between MENA countries and the rest of the world is a reduction in both standard trade barriers and real trade costs; including the cost of services inputs. These have already been identified as areas for research. From a political economy perspective, the marked absence of significant intra-industry trade within the region and within existing PTAs suggests it may be difficult to rely on a “traditional” goods liberalization centric PTA strategy to integrate markets. Investigating the drivers of increased participation of Tunisian firms in European (and global) production chains could help identify policy initiatives that might be adopted in other MENA countries on a cooperative basis. But the more general implication of the political economy dynamics discussed above may be that MENA countries should consider alternative integration paths that rely more on services or on factor market integration.

Enforcement and dispute settlement

An important dimension of the implementation of PTAs is dispute settlement. This is a big missing element in MENA PTAs. In PAFTA, dispute settlement is non-binding. There is no panel system along NAFTA or WTO lines, let alone a

standing body as in the EU. No retaliation is allowed or foreseen. The EU FTAs are also weak in terms of enforcement. As a result, very little is known about disputes and how they are resolved. This may reduce the private sector’s perceived value of and interest in the PTAs. The matter goes beyond PTAs. What about BITs? What actually happens there?

The absence of information on disputes is with no doubt a reflection, at least in part, of the lack of awareness of the “rights and obligations” under a PTA. Better information on implementation strategies should improve matters. But even with better information the question is what firms and consumers can do to hold governments accountable. One question for research is what can be learned from other regions. Bown and Hoekman (2005, 2008) argue that PTAs need to be complemented by mechanisms through which firms can more easily (i.e., at lower cost) obtain information on potential violations of agreements and channels through which the behavior of government agencies can be contested directly by the private sector. Identifying specific proposals to do this in the context of MENA PTAs is yet another subject for research that could have high payoffs in enhancing the relevance and thus the “ownership” of PTAs.

Accession procedures and conditions

Accession procedures are an important issue for both non-members and members of PTAs. How PTAs can/should be linked to (major) non-Arab partners. The fact that GCC does not have an accession procedure has been a factor impeding efforts by Yemen to join the group (Alabdulrazzaq and Srinivasan, 2006; Chami, Elekdag and Tchakarov, 2004). More generally, there are questions associated with relative costs and benefits of PTA accession mechanisms for non-members. How such costs and benefits compare with accession to the WTO and whether and how the two complement each other. Work on these types of questions has either been qualitative (e.g., Kheir-El-Din and Ghoneim, 2006) or has simply assumed that accession is feasible. The latter route is implicitly taken in the CGE literature, which has concentrated mostly on analyzing the expansion of free trade from a bilateral PTA (e.g., EU-Egypt) to include other partners such as the US or PAFTA (e.g., Hoekman and Konan, 2003; 2005).

Notes

1. There are many papers describing/analyzing the structure of MENA economies and the resulting incentives for trade and regional integration. See, e.g., Safadi (1998), Havrylyshyn and Kunzel (2000); Nabli and De Kleine (2000); Hoekman and Messerlin (2003); Devlin and Page (2001) and Nugent and Youssef (2005).
2. Although these numbers are suggestive of a proliferation of PTAs, it is important to recognize that a large number of the PTAs notified to the GATT and WTO have involved prospective members of the EU and became irrelevant once the countries acceded to the EU. After the expansion of the EU by 10 new members in 2004, some 65 PTAs between these countries and the EU became redundant (Pomfret, 2007). Note also that the numbers overstate the prevalence of PTAs because separate notifications are required under the WTO for agreements that cover both goods and services – as many more recent vintage PTAs do.
3. PAFTA is often also called the Greater Arab FTA (GAFTA) in the literature.
4. Mostly of them were implemented. Some products were exempted, with Egypt linking liberalization of 'sensitive' items to effective enforcement of rules of origin.
5. Reduce trade diversion; reduce possible negative hub-and-spoke effects.
6. In case of the EU the integration process was driven by political objectives, not so much economic ones. This is reflected in the creation of supranational institutions that are not found in the Arab context where integration efforts have always been limited to inter-governmental cooperation.
7. The sum of the squares of the market share of each export item in total exports. The lower the index, the less concentrated exports are.
8. The index is defined as $IIT = 1 - [\sum \sum |X_{ijk} - M_{ijk}| / (X_{ijk} + M_{ijk})]$, 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 .
9. Conflict has been another element driving labor flows. The neighbors within the region have accommodated large flows of refugees from Sudan, Iraq, and Palestine. The Middle East accounts for a large share of global refugee flows.
10. The "trade intensity" index is defined as the share of one country's exports going to a partner as a share of world exports going to the partner: $TI_{ij} = [x_{ij}/X_{it}] \div [x_{wj}/X_{wt}]$ 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. A value above (below) unity indicates bilateral trade is larger (smaller) than expected given the partner country's importance in world trade.
11. The gravity model explains bilateral trade between two countries i and j , and posits that 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 : $T_{ij} = \alpha_i^{\beta_1} P_i^{\beta_2} Y_j^{\gamma_1} P_j^{\gamma_2} D_{ij}^{\delta}$ 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.
12. [Discuss how many of these papers disaggregate non-oil exports]
13. This survey is presently being updated by Jamel Zarrouk for the World Bank in a way that will allow comparison with the 2000 data and thus determination of countries/areas where progress has been made in recent years and where policy efforts should focus in the future.
14. Recent developments in the literature, focusing on brain drain suggested a positive effect on human capital formation in the origin country (Beine et al., 2001).
15. Conflict has been another element driving labor flows. The neighbors within the region have accommodated large flows of refugees from Sudan, Iraq, and Palestine. The Middle East accounts for a large share of global refugee flows.
16. Maghreb countries have traditionally sent migrants to the EU, paralleling the pattern of trade in goods and services, and reflecting both proximity and historical connections with France.

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