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EXTERNAL STUDY

Perspectives of economic integration in the Arab countries

Abstract: Arab economic integration is an old issue which has been addressed frequently on the regional political level without ever yielding the hoped-for results. This study will argue, however, that the patterns of integration in the Arab world have shifted n several ways in recent years, opening new opportunities for integration processes which are based more strongly on private initiative and non-trade exchange:

- First, the Gulf with its more powerful private sector has been playing the leading role in terms of regional trade and even more so FDI.
- Secondly, FDI seems to have overtaken trade as dynamic driver of integration.
- Thirdly, all across the region, business has been a stronger and more mature driver of integration than governments.

While objective economic reasons to integrate will never be as compelling as in the European case, at least economic elites in the Arab world seem to have developed considerable interest in a regional economic space.

New integration trends demand new policies which are less focused on traditional issues of tariff reduction, and more strongly on non-tariff trade barriers, integration of service markets and investment regulations. This is a tall order, but the returns in terms of reducing transaction costs and utilizing regional complementarities in terms of factor endowments are correspondingly larger.

It will be difficult to devise trans-regional policies from scratch, so that it will make political sense to draw on functioning sub-regional arrangements such as the Gulf Cooperation Council in order to spearhead some of the more demanding policies. Regional initiatives should by and large be based on the principle of "open regionalism", in which liberalization is coordinated regionally, but applied globally to all trade partners: As intra-Arab economic exchange will always be smaller than that within large trading blocs such as East Asia or Europe, building regional privileges could potentially lead to large inefficiencies.

Europe has a strong interest in economic stability and cooperation on its fragmented southern flank and can assist a reoriented and reinvigorated Arab economic integration in several ways: through defining a new, clearly benchmarked vision of regional service and FDI integration, through working more strongly towards a multilateralization of its Euromediterranean policies, through targeted assistance on a regional level, and through select, and stronger, incentives for region- (or sub-region) wide liberalization, with clear goals and follow-up mechanisms.

Europe has greater credibility and greater economic influence in the Arab world than any other economic bloc, and its expertise in coordinating regulatory reforms in different states is unrivalled. To unfold its full leverage, however, Europe will have to make more reciprocal trade concessions than it has thus far, and it will have to come to grips with the pivotal role of the GCC economies in the Arab world.

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Introduction

Arab economic integration as a regional policy has a long history of great ambitions but modest outcomes. Recent intergovernmental attempts at lowering trade barriers are a partial exception at best. One might argue that yet another study on the subject will have little to add to the rather pessimistic existing analyses of low regional trade, high non-tariff trade barriers (ntbs) and low value-added in regional manufacturing and intra-industry trade.

It is true that both present outcomes and future potential of an inter-governmental trade integration project is considerably smaller than it has been e.g. in the European realm. This study will however question how important that finding really is: a traditional paradigm of inter-state trade cooperation arguably is not what the Arab world needs the most urgently, and it is certainly not the field of economic integration which has witnessed the most dynamic developments in recent years – or which holds the most promise.

The following pages will show that cross-border service provision and foreign direct investment (FDI) driven by large, and increasingly mature private Arab companies are the most important trends of economic integration, with very significant potential for future growth. Governments should reassess their focus on trade policy and move towards service liberalization and regulatory cooperation in order to create more scope for private cross-border projects. Europe could play a very serious role in terms of technical cooperation and capacity-building in this area.

1. A brief history of integration attempts in the Arab world

As most other developing countries, the majority of Arab states have seen several decades of import substitution policies, saddling them with a legacy of high tariffs, heavy state intervention in production and, in many cases, uncompetitive industries. Due to the reluctance of governments to lose control over national industrial policy and fear of losing tariff income, regional attempts of economic integration have yielded modest results. Various regional and sub-regional agreements since the 1950s have aimed at liberalization of trade, capital, and labour flows, but hardly saw consistent follow-up and implementation. States have been reluctant to expose local industries to competition from often very similar industries in neighbouring countries or to yield any discretion over trade policy through binding regional agreements, not to speak of regional institutions.

In the late 1950s and the 1960s in particular, regional politics interfered in further attempts of integration. A 1964 blueprint for an Arab common market resulted in tariff reductions here and there, but never led to comprehensive liberalization. Private sectors were small and weak, while governments were engaged in heated ideological competition that hardly allowed for pragmatic cooperation on economic issues.

After a period of region-wide regime consolidation in the 1970s, Arab governments generally emerged as more stable, more pragmatic and less belligerent players. Will to forsake control over national economic policy was still lacking, however. A 1981 Arab League trade agreement lacked a cogent implementation timetable and followed "positive list" approach, in which every individual good the trade of which was to be liberalized had to be included in a generally agreed roster – a recipe for stalemate and infighting.

Perhaps due to the slow progress of regional initiatives, the Arab world has witnessed the conclusion of numerous bilateral and several sub-regional agreements, with various degrees of success.[1] Agreements have generally been concluded in reaction to political developments, and their most tangible components have usually been focused on traditional subjects such as tariff reductions, leaving out non-tariff trade barriers, trade in services, cross-border investment, common regulatory standards,

[1] Although bilaterals have helped to increase the trade between dyads such as Syrian and Lebanon, it is not clear whether they have increased overall economic integration due to trade diversion effects.

intellectual property issues etc. The most recent region-wide initiative, the 1997 Executive Program for Arab Free Trade that was signed by 17 of 22 member states of the Arab League, is no exception to this pattern (for more details, see below).

2. The growing importance of economic pragmatism: recent growth and the private sector's role

The relative stagnation on the political level needs to be contrasted with the dynamic developments on the level of private business, in particular during the last 6 years of augmented oil prices. To understand cross-border developments in regional business, we need to briefly discuss the general economic environment as it has presented itself in recent years. Table 1 below gives some basic aggregate figures on economic developments in Middle East and North Africa in recent years.

Table 1: Overview of MENA economic development – some aggregate figures

	1960	1970	1980	2000	2001	2002	2003	2004	Share in world total
Current account balance (% of GDP)	..	..	1,3	4,9	1,5	1,1	2,1	1,5	..
External debt, total (DOD, million US$)	..	4.822	64.482	145.225	142.993	151.383	161.162	163.934	..
FDI, net inflows (BoP, million US$)	..	111	1.456	4.145	3.394	3.712	5.599	5.340	0,85%
GDP (million US$)	..	..	..	447.482	449.621	439.469	483.413	547.496	1,33%
GDP growth (annual %)	..	..	-0,4	3,2	3,3	3,9	2,6	5,9	
Merchandise exports (million US$)	2.919	8.766	90.244	124.324	107.694	113.161	131.720	170.600	1,87%
Total reserves (includes gold, million US$)	1.565	3.735	49.046	65.316	76.946	90.055	119.189	140.020	3,34%

Source: World Bank Development Indicators

GDP growth rates between 3 and 6%, quickly growing foreign reserves as well as a gradually growing FDI stock make the economies of the Arab world look much more hopeful than during the gloomy 1990s. Both aggregate reserves and annual exports now are larger than aggregate international debt. The IMF reports 2005 real GDP growth in the Middle East at 5.9%, and estimates figures of 5.8% and 5.4% in 2006 and 2007. The Arab world currently goes through the second oil boom, as oil prices have reached levels comparable to the 1981 price peak. As important, they are likely to remain above at least 40 US$ for several years due to unprecedented capacity constraints in the upstream sector of the international oil market.

The boom appears to be more sustained and considerably better managed than the first one in the 1970s and early 1980s. Especially the governments on the Arabian Peninsula exhibit better management capacities and a much more cautious fiscal approach than a quarter of a decade ago. Less money is wasted, projects are more targeted, and more reserves are built up and managed in more sophisticated and diversified ways. All this augurs well for stable and sustained economic expansion, improvements in public services and the systematic removal of infrastructural bottlenecks.

The most important difference to the last boom however is arguably the role that private business plays in sustaining economic growth and in converting the psychological and, lately, fiscal boost of augmented oil prices into diversified growth. Large Arab companies – especially those based in the Gulf – have embarked on a rapid investment and expansion drive. Managerial expertise is much broader than 20 years ago, and private capital resources are huge thanks to decades of rent accumulation. Moreover, although expansionary budgets are welcome, large parts of the Gulf private sectors are much more independent from state contracts than they used to be, catering to private demand and contributing the majority share to national capital formation.

Crucial in our context, Arab capital which was mostly held abroad during the lean years of the 1980s and 1990s is increasingly invested regionally, often in cross-border ventures. Companies such as the UAE's Etisalat (telecoms) and Emaar (real estate) have initiated billion-dollar projects in neighbouring Arab countries, and large private investors from Kuwait and Saudi Arabia are setting up consortia for large investments in poorer Arab countries such as Syria, Sudan or Jordan.

3. Facts and figures

3.1 Trade balances and balances of payments

Before discussing which opportunities this opens for official regional cooperation and what the European role in this process might be, this study will give a more detailed overview of key figures reflecting the region's current position in the arena of international trade and investment, as well as structures of intra-regional trade and investment.

Thanks mostly to oil price developments, Arab exports have expanded spectacularly during the last six years, leading to a large trade surplus of the region in total (see tables 2 and 3). Balances of payment of most states – including non-oil exporters – have been looking healthy; debt and currency crises as witnessed in the 1980s and 1990s appear a distant prospect in most cases (see table 4).

Directions of trade have been gradually shifting over the years (see table 2). Most Arab exports have traditionally gone to importers outside of the region. Intra-Arab trade has roughly doubled its share in the overall trade of Arab states during the last two decades, however. Remarkably, the recent export boom has led to more than a tripling of intra-Arab trade between 2000 and 2005. At the same time, its share in overall trade still hovers around only 10%. In Asia, by comparison, intra-regional trade is about 40% of total trade.

3.1.1 Trade within the region

More than half of Arab trade tends to consist of the global commodity of oil, however, which means that the low figures are somewhat misleading. About a fifth of the total MENA non-oil trade is intra-regional, which is a more respectable score, comparable to that of regional groupings such as Mercosur in Latin America or the Association of Southeast Asian States.

Table 2: Middle East exports by region of destination (US$ '000)

	1980		2000		2005	
Middle East[2]	9.125.560	4,8%	15.428.300	5,8%	47.734.700	8,9%
Asia	23.643.200	12,5%	74.368.300	27,8%	157.684.000	29,5%
China (P.R.: Mainland)	298.964	0,2%	9.323.480	3,5%	29.262.900	5,5%
Developing Countries	45.945.600	24,3%	107.179.000	40,0%	244.568.000	45,8%
European Union	72.862.300	38,5%	56.858.700	21,2%	101.209.000	18,9%
United States	27.247.200	14,4%	36.388.600	13,6%	63.092.200	11,8%
World	189.246.000	100,0%	267.680.000	100,0%	534.437.000	100,0%

Source: calculated from IMF Directions of Trade data base

Table 3: Middle East imports by region of origin (US$ '000)

	1980		2000		2005	
Middle East	7.314.840	7,9%	14.888.500	8,6%	48.174.700	12,3%

[2] IMF statistics define the Middle East as containing Bahrain, Egypt, Iran, Iraq, Israel, Jordan, Kuwait, Lebanon, Libya, Oman, Qatar, Saudi Arabia, Syria, the UAE, West Bank/Gaza, and Yemen. This is not fully identical with the Arab world, but is more akin to a natural trading region. As we will see below, Maghreb states are hardly engaged in trade with "Middle Eastern" Arab states. In any case, intra-Arab trade figures strictly speaking are not been significantly different from intra-"Middle East" trade figures as per IMF definition.

Asia	7.867.590	8,5%	29.493.500	16,9%	87.276.000	22,2%
China,P.R.: Mainland	853.536	0,9%	5.856.650	3,4%	26.751.000	6,8%
Developing Countries	21.410.600	23,2%	60.493.200	34,7%	185.313.000	47,2%
European Union	38.612.800	41,8%	63.860.400	36,7%	132.932.000	33,9%
United States	12.065.500	13,1%	21.532.000	12,4%	36.682.600	9,3%
World	92.439.000	100,0%	174.118.000	100,0%	392.628.000	100,0%

Source: calculated from IMF Directions of Trade data base

Table 4: Arab current account balances (% of GDP)

	1980	2000	2001	2002	2003	2004
Algeria	0,59	..	..	..	..	..
Bahrain	6,00	10,41	2,86	-0,60	2,07	3,77
Egypt	-1,90	-0,95	-0,40	0,71	4,51	4,98
Jordan	9,44	0,70	-0,05	5,62	11,60	-0,16
Saudi Arabia	25,26	7,60	5,11	6,30	13,07	20,72
Kuwait	53,43	39,79	24,44	12,08	22,55	33,89
Libya	23,11	22,44	11,39	0,60	15,52	12,72
Mauritania	-18,79	..	..	..	..	..
Morocco	-7,47	-1,42	4,75	4,09	3,61	1,94
Oman	15,75	15,75	9,45	6,73	4,07	1,82
Somalia	-22,56	..	..	..	..	..
Sudan	-4,15	-4,25	-3,83	-6,33	-5,28	-3,88
Syria	1,92	5,88	6,28	7,10	3,53	0,88
Tunisia	-4,04	-4,22	-4,21	-3,55	-2,92	-1,97
Yemen	..	14,16	7,06	5,44	1,35	1,75

Source: World Bank Development Indicators

Although the Arab world has not seen industrial development on the scale of newly industrializing countries in Asia or Latin America, intra-regional trade is considerably more diversified than it was 20 years ago.[3] Mid-level manufacturing has grown in importance, and diversification and upgrading has taken place in sectors such as aluminium, machinery, and plastics. From the mid-80s to the mid-90s alone, non-oil exports in the region have doubled, with Tunisia, Egypt, and Morocco being particularly successful diversifiers.

Table 5 gives an overview of leading industrial products in regional trade other than crude oil. The strong role of oil- and gas-related products is not per se a bad sign, as it reflects the rational utilization of the region's comparative advantage in terms of its resource endowment, with a view to increasing value added through associated mid- and downstream industries.

Nevertheless, trade is still relatively concentrated in a limited number of goods for most countries, including non-oil exporters, indicating the relative narrowness of the industrial base. Value added often is limited, much manufacturing only consists of final assembly, and export competitiveness is frequently lacking. Industrial structures of neighbouring countries are often very similar, making for limited sub-regional complementarity.[4]

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[3] This is true regarding both measures of export diversification according to Standard International Trade Classification (SITC) and to the Herfindahl-Hirschman Index applied to traded goods.

[4] With the partial exceptions of Egypt, Tunisia, Morocco and the UAE, the importance of intra-industry trade in overall trade is still rather low, which indicates the absence of advanced production structures and a smooth regional division of labour. Sophisticated exports – i.e. medium- and high-technology exports – only accounted for 16% of the region's total exports in 2003, up from 10.7% in 1995.

Table 5: MENA – largest intra-regional trade by product, 2003

Rank	Product	Trade value (US$ billion)	Share of total intra-regional trade (%)
Source: UN Comtrade / Oxford Analytica			
1	Gas, natural and manufactured	1,589.0	12.1
2	Petroleum products, refined	594.9	4.5
3	Iron and steel bars, rods, angles, shapes	435.3	3.3
4	Petroleum oils, crude	425.8	3.2
5	Passenger motor cars, for transport	333.7	2.5
6	Vegetables, fresh, chilled, frozen/preserved	327.1	2.5
7	Tobacco, manufactured	313.8	2.4
8	Lime and cement	302.9	2.3
9	Ingots and other primary forms of iron	258.3	2.0
10	Fruit & nuts (excluding oil nuts)	255.1	1.9

Source: Oxford Analytica/UN Comtrade

While industrial structures are relatively similar in most cases, directions of trade differ greatly from country to country. Table 6 contains the export volumes of a number of important Arab countries broken down by region of destination. Smaller economies such as Jordan, Syria, and Lebanon tend to have a higher share of regional as compared to global exports. Political economists would expect this to undermine the political drive towards trade integration, as larger and more powerful players like Saudi Arabia can be expected to have a lesser economic interest in it.

In absolute terms, Saudi Arabia has by far the largest exports into the region, despite their small share in the kingdom's total exports. Conversely, six Arab countries send more than a fifth of their regional exports to Saudi Arabia, further underlining its pivotal role in the regional political economy (for a detailed country-by-country breakdown see annex). With the partial exception of Tunisia, North African countries are hardly integrated with the rest of the Arab world, warranting their analysis as a separate block (as practiced in IMF trade statistics). The Maghreb has a share of only 6.8% among total intra-Arab exports, whereas the shares of GCC and Mashreq countries are 60.6% and 29.5% respectively.

Table 6: Main international export destinations of select Arab countries (2005, in '000 US$)
(dominant shares above 30% are highlighted)

		Exporting country										
		Algeria	Egypt	Jordan	Kuwait	Lebanon	Libya	Morocco	Saudi Arabia	Syria	Tunisia	UAE
Export Destination	Asia	739.513	1.186.950	538.415	18.361.400	52.839	950.274	1.278.020	54.992.100	449.272	213.245	30.296.300
	(share in total)	1,7%	7,8%	13,7%	52,3%	2,4%	3,3%	9,1%	34,3%	3,1%	2,2%	32,3%
	Arab countries([5])	933.179	2.752.230	1.532.664	1.373.875	1.273.942	1.042.769	372.700	15.341.447	7.824.727	840.356	7.082.208
	(share in total)	2,2%	18,2%	39,1%	3,9%	57,8%	3,6%	2,7%	9,6%	64,2%	8,5%	7,6%
	EU	23.431.200	5.826.680	215.316	3.655.450	243.188	21.922.500	10.308.600	24.729.200	3.288.340	7.780.050	10.349.900
	(share in total)	54,4%	38,5%	5,5%	10,4%	11,0%	76,1%	73,6%	15,4%	22,9%	78,7%	11,0%
	United States	9.849.730	2.019.090	1.148.680	4.194.730	82.909	1.506.450	431.273	26.332.700	319.545	220.455	1.401.450
	(share in total)	22,9%	13,4%	29,3%	11,9%	3,8%	5,2%	3,1%	16,4%	2,2%	2,2%	1,5%
	World	43.081.300	15.121.000	3.915.830	35.128.000	2.204.350	28.806.600	14.003.800	160.310.000	12.193.100	9.879.850	93.778.300

Source: calculated from IMF Directions of Trade data base

[5] This includes Algeria, Bahrain, Djibouti, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, Qatar, Saudi Arabia, Somalia, Sudan, Syria, Tunisia, UAE, and Yemen. Although the Comoros are member of the Arab League, they were excluded due to their geographical position outside of the Middle East. The IMF Directions of Trade data base contains no data for the Palestinian territories.

Trade is moreover strongly clustered within sub-regions: 58.0% of the intra-Arab exports of the Gulf Cooperation Council (GCC) countries go to other GCC countries, and 57.2% of Maghreb trade is with other Maghreb countries (the comparatively high Arab share in Tunisian trade consists almost exclusively of trade with Algeria, Libya and Morocco). Mashreq countries have the most diversified intra-Arab export structures, with only one third of Mashreq Arab trade being with other Mashreq countries. There are several strong bilateral relationships in the Arab world such those between Syria and Lebanon, Jordan and Iraq, or Bahrain and Saudi Arabia.

Econometricians disagree on whether regional trade is too low, i.e. whether the potential for regional exchange is underexploited due to tariff and other obstacles. Depending on the model applied, current levels of trade are interpreted as just right or too low by up to 100% of current volumes. Considering the still considerable non-tariff trade barriers in the Arab world (see below), there is likely to be some further scope for trade integration, especially between the sub-regional blocs. At the same time, the modest share of the MENA region in global GDP – 1.33% in 2004 – and its intermediate level of technological development make the evolution of a high-powered trading bloc akin to the EU unlikely.

3.1.2 Trade with Europe

Indeed, for all large economies of the Arab world, extra-regional trade partners are more important than regional partners. There are however significant differences as to the direction of extra-regional exports. Table 6 shows that Europe is the dominant trading partner of Maghreb countries by a very wide margin, whereas Asia has become the most important destination of exports from the three biggest Gulf economies Saudi Arabia, Kuwait and UAE. Due to the structure of the European refining industry, EU crude oil imports come from North Africa rather than from the Gulf.

Europe still plays a very important role as exporter to the Gulf countries however, its share ranging between one quarter and more than one third (see table 7). Moreover, in 2004 it still imported marginally more *non-oil* products from the Middle East as defined by the WTO([6]) than Asian economies did (see annex). Its shares as both exporter and importer have been declining in favour of Asia, however.

The increasing Asian role in the Middle East is the most important secular trend in Arab trade, with the Asian share in total exports and imports increasing by about two and a half times between 1980 and 2004 to about a quarter (tables 2 and 3). This is not least the result of the very focused, somewhat mercantilist trade diplomacy of the Chinese government, which has been gaining ground especially in the GCC in recent years. The proactive and tightly coordinated Chinese approach in the Gulf stands in marked contrast to the dispersed and reactive policy of the EU towards the GCC states.

Table 7: Share of EU in total imports of Arab states (2005)

Algeria	61,0%
Bahrain	22,7%
Djibouti	12,1%
Egypt	34,4%
Iraq	16,8%
Jordan	26,5%
Kuwait	34,0%
Lebanon	42,6%
Libya	56,3%
Mauritania	48,6%
Morocco	52,1%
Oman	24,7%
Qatar	41,0%
Saudi Arabia	34,9%
Somalia	2,5%
Sudan	17,1%
Syria	21,6%
Tunisia	74,6%
UAE	33,8%

3.2 Foreign direct investment trends

While trade structures have been shifting relatively slowly in the Arab world, developments in foreign direct investment have been more dramatic. Table 8 shows that FDI levels in the Middle

[6] I.e. excluding North Africa.

East are still modest by global comparison, but have increased very rapidly since 2000 (again, 2005 figures are not available, but are likely to be significantly higher).

Table 8: Annual FDI inflows of Middle Eastern and North African states

	Percentage of world total				Millions of dollars
	1980	1990	2000	2004	2004
North Africa	*0,28*	*0,56*	*0,24*	*0,81*	*5.269,7*
Algeria	0,63	0,02	0,03	0,14	881,9
Egypt	0,99	0,35	0,09	0,19	1.253,3
Libyan Arab Jamahiriya	-1,98	0,08	0,01	0,02	131,4
Morocco	0,16	0,08	0,03	0,13	853,1
Sudan	0,02	-0,01	0,03	0,23	1.511,1
Tunisia	0,45	0,04	0,06	0,10	638,9
West Asia	*-5,89*	*0,22*	*0,27*	*1,52*	*9.840,0*
Bahrain	-0,76	-0,09	0,03	0,13	865,3
Iran, Islamic Republic of	0,15	-0,17	0,00	0,08	500,0
Iraq	0,00	0,00	0,00	0,05	300,0
Jordan	0,06	0,02	0,06	0,10	620,3
Kuwait	0,00	0,00	0,00	0,00	-20,0
Lebanon	-0,02	0,00	0,02	0,04	288,0
Oman	0,18	0,06	0,01	0,00	-18,2
Palestinian territory	..	..	0,00	..	..
Qatar	0,02	0,00	0,02	0,10	679,0
Saudi Arabia	-5,79	0,15	0,01	0,29	1.867,5
Syrian Arab Republic	0,00	0,03	0,09	0,19	1.206,0
Turkey	0,03	0,33	0,07	0,42	2.733,0
United Arab Emirates	0,18	-0,06	-0,04	0,13	840,0
Yemen	0,06	-0,06	0,00	0,00	-20,9
World	100,00	100,00	100,00	100,00	648.146,1
Developed economies	84,61	82,77	81,22	58,63	380.021,7
Developing economies	15,34	17,19	18,13	35,98	233.227,3
Developing economies excluding China	15,24	15,51	15,21	26,63	172.597,3
LDCs	0,97	0,28	0,27	1,65	10.702,1
Sub-Saharan Africa	0,47	0,80	0,47	2,21	14.331,8

Source: UNCTAD

Increased FDI reflects increased local and international confidence in Arab economies in the course of the recent oil boom and the way it is being managed – different from the last boom, which led to an import and service boom, but an outflow of capital, as the 1980 column in table 8 shows. The last three years have brought heightened international interest in the Gulf economies in particular, as extra-regional institutional investors and industrial players are slowly moving into markets that have seen a progressive erosion of national privileges and investment restrictions since the late 1990s.

Up-to-date FDI figures broken down by region of origin are available only for a few countries, but are nevertheless worth presenting due to the striking biases they reveal regarding both intra-Arab and European investment:

Table 9: FDI inflows by region of origin, select Arab countries (million US$)

	Global	EU	Arab
Morocco (2002)	533	389	68
Tunisia (2002)	821	546	164
Saudi Arabia (2004)	1867	92	1096

Source: UNCTAD, Saudi Arabian General Investment Authority

As one would expect, EU investors are strongly present in North African countries, where dyadic relationships between former colonial powers and their ex-colonies tend to predominate. Conversely, European investors are practically absent in Saudi Arabia, by far the most important economy in the Arab world, but one without deep and continuous historical links to Europe.

In the area of investment, the Arab world has seen stronger bottom-up integration than in trade, as private Arab investors have displayed a growing predilection for regional projects despite an often difficult regulatory environment. During the last decade, one third of regional investment was intra-Arab, and the share has almost certainly grown further in 2005 and 2006. With large capital reserves, growing surpluses and scepticism of Western investment destinations after 9/11, the gradually liberalizing region has gained new attractiveness for Gulf investors. Not surprisingly, Gulf capital plays the leading role in intra-Arab investment, much of it focused on real estate and service developments (which tend to have only limited impact on trade patterns). Private companies and independently managed, profit-oriented public companies dominate cross-border investment, resulting in projects which are based on economic rather than on symbolic or political criteria as often was the case with government-driven undertakings in the past.

An existing tradition of Gulf investment in the Mashreq has been considerably deepened in recent years. Investment happens in the sectors of industry, finance, telecoms and, in particular, tourism and real estate (for details see appendix). In all these sectors, regional champions have emerged, usually based in the Gulf. Local liberalization measures seem to have disproportionately benefited regional investors.

Moreover, large-scale Gulf investment in Maghreb countries has emerged as a new intra-regional phenomenon. It is of far greater importance than the still small trade between Maghreb and other Arab states, and targets telecoms and real estate/tourism in particular. Gulf money is also flowing into North African industry and utilities, although on a lesser scale. Gulf investors have moreover initiated tourism and transport infrastructure projects in poor and peripheral Arab countries such as Djibouti and Sudan, which are otherwise avoided by international investors.

With projects in the billion-dollar range, some of the enormous overseas capital resources of the Gulf bourgeoisie – estimated at 800 billion US$ or more – have clearly been unlocked in recent years. The repatriation of even small share of this wealth can make a big difference to regional capital formation. Although large investment projects are clustered in a limited number of sectors, they are likely to have a discernible impact on local economies.

Most of the largest Arab investment consortia and companies are now located in the Gulf, although they often have a considerable share of non-Gulf Arabs in their management. Some regional champions are also emerging outside of the Gulf, notably Egypt's Orascom Telecom. Arab investors in general seem to increasingly draw on their local skills (and sometimes personal and family linkages), allowing them to operate in relatively hostile investment environments in which large Western companies do not tread as easily.

3.3 Regional stock market trends

Growing regional FDI has been accompanied by an increasing integration of capital markets and portfolio investment across the region – once again a trend driven by market players rather than through top-down government policy. In early 2006, non-Jordanian investment was estimated to make up about 45% of Jordan's stock market capitalisation, with Gulf capital playing a leading role. Similarly, some 30% of the investment on the Egyptian stock market was estimated to be Gulf money, half of it Saudi. These shares have been fluctuating, and non-Gulf stock markets were affected by the slow-motion crash that GCC capital markets have seen since late 2005.

Nevertheless, the injection of Gulf capital has created new opportunities for start-ups and the creation of companies which operate on a regional level. For a while in 2005 and 2006, the capitalization of Gulf stock markets exceeded one trillion US$, reflecting the scale of available capital resources. An emerging regional private equity industry, a constant trickle of initial public offerings (IPOs) which are open to regional and international investors, as well as an increase in mergers and acquisitions all point towards the gradual integration of regional capital markets. The market corrections of the last 12 months have slowed the enthusiasm for speculative stocks and quick IPOs. They have not slowed regional economic growth however, as fundamentals remain positive, and are unlikely to stymie long-term trends of cross-border investment.

In trade and more so, investment terms, the Arab world today is best understood as a system that is increasingly centred around the Arabian Peninsula. The Mashreq countries have a tradition of relatively intense trading relations with the Gulf and have deepened their existing role as investment destination for Gulf capital. The Maghreb remains peripheral to Arab trade, but has recently emerged as an important investment location for Gulf money. Private investment has taken over official aid as main component of cross-border capital flows.

4. Intra-regional complementarities: factor endowments

We have mentioned above that industrial sectors of neighbouring Arab countries are often in competition rather than being complementary. Nonetheless, on the more fundamental level of factor endowments, the economies of the Arab world are highly complementary – as is borne out by recent investment trends: Whereas Gulf economies are rich in capital and rich in certain natural resources, Maghreb and Mashreq countries have large labour forces and natural resources which partially complement those of the Arabian Peninsula. Levels of technological development of different countries are roughly comparable, which is generally seen as conducive to the success of regional trading agreements.

Mashreq and Maghreb Arab labour is neither very cheap nor very highly skilled in global comparison. On a regional level, it can nonetheless clearly complement the large capital resources in the Arabian Peninsula, especially in services which are not globally tradable and which have boomed in recent years. Remittances of nationals working abroad (mostly in the Gulf) are up to one fifth of the GDP and half of exports of some Arab countries. With increasing cross-border investment, there is a chance of bringing together Gulf capital and non-Gulf labour outside of the Gulf, which will prevent brain drain and mitigate dependence on the labour import policies of GCC countries.

With the technological and managerial development of the oil- and gas-rich states of the Arab region, natural resources can also increasingly be used for a regional drive towards industrialization, buttressed by an emerging regional energy transport infrastructure (the Mediterranean being an ideal transport environment). The Arab world has genuine comparative advantage in petrochemicals and other heavy industries and is increasingly putting non-Arab competitors under pressure. World Bank research has shown that the revealed comparative advantage in a number of regional products is very high.

5. Existing integration projects: an evaluation

The recent trend of cross-border economic activity is all the more striking when seen contrasted with the relative stagnation on the level of inter-governmental policy integration in the Arab world.

5.1 Pan-Arab projects: GAFTA

The Greater Arab Free Trade Area (GAFTA) accord signed in 1997 stipulates an annual reduction of tariffs by 10%, reducing eventually in full liberalization of intra-Arab trade by 2007. It follows a negative list approach, i.e. tariffs are, in principle, automatically reduced for all goods as long as they are not included on a specific list. GAFTA is in principle designed to be WTO-compatible and also aims at liberalization of trade-related services, legislative coordination, common research and coordination of intellectual property standards. It does not include service liberalization per se, however.

GAFTA was to some extent a reaction to fears that bilateral Euro-Mediterranean agreements between the EU and individual Arab countries could create a hub-and-spoke system: a constellation in which markets are served from Europe rather than from within the Arab world, as bilaterals make it easier to deal with several markets at once from the European centre than from within the segmented Arab system.

Although tariff reductions have taken place, GAFTA has run into a number of implementation problems: Due to similar production structures, governments have requested too many exceptions in exactly the areas of manufacturing in which intra-Arab trade is likely to take place. Rules of origin which allow goods to be designated as originating within GAFTA have been loosely defined, which creates the danger of cheap Asian imports being only marginally modified and dumped on the Arab internal market – in turn potentially creating suspicion between trading partners.

With the exception of the GCC, Arab customs regimes are still rather restrictive on a range of manufactured products. Algeria, Tunisia, Egypt, and Morocco, which have some of the most advanced Arab industries, are by the same token rather protected markets. Tariffs as a share of state income are still relatively high in non-oil countries, making trade liberalization potentially costly:

Table 10: Share of customs income in overall state revenue (%)

Algeria (2002)	12.9
Bahrain (2004)	4.3
Jordan (2004)	11.3
Oman (2001)	2.8
Tunisia (2004)	7.2

Source: World Bank Development Indicators

Intra-Arab exporters have also had to cope with sometimes unpredictable and/or heavy non-tariff customs charges. This is closely related to the broader issue of non-tariff trade barriers, which remain considerable in most Arab countries: Intrusive and time-consuming inspection regimes, unnecessary or unusual product standards and documentation requirements tend to lift transaction costs in Arab trade above global averages. Exceptions like Dubai with its swift customs bureaucracy have not inspired comprehensive change elsewhere. Some GAFTA members are not yet in the WTO, further opening the door for non-tariff trade barriers.

Dealing with the nitty-gritty of non-tariff barriers remains elusive, as the Arab League relies on the Council of Ministers together with its small secretariat for GAFTA implementation, leaving the agreement without cogent mechanisms to resolve disputes and follow up on details. There still is little effective regional policy coordination, product and procedural standards are not coordinated, national competition policies, if extant at all, remain fragmented etc. Policy and administrative streamlining on the level of individual countries is a result of bilateral agreements with US or EU rather than of GAFTA. Although reform is happening, it remains too haphazard and uncoordinated, and a regional focus on service liberalization is lacking.

5.2 The Gulf Cooperation Council

The Arab League is politically heterogeneous and, with 22 members, a large organization. It has been argued that sub-regional agreements with a smaller number of more similar members will allow swifter and more comprehensive economic integration, which can subsequently be used as stepping-stone to trans-regional cooperation. The GCC is the most advanced sub-regional agreement which, within certain limits, bears out at least the first part of this argument. Although created in 1981 primarily for security reasons, the organization was from its inception also endowed with ambitious economic aims. These included trade liberalization, financial integration, labour mobility, and investment liberalization, in other words: full factor mobility among its members. A common external tariff was agreed upon, in principle, in 1981.

As we have seen, the GCC nowadays dominates the external trade of the Arab world and contains its largest economies. The relatively low proportion of intra-Arab exports in total GCC exports (8.2%) is mostly a function of its large global oil exports, as the high share (60.6%) of GCC exports in total intra-Arab exports shows. The relatively high share of intra-GCC exports among total GCC exports to Arab countries (58.0%) underlines the GCC's relative success in internal trade integration, as this trade consists to a lesser extent of fossil fuels than is the case between GCC and non-GCC Arab states.

The GCC has been relatively successful in terms of trade integration, creating labour and capital mobility, and setting common standards in various areas of regulation (such as professional accreditation). Cross-border capital flows and FDI within the GCC have been huge in recent years. In several areas such as investment, stock market participation, and government procurement, at least some of the GCC governments have extended national privileges to nationals of other GCC countries.

On the political and administrative level, several fundamental problems of GCC integration remain unsolved, however: The 2003 customs union is still not fully implemented, as GCC members request exceptions and bilateral agreements of the US with individual GCC states undermine the coherence of its external tariff regime. Certain non-tariff trade barriers remain, and national administrations often are slow in implementing long-agreed liberalization and standardization measures. Preparations for the 2010 GCC monetary union have been delayed, and political tensions between Saudi Arabia and its neighbours, particularly Qatar, could throw a spanner into the works of "deepening" the GCC. Nonetheless, it has been the most dynamic and remains the most promising sub-regional organization in the Arab world.

5.3 Arab Maghreb Union

The Arab Maghreb Union (AMU) is the only other still existing sub-regional integration scheme with a longer history, and its record is much less impressive than that of the GCC. The AMU was founded in 1989, but soon ran into political problems which prevented any of its significant aims from being established. Customs union and common market had been envisaged for 1995 and 2000 respectively, but have not materialized. As early as 1992, Morocco declined to take up the AMU presidency due to disagreements with Algeria (mostly on the Western Sahara issue), and the border between the two countries was closed.

There have been some bilateral agreements between AMU members, as e.g. between Tunisia and Morocoo, which have not been completely stalled politically. Altogether, however, the AMU as a region has been of lesser economic relevance to its members to start with, as the low share of intra-AMU exports in total AMU exports show (a mere 1.9%, despite the high share of intra-AMU exports among total exports to Arab countries).

The AMU has not yet recovered its political coherence. A May 2005 summit was postponed due to persistent disagreements on the Sahara issue. According to econometric research, there is potential for further trade integration among AMU members, and further infrastructure integration could unlock certain complementarities in terms of natural and human resources. Any substantial progress would require changes in the political situation, however. Even if the politics of the AMU should change fundamentally, the organization does not have the potential to function as kernel of Arab integration.

To summarize in brief, three main patterns are visible in the process of economic integration in the Arab world: First, the Gulf has been playing the leading role in terms of trade and even more so FDI. Secondly, all across the region, business has been a stronger driver of integration than governments. Thirdly, FDI seems to have overtaken trade as dynamic driver of integration. While objective economic reasons to integrate will never be as compelling as in Europe, at least economic elites seem to have developed considerable interest in a common Arab economic space.

6. Discussion: Which strategy for the EU towards Arab economic integration?

6.1 Pure economic vs. stability interests

In discussing aims of integration, it is necessary to clearly distinguish pure economic returns from broader political pay-offs. The latter will be discussed first.

The political rationale of any integration project will have to be more modest than the (contentious) eventual aim of "ever closer union" of the EU, and also more modest than the supranationalism already achieved in Europe. The Arab world is too underdeveloped, too dependent, too small, and politically too heterogeneous to become a tightly integrated economic powerhouse with independent political agency akin to the EU.

Nonetheless, the EU's underlying rationale of creating political stability and pressure for cooperation through economic interdependence can also be applied to the Arab world. Overall levels of intra-regional trade within the region will never be as high as in Europe, but at least within Mashreq and Gulf and between specific neighbours, they are already on a level at which governments can ill afford a political interruption of commerce. With further deepening of trade and integration between sub-regions, this rationale will be strengthened.

More importantly, growing levels of cross-border investment create a strong interest in stability and cooperation in the private sectors of the countries of origin and among the governments of receiving countries. Mashreq and Maghreb countries have been actively wooing Gulf investors; increasing levels of exchange on the levels of administration and business create networks of cooperation and lobbies for inter-governmental coordination. The more capital is anchored in neighbouring countries, the more service and capital markets are integrated, the more painful it will be to cease cooperation, and the more incentives there will be for further steps of integration. ASEAN and Mercosur – less ambitious creatures than the EU – arguably provide evidence for such processes.

The GCC should in this context be seen as an anchor of stability in the Arab world: Relatively weak in military terms, it has a vested interest in political calm, as it can then play out its economic muscle. In this sense, Arab economic integration can be "sold" rather well among GCC elites – something that EU strategies on the GCC, as far as existing, have not yet taken into account.

Payoffs of political stability can also accrue to the EU, which has been understandably concerned about the stability of its southern flank. The trade-offs of economic integration through Euromed agreements must not be seen in strictly economic terms, but should take into account important dividends in terms of mid-term stability and regional political influence. This means that unilateral concessions on agriculture and other protected sectors are easily justified by the political returns of Arab economic growth and integration. For the same reason, the EU should also be willing to invest more resources on assisting in the upgrading and reshaping of production structures, and in technical assistance to Arab governments, even if there are no immediate economic returns. Through this, it will put itself on the map as a collective actor in the Middle East – where nature and importance of the EU are often still misunderstood – and stake out a role which is different from that of the increasingly loathed US. A more united Arab region will also greatly facilitate future inter-governmental cooperation.

6.2 Paradigms of integration: trade integration or "deep" integration?

Both Arab League and sub-regional organizations are unlikely to acquire the wide-ranging supranational regulatory functions and responsibilities that EU organizations have acquired. At the same time, limiting common Arab economic policies to traditional trade integration appears an outmoded approach which is not in line with emerging economic realities in the region. Arab economic integration, even if mostly inter-governmental in nature, will have to focus on FDI and services head-on to maximize the returns from regional exchange.

Most of the recent intra-regional FDI has been not in manufacturing, but in services which can only partially be traded across borders and require a local commercial presence (tourism, real estate provision, finance, ICT etc.). Such FDI requires policies that transcend traditional trade rules of cross-border exchange and deal most of all with domestic regulatory structures, which are often still opaque and cumbersome. Arab economic integration should not least become a program for targeted bureaucratic reform and standardization. The scope of current FDI, which has grown despite administrative obstacles, indicates how large the gains in a more thoroughly liberalized regional environment could be.

Regional FDI policies will have to deal with standardization of investment regulations, dispute settlement and accounting procedures, as well as streamlined and non-discriminatory licensing. Policies on services – whether provided across borders or through FDI in situ – will have to be based on non-discrimination (e.g. in public procurement), principles of mutual recognition, regional standards, and a predictable legal environment for foreign actors. This will also help in moving the Arab world towards compliance with the WTO's General Agreement on Trade in Services (GATS).

Regional "regulatory economies of scale or scope" will reduce costs for regulators and, more so, for the regulated. Regional sharing of expertise and procedures will help national governments to upgrade their administrative capacities. For Arab companies it will reduce the great costs of dealing with intransparent national administrations. Mitigating regulatory fragmentation will further the emergence of regional champions.

Some sectors related to efficient cross-border exchange, such as distribution and retail, are still very fragmented in the region. Regulatory coordination will contribute to the "de-Balkanization" of the Arab world, which has already started in fields such as ICT and transport. Greater integration of "backbone services" (which also include finance, business services, telecoms, and electricity) can have strong spill-over effects in enabling companies in other sectors to smoothly operate across borders. Even in the area of trade proper, policies will have to be more focused on administrative reform and standardization and less on pure tariff reductions. The WTO offers extensive books of rules on ntbs which can be agreed upon regionally.

All such bureaucracy- and procedure-oriented reforms will also help to attract international investors, not least as they will be able to operate in a larger, integrated market (similar processes have occurred in ASEAN and Latin America e.g.). The gradual emergence of regional leaders in sectors such as ICT, transport, finance and contracting, some of them with substantial extra-regional investments, indicates that the Arab world can hold its own against international service providers. Service provision often requires extensive local skills, which makes integration in the common cultural space of the Arab world all the more promising.

Against the background of greater regulatory convergence, governments should also aim at the common provision of public goods such as education, training, research, and common regional infrastructure (shared projects are usually still limited to immediate neighbours). GCC money could play a crucial role here. Increasingly, the Arab private sector can also take over above-mentioned public tasks, and also certain types of regulation and licensing, as has already happened in some Gulf countries on the national level.

A smoother regional regulatory environment and integrated services will also reflect positively on trade, making intra-industry cooperation across borders easier. Thus, the differentiated factor endowment of the region can be put to full use, facilitating higher value-added, flexible production chains as has happened in Eastern Europe or East Asia. Industrial cooperation schemes of ASEAN might be taken as an example, in which manufacturing processes connecting different countries can be subject to special privileges. In countries which are not ready for wholesale liberalization, special investment zones should be considered as an option.

The steps outlined above should be kept in conformity with global (usually WTO) standards as far as possible, and only the most advanced steps of liberalization should be applied to regional companies only – the important principle is not to create regional privileges, but rather to coordinate reform regionally. Even if reforms cannot happen overnight, GATS pre-commitments could be used to boost credibility with investors in certain sectors (for detailed sector-by-sector discussion cf. Jenssen). Such “open regionalism” will boost efficiency and international competitiveness which are indispensable for long-term diversification.

The Arab world, although increasingly integrated in FDI terms, is too close to Europe to become an independent block of privilege. Conversely, the gigantic and very close European market offers a unique development opportunity for the Arab world, similar to what the US market has provided to Mexico through NAFTA in both trade and investment terms. If Arab production becomes flexible and responsive enough, it will be able to grab a much larger share of the European market currently served from faraway East Asia.

6.3 Potential economic gains of different types of integration

It is difficult to quantify the economic gains of the program outlined above. Studies have shown that in certain areas of manufacturing such as processed foods and fertilizers, intra-Arab trade can profitably replace imports from developed countries. Researchers also generally agree that the benefits of “deep” trade integration, i.e. of integration which addresses ntb issues rather than only tariffs, are more substantial.

A study by Denise Eby Konan on Egyptian-Tunisian trade integration shows that conventional trade liberalization through GAFTA together with Euromed agreements leads to growth effects of 3.03% and 0.01% of GDP respectively. The same program, but including the removal of ntbs, leads to growth effects of 7.71% and 2.74% respectively.

There is also a consensus that open regionalism (as in the above example) has much stronger growth effects than liberalization which is limited to the Arab world, as trade exchange with the outer world remains more substantial. In a 2006 study, Allen Dennis demonstrated that welfare gains of trade integration with the EU are at least twice as those of pure regional integration.

Growth effects of service and FDI integration are more difficult to model, but are likely to be very substantial. "Dynamic gains" through competition effects, technological upgrades, economies of scale etc. – not analyzed in conventional "comparative static" econometrics – are likely to be especially high in FDI and services. This is true in particular if competition with European companies is provided for (although this is also likely to be more disruptive to existing local business structures, see below). Free trade in the Euromed area is expected to yield static gains of around 2% of GDP, whereas dynamic effects of deep integration including services and FDI are estimated between 4 and 20% depending on the depth of integration (for a survey of econometric studies cf. SIA-EMFTA Consortium 2006).

7. Discussion: which policy instruments?

7.1 Regional policy instruments

"Deep integration", whether in trade or in services and FDI, requires more attention and perseverance than mere tariff reductions. How can the Arab world sustain such reforms?

First of all, awareness should be built that sooner or later, many of the kinds of reforms envisaged in this report will be forced on Arab countries by their more powerful trading partners anyway. It hence makes eminent sense to coordinate policies, determine timing locally, keep ownership over reform processes, and reduce intra-regional barriers rather than falling victim to hub-and-spoke structures. The Arab region, or its sub-regions, will be more potent actors in international negotiations if common positions can be found and implemented.

High-level political attention for non-tariff integration issues will be required, as it is administrative and political rather than pure economic interests which hold up regional integration. The danger of aiming at too many changes at the same time can be controlled by using external benchmarks, such as GATS standards, as far as possible in defining reform goals.

Administrative capacities of regional bodies will have to be augmented and funds injected accordingly. Solid reporting and supervision mechanisms are needed to follow up on implementation, and multilateral dispute-settlement mechanisms (as e.g. in the North American Free Trade Agreement NAFTA) should be considered. Currently too many members of the Arab League are not sticking to agreed rules and the decisions of the economic and social committees. Regional summits should be more clearly focused on milestones and clear timetables of integration.

The European experience also shows that clearly defined ultimate targets of integration must be set; currently the economic policies of the Arab League are piecemeal and grand targets diffuse. The credibility of commitments can be increased through comprehensive and public reporting obligations, quantification of targets and the use of clear and internationally accepted benchmarks. Independent regional bodies could be created for administrative reform and/or reform benchmarking. Follow-up mechanisms in other regional agreements should be studied.

Arab agreements could help to accelerate some national reforms, similar to what has been achieved in the EU on a larger scale. A publicly visible locking in of reform commitments can enhance the credibility of a region as investment destination, as happened in Southeast Asia. Stronger participation of the increasingly mature Arab private sector in regional policy coordination can further improve the quality of implementation, especially when it comes to details of bureaucratic reform.

A tradition of regulatory cooperation can emerge only gradually, as Arab administrations are often fragmented and inward-looking. It is therefore crucial that powerful institutional bridgeheads are built by political leaders in specific policy areas (e.g. customs administration, product standards or capital markets regulation). Intermediate steps of cooperation can be taken through information-sharing and twinning programs between bureaucracies.

Although economically sub-optimal, it seems politically necessary to tackle some of the more demanding reforms on a sub-regional level, where stronger traditions of exchange usually exist between private sectors and sometimes between governments. Once advanced reforms have been tried and tested in the laboratory of the GCC e.g., they could be generalized on the Arab League level. In some cases, sub-regional bodies might be the right channels to implement and follow up on region-wide agreements.

Provisions for sub-regional triangles or quadrangles of deeper cooperation as in Southeast Asia should be considered. Clear timetables for regionalizing and internationalizing reforms should be set, however, and sub-regional initiatives should only be concerned with reforms that clearly go beyond general WTO and GATS rules (such as e.g. regional competition policies or full electricity sector liberalization). On the regional level, it should be possible for less administratively advanced countries such as Libya, Sudan or Syria to opt out of specific clauses of reform agreements, whereas smaller groups of advanced countries could go for deeper integration ("multiple speeds").

7.2 European policy instruments

What should be the EU's role in supporting "deep" Arab economic integration? The scope of the existing Euromed agreements (EMAs) with 8 Mediterranean Arab countries in principle extends to services, capital markets and competition. Progress on deepening agreements beyond trade has been slow, however, and deadlines for services negotiations with Tunisia and Morocco have already been missed. Although the EU has provided some institutional support on judicial upgrades and public sector reform in specific countries, those have been rather demand-driven, hence differ from country to country, and are not based on a common vision of regulatory reform.

The current bilateral structure of Euromed does moreover lead to the above-mentioned danger of a hub and spoke system. The EU aims at multilateralization of EMAs into a Euromediterranean Free Trade Area (EMFTA) by 2010, but the main focus of cooperation so far has been bilateral, and the deadline has been slipping towards 2015. Needless to say, EMFTA extends to trade in goods only. It is in services and FDI, however, that a regional vision is the most compelling, with both EU and Arab countries profiting substantially.

There is need for a new vision of European economic policy towards the Arab world, and for renewed high-level commitment to tangible policy goals beyond trade. The EU should think about stronger cooperation with sub-regional groups or at least aiding partial multilateralization of EMAs in the process of implementation (e.g. through the full implementation of standardized cumulation of rules of origin in regional goods). Soft pressure towards these aims should be acceptable for most Arab countries. From 1995 to 2003, the EU committed 5.5 billion Euros in Euromed cooperation programmes, projects and other supporting activities, but regional activities comprised only around 15% of this budget. Policies in general have been too demand-driven, too bilateralized and fragmented, and too little focused on the most promising areas: regional service and FDI liberalization.

Considering the growing importance of the Arab world for European security, support levels should be further augmented and support refocused towards a coherent vision. It will not always be easy to convince Arab governments of the virtues of liberalization, but at the same time, the EU has not yet used the full incentives and leverage it could have towards the Arab world – not least as the essential issue of agriculture has not been dealt with adequately through EMAs. Europe could gain enormous credibility if it offered real reciprocity in this field instead of demanding liberalization in only the sectors in which it enjoys comparative advantage.[7] Another substantial European bargaining chip could be increased mobility for qualified labour from Arab countries. Making real concessions will greatly boost the EU's credibility and its capacity to make conditional demands on more difficult service and FDI liberalization.

Currently, European debts of Arab countries are usually much higher than any assistance the EU is willing to offer. Aid and debt should be addressed together comprehensively in the EMA framework. Although liberalization tends to lead to aggregate welfare gains, it produces losers in specific sectors, whom the EU – benefiting from liberalized markets – should assist in adjusting to economic restructuring (for details, cf. SIA-EMFTA Consortium 2006). The EU has extensive experience with such policies.

It would be in the EU's self-interest to invest more resources in local upgrading programs in the Arab world as a contribution to ever-more urgent regional stability and prosperity. Institutions have emerged as the main problem of Arab economic integration in this paper. EU institutions have considerable experience in guiding legal and regulatory reform and appear ideally placed to help in building standards and capacities – particularly on the thus far neglected sub-regional and regional levels. More resources could be devoted to regional projects instead of bilateral undertakings inspired by dyadic relations of former colonial powers.

Additional assistance programs could be offered for quicker reformers, and benchmarking systems similar to those used in the process of EU expansion could be used to evaluate progress, working towards a partial southward expansion of the European single market. In working towards regulatory reform, it will however be important not to apply an EU-centric "one size fits all" rule: Applying EU regulatory standards could create prohibitive costs for less developed Arab countries. Procedures need to be adjusted to given levels of development, and often limited regulatory convergence suffices to guarantee globally accepted standards.

Enhanced European support could include twinning programs between national and supranational European institutions on the one hand and Arab institutions on the other, regionally coordinated support for administrative reform, partnership with regional private sector players in building self-regulation and trade-related service capacities, and assistance in building new (sub-)regional agencies focused on services, FDI, administrative reform etc. Approaches such as "EuroMed market" or "EuroMed Quality" to support partner country administrations' understanding of EU standards should be expanded. Many of the policies required are domestic in nature, but at the same a regional vision will help greatly to "lock in" commitments and give clear benchmarks and incentives for integration.

8. Taking into account the pivotal role of the Gulf economies

From a regional Arab perspective, the biggest problem of the EMFTA project might be that it excludes the Gulf, which is emerging as pivot of the regional Arab economy. The GCC is a crucial geo-economic region in its own right in which the EU has been hardly present as collective actor. In our context, the GCC countries have considerable leverage over Arab policies and are the main sources of FDI in the region. They have a strong interest in liberalization of the rest of the Arab world and should therefore be seen as natural partners of the EU in assisting Arab economic reform and integration. Although capital flows from GCC to other Arab countries are largely one-way, they are welcome thanks to their domestic employment effects and the fact that they do not bring along as strong displacement effects as trade.

[7] Capital market, service, and competition policy are areas in which reform can be costly for Arab countries, but does not endanger more advanced Europe.

The GCC is increasingly focusing on cooperation with neighbouring countries, eager to play a leading role in the region and strongly oriented towards the EU as paradigm of economic integration. As it is a more solid institution than any other Arab body, common projects with the EU are easily conceivable, concerning e.g. service and capital market integration, competition policies, infrastructure development, and cooperation with poor neighbouring states. This could set both precedents of multilateral cooperation and serve as a stepping stone for region-wide cooperation.

EU and GCC have recently appeared to approach the conclusion of a free trade agreement, which has been in the making for many years. This will be an essential foundation for further institutional cooperation. Even if the GCC remains an imperfect entity, it is still the best bet the EU has for multilateral cooperation in the Arab world, and the most liberal sub-region. Attention for and will to cooperate with the Gulf have clearly been lacking in Europe, while emerging international actors like China have been devoting very high-level attention to the GCC – and were received with open arms. By comparison, the EU's protectionist instincts regarding its own heavy industries and its apparent attempts to introduce new demands at a late stage of FTA negotiations have not endeared it to the GCC. Still, the EU plays an important function as role model for GCC projects like the common currency, and EU willingness to operate on a multilateral level – different from the US, whose policies are undercutting the GCC – is well appreciated. If there is a future in EU cooperation with Arab multilateral bodies, it is likely to begin with the GCC.

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- Extensive bibliography available on request -

Data Appendix

Table A.1: Trade shares over time

		1980	1985	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Middle East	Africa	1,4	1,8	2,1	2,5	2,2	2,6	3,2	2,2	3,2	3,2	3,2	3,2	3,3	3,4
	Asia	12,5	13,4	14,2	20,8	24,9	26,6	23,5	26,8	27,8	27,6	27,0	27,9	27,5	29,5
	Developing Countries	24,3	32,5	32,6	36,5	39,4	41,3	40,2	40,4	40,0	41,6	42,1	42,1	44,0	45,8
	Industrial Countries	73,8	60,7	61,2	50,8	52,5	51,9	52,2	52,3	53,3	51,2	50,0	50,0	48,6	47,1
	Middle East	4,8	6,5	8,2	8,1	7,5	7,6	9,3	7,8	5,8	7,3	8,3	7,3	9,0	8,9

Source: IMF Directions of Trade

Table A.2: Merchandise exports of the Middle East(*) by major product group and main destination, 2004 (billion US$, %)

	Value	Share		Annual percentage change			
	2004	2000	2004	2000-04	2002	2003	2004
Total merchandise							
World	389,7	100,0	100,0	10	5	20	29
Asia	193,0	51,5	49,5	9	-4	28	28
Europe	64,0	18,9	16,4	6	-4	19	30
North America	55,1	15,6	14,1	7	-7	23	22
Intra-Middle East	21,5	5,6	5,5	10	27	7	...
Fuels and mining products							
World	290,9	100,0	100,0	9	0	24	32
Asia	170,9	61,3	58,7	8	-6	29	27
Europe	40,3	16,5	13,9	4	-6	21	31
North America	36,3	12,2	12,5	10	-12	33	29
Manufactures							
World	86,1	100,0	100,0	13	21	11	22
Europe	20,7	27,2	24,0	9	-1	16	29
Asia	20,0	19,2	23,2	18	11	24	34
North America	17,2	28,9	19,9	3	2	7	10
Intra-Middle East	14,1	14,6	16,4	16	49	10	...
Agricultural products							
World	9,3	100,0	100,0	11	28	2	11

Source: WTO

* "Middle East" according to the WTO definition excludes North African countries

Table A.3: FDI inflow and inward stocks of Arab countries, Iran and Turkey

		Percentage of world total							Millions of dollars
		1980	1990	2000	2001	2002	2003	2004	2004
ECONOMY									
North Africa	FDI inflows	0,28	0,56	0,24	0,66	0,54	0,83	0,81	5.269,7
	FDI stock	2,24	1,39	0,77	0,79	0,81	0,80	0,79	70.213,2
Algeria	FDI inflows	0,63	0,02	0,03	0,14	0,15	0,10	0,14	881,9
	FDI stock	0,29	0,09	0,06	0,08	0,09	0,08	0,08	7.423,3
Egypt	FDI inflows	0,99	0,35	0,09	0,06	0,09	0,04	0,19	1.253,3
	FDI stock	0,43	0,62	0,32	0,30	0,29	0,25	0,23	20.901,6
Libya	FDI inflows	-1,98	0,08	0,01	-0,02	0,02	0,02	0,02	131,4
	FDI stock	0,35	0,04	0,01	0,01	0,01	0,01	0,01	758,1
Morocco	FDI inflows	0,16	0,08	0,03	0,34	0,07	0,37	0,13	853,1
	FDI stock	0,54	0,20	0,15	0,19	0,18	0,21	0,20	17.959,3
Sudan	FDI inflows	0,02	-0,01	0,03	0,07	0,10	0,21	0,23	1.511,1
	FDI stock	0,01	0,00	0,02	0,03	0,04	0,05	0,06	5.545,2
Tunisia	FDI inflows	0,45	0,04	0,06	0,06	0,11	0,09	0,10	638,9
	FDI stock	0,63	0,43	0,20	0,19	0,21	0,20	0,20	17.625,8
West Asia	FDI inflows	-5,89	0,22	0,27	0,86	0,79	1,03	1,52	9.840,0
	FDI stock	0,12	1,81	1,11	1,11	1,08	1,13	1,12	100.141,4
Bahrain	FDI inflows	-0,76	-0,09	0,03	0,01	0,03	0,08	0,13	865,3
	FDI stock	0,01	0,03	0,10	0,10	0,09	0,08	0,09	7.585,3
Iran	FDI inflows	0,15	-0,17	0,00	0,01	0,08	0,08	0,08	500,0
	FDI stock	0,56	0,12	0,04	0,04	0,05	0,04	0,05	4.065,1
Iraq	FDI inflows	0,00	0,00	0,00	0,00	0,00	0,00	0,05	300,0
	FDI stock	***	***	***	***	***	***	0,00	273,0
Jordan	FDI inflows	0,06	0,02	0,06	0,01	0,01	0,07	0,10	620,3
	FDI stock	0,03	0,03	0,04	0,04	0,04	0,04	0,04	3.500,7
Kuwait	FDI inflows	0,00	0,00	0,00	-0,02	0,00	-0,01	0,00	-20,0
	FDI stock	0,01	0,00	0,01	0,01	0,01	0,01	0,00	381,3
Lebanon	FDI inflows	-0,02	0,00	0,02	0,03	0,04	0,06	0,04	288,0
	FDI stock	0,00	0,00	0,02	0,02	0,02	0,02	0,03	2.268,6
Oman	FDI inflows	0,18	0,06	0,01	0,05	0,00	0,08	0,00	-18,2
	FDI stock	0,09	0,10	0,04	0,05	0,04	0,04	0,04	3.432,3
Palestinian territory	FDI inflows	..	..	0,00	0,00	0,00	..	..	..
	FDI stock	..	..	0,02	0,02	0,01	0,01	0,01	946,9
Qatar	FDI inflows	0,02	0,00	0,02	0,04	0,09	0,10	0,10	679,0
	FDI stock	0,02	0,00	0,03	0,04	0,04	0,04	0,05	4.143,5
Saudi Arabia	FDI inflows	-5,79	0,15	0,01	0,06	0,06	0,12	0,29	1.867,5
	FDI stock	***	0,82	0,29	0,28	0,27	0,23	0,23	20.454,0
Syria	FDI inflows	0,00	0,03	0,09	0,11	0,14	0,17	0,19	1.206,0
	FDI stock	0,00	0,02	0,14	0,15	0,15	0,14	0,14	12.490,6
Turkey	FDI inflows	0,03	0,33	0,07	0,40	0,15	0,28	0,42	2.733,0
	FDI stock	1,67	0,63	0,33	0,32	0,28	0,41	0,40	35.188,0
UAE	FDI inflows	0,18	-0,06	-0,04	0,14	0,18	0,00	0,13	840,0
	FDI stock	0,08	0,04	0,02	0,04	0,05	0,04	0,05	4.422,3
Yemen	FDI inflows	0,06	-0,06	0,00	0,02	0,01	0,00	0,00	-20,9
	FDI stock	0,04	0,01	0,02	0,02	0,02	0,01	0,01	989,8
Developing economies	FDI inflows	15,34	17,19	18,13	26,38	21,72	26,29	35,98	233.227,3
	FDI stock	24,90	20,58	30,07	29,54	26,32	25,14	25,08	2.232.867,8
Dev. Ec. excluding China	FDI inflows	15,24	15,51	15,21	20,70	14,35	17,84	26,63	172.597,3
	FDI stock	24,70	19,41	26,73	26,27	23,09	22,28	22,32	1.987.400,8
LDCs	FDI inflows	0,97	0,28	0,27	0,83	0,88	1,64	1,65	10.702,1
	FDI stock	0,87	0,53	0,66	0,73	0,77	0,77	0,81	71.952,5
Developed economies	FDI inflows	84,61	82,77	81,22	72,20	76,49	69,90	58,63	380.021,7
	FDI stock	75,10	79,41	68,72	68,82	71,76	72,82	72,68	6.469.832,3
World	FDI inflows	100	100	100	100	100	100	100	648.146,1
	FDI stock	100	100	100	100	100	100	100	8.902.153,5

Source: UNCTAD

Box A.1 Gulf investment in the non-Gulf Arab world: some project examples

Gulf investment in the Mashreq countries has boomed in recent years, covering:

- *Industrial projects*, especially in the relatively advanced Egyptian manufacturing sector, e.g. by the Saudi Al-Zamil group, and the Kuwaiti Khorafi group. Projects currently in the pipe include a Kuwaiti-Saudi refinery for 1 billion US$ in Egypt, a 230 million US$ Kuwaiti cement project in Jordan.
- *Tourism and real estate projects*: Regional real estate leader Emaar is about to develop a 4 billion US$ commercial and recreation community in Egypt called Cairo Hills. The 1 billion US$ Royal Metropolis project in Jordan is also financed mostly through Gulf investment companies. Saudi Oger and Jordanian real estate company Mawared are executing another 1 billion US$ urban regeneration project in Amman, in which Kuwait Projects Company (KIPCO) has a 400 million US$ share. Even "difficult" Syria is about to see the development of large Gulf-financed tourism ventures, with Emaar reportedly planning a 4 billion US$ project.

Further investment is happening in telecoms, with regional champions such as Kuwaiti MTC and the UAE's Etisalat bidding for fixed and mobile network licenses in neighbouring countries. Banking has also seen some cross-border investment, e.g. in the form of Lebanese and Saudi ventures in the previously closed Syrian market.

Unprecedented Gulf investment in the Maghreb includes the following projects:

- The UAE's Emaar has started half a dozen large tourism and realty projects in Morocco. Together with Dubai International Properties, a subsidiary of Dubai Holdings, it has committed more than 9 billion US$ of investment over the next 10 years. In April, Emaar Properties also announced plans to develop the 1.9 billion US$ "Al-Qussor" project on Tunisia's eastern coastline. Similar projects have recently been envisaged for Libya and Algeria, countries which are often considered as too unpredictable and bureaucratic for Western investors.
- A consortium of Dubai's Tecom and Dubai Investment won a tender for shares in Tunisie Telecom this year. The group paid 2.25 billion US$ for a 35% stake in the company, which holds a fixed-line monopoly and competes against Tunisiana for mobile customers – a joint venture of Kuwait's Wataniya and Egypt's Orascom. Wataniya is also present in Algeria, where it runs the mobile phone service Nedjma.

There is a speculative element specifically in some of the realty projects, but prospects for regional tourism and real estate development appear good in general, not least as rich (and increasingly richer) Arabs are more and more looking for tourism opportunities and second residences in Arab Muslim countries.