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WP/98/116

INTERNATIONAL MONETARY FUND

Middle Eastern Department

**Impact of European Union Association Agreements on Mediterranean Countries**

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August 1998

**Abstract**

By establishing free trade for industrial products in 12 years, the European Union's Association Agreements with countries in the Mediterranean region seek to promote accelerated economic growth. This paper reviews the literature and evaluates the economic benefits and costs for Tunisia, Morocco, Lebanon, Egypt, and Jordan. It concludes that the benefits could be substantial, but only if accompanied by deep supplementary reforms, including extending trade liberalization to services and agriculture and on a multilateral basis, improving the environment for foreign direct investment, ensuring an adequate fiscal and exchange rate policy response, and strengthening European Union assistance.

JEL Classification Numbers: F13, F15, O19

Keywords: European Union, Trade liberalization, Mediterranean countries

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<sup>1</sup>This paper is based on the author's presentation given at the IMF/European Union Seminar held in Brussels on April 2–3, 1998. I wish to thank Paul Chabrier, Saleh Nsouli, Karim Nashashibi, Klaus Enders, Patricia Alonso-Gamo, and participants in the seminar for helpful comments and suggestions.

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## SUMMARY

By establishing free trade for industrial products over 12 years, the European Union's Association Agreements with countries of the southern and eastern Mediterranean seek to promote accelerated economic growth. For Tunisia, the static benefits of improved resource allocation and the dynamic gains from greater efficiency have been projected to eventually exceed 4 percent of GDP. The agreement is also expected to encourage foreign investment. But the loss of import tax proceeds requires compensating fiscal measures, and transitional unemployment imposes a cost. On balance, the agreement is seen as beneficial for Tunisia.

Benefits are also important for Morocco, although dampened by the limited increase in access for its agricultural exports to Europe. Gains are lower for countries of the eastern Mediterranean. Lebanon is highly dependent on budgetary revenue from import duties and its agreement is seen as yielding a positive result only if accompanied by foreign investment and technology transfers to its services sector. For Egypt and Jordan, the relatively low share of imports originating in the European Union (EU) results in substantial trade diversion.

Policymakers now face the challenge of making full use of the opportunities provided by the Association Agreements and employ them as a tactical vehicle for fostering comprehensive supply enhancing reforms to achieve the hoped for optimal effects. The paper recommends extending trade liberalization to non-EU countries and to services and agriculture and accelerating structural reforms conducive to increased foreign investment in labor intensive export-oriented sectors. The macroeconomic policy response to the agreements should combine fiscal discipline with social safety net provisions, thus allowing room for exchange rate flexibility while maintaining financial stability. Well focused assistance and cooperation from the European Union should help achieve the dynamic benefits, and, combined with more generous access to European markets, could be a powerful signal of genuine partnership.

## I. INTRODUCTION

1. This paper reviews the economic impact on several Southern and Eastern Mediterranean (SEM) countries of Association Agreements with the European Union (AAEU). Within the framework of the broader Euro-Mediterranean partnership initiative, Tunisia, Morocco, and Jordan, amongst others have concluded such agreements in the past three years, while negotiations are advanced with Egypt and Lebanon, and under way with Algeria and Syria.
2. The topic under discussion has generated a substantial literature that forms part of the renewed debate over the costs and benefits of regional trade liberalization. Havrylyshyn (1997) provides a comprehensive overview of the issues that confront policy makers of the SEM countries in making optimal use of the opportunities presented by the agreements. In order to attain their benefits, the agreements need to be complemented by deeper structural reforms as part of these governments' overall development strategy. The present paper explores certain questions further. How robust are the various estimates of costs and benefits of the AAEUs? What empirical evidence of their impact is available to date? How can the signatory countries enrich the agreements to ensure maximum benefits for their economies?
3. The paper proceeds as follows. Section 2 discusses the main features of the AAEU with Tunisia, as one particular case study, and evaluates the benefits and costs. As the first agreement signed in June 1995, the AAEU with Tunisia served as reference in subsequent negotiations with other countries. Also, its early implementation from January 1996 onward, two years ahead of full ratification by all European Union (EU) members, provides some, albeit still limited empirical evidence of its actual impact. Section 3 compares the other AAEUs with SEM countries against the benchmark case. Section 4 discusses the various issues confronting policy makers and Section 5 concludes.

## II. TUNISIA AGREEMENT: MAIN ISSUES

4. By 1995 Tunisia had begun opening up its economy against the backdrop of successful economic performance: annual economic growth averaged 5.5 percent over the preceding three decades; social indicators were among the best in the region; and prudent fiscal and monetary policies had restored external and domestic balance. The development strategy had begun to shift from import substitution and state intervention toward a more market-based and export-oriented policy. Protection had been brought down significantly, mainly through the roll-back of quantitative import restrictions, including within the framework of formal accession to the GATT in 1990 and the WTO in 1995. Reduced availability of oil revenue in the 1980s gave rise to a policy of export promotion and diversification through tax-exempt labor-intensive offshore processing facilities. Nonetheless, a dual industry structure remained. The offshore enterprises produced limited value added, had developed few linkages with the domestic economy, and provided minimal competition on the local market which remained sheltered. By end-1996 the weighted average import tariff was still 32 percent, significantly higher than in Latin America, while tariff dispersion resulted in an average effective rate of

protection estimated at 56 percent. Signing the AAEU allowed Tunisia to make further strides in opening up its economy and to counter the erosion of its preferential treatment in the EU following the Uruguay Round by locking in its existing tariff free access for industrial goods in exchange for providing reciprocal access for European exports.

5. For the EU, the agreements are part of a stepped-up effort toward deepening and widening its relations with the SEM countries. This is to be achieved through far-reaching economic, financial, cultural and political cooperation including on issues such as immigration, environment, law enforcement, and infrastructure. In the economic field, the objective is to build a Euro-Mediterranean Economic Area, as called for in the Declaration of the Barcelona Conference of November 1995, and as part of a broader European strategy to forge various trade alliances. At the core of the AAEU is the establishment of a free trade area in most industrial products over a 12-year period. For European firms, the resulting dismantling of tariff protection in Tunisia expands market access. For Tunisia, it improves resource allocation which, combined with harmonization of trade-related regulations and increased assistance from the EU, should enhance prosperity and employment. Thus, the AAEU is expected over time to promote income convergence and ensure political stability and security on both sides of the Mediterranean.

6. For the coming years, the AAEU provides an important impetus for opening up the Tunisian economy. It creates a unique opportunity to credibly pursue far-reaching liberalization of trade in a gradual fashion. The commitments Tunisia made under the AAEU, although narrower in geographical coverage, go far beyond what it offered at the multilateral level under the Uruguay Round. The public commitment to a 12-year program with concrete way points and a detailed timetable announced in advance and sanctioned by international treaty should provide a powerful focal point for trade liberalization. Furthermore, the AAEU has its own disciplines for enforcing compliance with commitments. The vision of closer linkage to Europe and the offer of assistance to help reduce disparities in income across the Mediterranean is a mobilizing force.

7. Beyond trade opening, the AAEU has become a catalyst for Tunisia's overall economic reform and modernization strategy. It did so by committing the country to a course that can be completed successfully only through the implementation of a range of supplementary economic policy reforms. This is not surprising: by themselves, the agreements address only a subset of the wide range of mutually reinforcing structural policies required for a successful development strategy. Furthermore, being second-best, they create new distortions that require addressing.

#### **A. Benefits: Impact on Economic Growth**

8. Using a growth accounting framework, the expected beneficial impact of the AAEU stems from both higher total factor productivity and increased levels of investment. Limiting themselves to total factor productivity, Rutherford et al. (1995) estimated the overall welfare gains for the Tunisian economy at the equivalent of an additional 4.5 percent in annual GDP,

once the agreement is fully implemented. These welfare gains include the “traditional” static efficiency gains of trade creation net of trade diversion (1.7 percent of GDP) which result from the reallocation of labor and capital to sectors of comparative advantage following the removal of protection induced distortions in traded goods prices.

9. Most observers have emphasized the high welfare gains expected from the AAEUs through “dynamic” increases in total factor productivity. The lack of a price equivalent makes it difficult to quantify such benefits from “deeper integration”. In the above referred study they are estimated at 2.8 percent of GDP annually once the agreement is fully implemented. First, the value to Tunisia of the envisaged harmonization of health and technical regulations with the product quality standards of the EU is estimated at 1.3 percent of GDP, as Tunisian products gain wider acceptance in the EU and export prices improve. Second, increased efficiency in trading with the EU due to the liberalization and upgrading of financial, telecommunication, and transportation facilities—as part of the agreement and with EU assistance—is expected to lower import costs and raise export prices. The authors consider their numerical estimates conservative, as they do not include other beneficial impacts such as the rate at which best practices and technologies from abroad are absorbed in the economy as a result of greater openness.

10. Most importantly perhaps, the AAEU is expected to promote a business environment that stimulates domestic and foreign investment, thereby increasing capacity growth (in addition to accelerating the transfer of technology). High hopes have been based on the experience of the integration of Spain and Portugal in the EU following their membership and the closer links established between the EU and Central European countries and between the United States and Mexico after NAFTA, all cases of substantial increase in inward foreign direct investment. The following channels have been distinguished. First, the agreement is expected to reduce uncertainty for investors in several ways: it provides contractual assurances of access for Tunisian exports to European markets; it also enhances the credibility of the Tunisian authorities’ economic reform commitment through the perceived locking in of reforms as a result of the agreement itself, and more generally the acceleration of the move toward a fully market-based and open economy. Second, the dynamic increases in productivity, for example through adoption of EU standards and regulations, can be expected to raise the return on capital.

11. Several comments can be made regarding the above described benefits. As regards the static welfare gains, other studies have confirmed the finding of net gains that are small but positive once capital has been reallocated fully among sectors. Brown et. al (1997), using a different computational general equilibrium model estimate the net welfare gains for Tunisia to be slightly negative in the short term but to rise to the equivalent of 3.3 percent of GDP over the long term. Interestingly, their model also calculates the static benefits of the Tunisia agreement for EU member countries. These are found to be eight times larger in absolute value, although negligible in relation to the size of the EU, and to accrue mostly to France, Italy and Spain. For Tunisia, the static benefits stem from trade creation made possible by the lowering of effective protection that results from the reduction in the dispersion of tariffs

which inevitably accompanies their elimination. By contrast, for the EU the benefits come from trade creation made possible by the reallocation of factors of production to export sectors in response to lower Tunisian import barriers.

12. The dynamic benefits constitute an encouraging finding. Nonetheless, there is considerable uncertainty about their eventual magnitude, as the methods used to quantify them are inevitably arbitrary. Also, experience in South America seems to suggest that successful regional trade initiatives tend to be an extension of domestic reforms rather than a catalyst that generates such reforms. (Hufbauer, 1997).

13. The initial expectation of large additional investment that might be triggered by reduced uncertainty owing to the AAEU was probably excessive. First, unlike Spain and Portugal earlier, membership of the EU is not a prospect for the SEM countries. There is no increased access to the EU for export of manufactures, and Tunisia already had processing facilities for production sharing with EU producers. Second, each SEM country faces strong competition in attracting foreign investors. Also, the subsequent signing of other AAEUs, say with Morocco or Egypt, tilts incentives away from investing in Tunisia and toward investing in Europe through the “hub and spokes” effect, as long as trade barriers among the individual SEM countries exceed these countries’ bilateral tariffs with the EU. Third, the agreement will not automatically improve the investment climate. There has not been a sharp upturn in investor sentiment toward Tunisia or in actual inflows over the past two years as a result of the agreement. The country’s record on macroeconomic stability was already quite robust and the AAEU will not automatically add to it anytime soon, given the long and uncertain transition period and the presence of safeguard clauses in the event of balance of payments difficulties. The agreement’s leverage for helping establish a regulatory and judicial climate conducive to foreign direct investment beyond what would have been implemented in its absence also remains to be assessed.

14. Finally, the envisaged benefits are back loaded over the 12-year transition period. No static benefits from resource allocation are expected during the first five years due to the increase in effective protection during this period that results from tariff reductions on capital goods, raw materials and intermediate goods earlier, and on final goods later in the transition period. Also, the full beneficial impact will take more than 12 years, as it requires the reallocation of capital in addition to that of labor. The dynamic welfare benefits from lower costs will also accrue only over time. One exception could be a new sense of urgency to accelerate implementation of supporting structural reforms, linked to the additional aid from the EU.

## **B. Costs**

15. On the cost side two aspects have been highlighted: the adverse fiscal revenue impact and the cost of transitional unemployment and idle capacity. Both can be mitigated through additional financial assistance from the EU.

16. Estimates indicate a likely fiscal revenue loss for Tunisia as a result of the AAEU that rises steadily from 0.2 percent of GDP in 1996 to 0.5 percent in 1997 and further to 2.4 percent of GDP by 2008, when the agreement will be fully implemented. To put these numbers in perspective: revenue from customs duty was 4.3 percent of GDP in 1995. Hence, nearly half of custom duty receipts would still remain after the AAEU is fully implemented owing to the exclusion from the agreement of some dutiable imports (such as industrial commodities with agricultural content) and the fact that an estimated 31 percent of imports subject to taxation originates from outside the EU. In comparison, collection of value added tax (VAT) and excise taxes combined amounted to 8.7 percent of GDP in 1995. Thus, the estimated revenue loss, once the agreement is fully implemented, corresponds to about one fourth of these domestic indirect taxes. The revenue loss would be higher if account is taken of the impact of trade diversion and of a possible temporary setback in other tax revenue as the growth of export industry (often tax exempt) makes up only gradually for the adverse impact of the agreements on the import substitution sector. Working in the other direction, however, higher economic growth from the agreements will generate additional fiscal revenue, which would lower the government deficit, assuming government expenditure does not rise with GDP growth.

17. The tariff reduction can be expected to aggravate external and domestic imbalances. Fiscal neutrality, however, can be preserved by raising the rates, or preferably broadening the base through removal of exemptions of domestic indirect and direct taxes, and by strengthening tax administration. However, distributional issues can cause complications. At first sight, the revenue loss of the government is the gain of the nongovernment sector who benefits through lower prices of imported goods. In practice, however, introducing compensating revenue measures may be complicated if importers and producers do not pass on the benefits of the tax break to consumers who are likely to bear the brunt of the offsetting tax increases. Moreover, preferential (as opposed to most favored nation) liberalization carries the risk that a portion of the foregone fiscal revenue is captured by EU exporters to the extent that tariffs which remain on non-EU imports create room for raising European export prices (see Panagaryia, 1995); this would aggravate further the deterioration in the terms of trade that comes with trade diversion. It must be on these grounds that SEM countries have invoked the fiscal revenue loss as justification for increased financial assistance from the EU. Alternatively, fiscal neutrality could be preserved through expenditure reduction, which would also be consistent with reducing the size of government in the economy.

18. The experience of 1996 and 1997 in Tunisia illustrates the difficulty of taking additional revenue measures that compensate fully for the fiscal losses incurred. While revenue from compensating measures, such as raising VAT rates, that were introduced in the budget for both years is at least as high as the estimated losses from tariff reductions, overall revenue collection in 1996 fell short of the target. This suggests that the compensating measures were needed in any event to sustain fiscal revenue, even in the absence of the AAEU. In 1997 revenue was also short of target, but the authorities implemented expenditure cuts, mainly of investment outlays.



19. The other main cost is the transitional output loss associated with unemployment and enterprise closure, including as a result of the reallocation of capital. Different methods have been used to capture the social cost of the transition. Computational general equilibrium models that assume full employment measure the magnitudes of shifts in the sectoral composition of production and the accompanying movement of labor. Rutherford et al. (1995) equate the cost of shifting and retraining labor to one year of salary per worker who moves to a different industry. Total adjustment costs have thus been calculated at 4 percent of GDP, as workers who transfer to a different industry eventually comprise 8 percent of the labor force. Some authors have stressed that this is a one-time adjustment cost, which in the actual Tunisian case would be spread over the period from the fifth year of the AAEU until the capital stock is reallocated, which would be beyond the twelfth year. Although the 8 percent of the labor force affected does not constitute a permanent increase in unemployment, the changes in output across sectors and the associated adjustment cost is nonetheless substantial. This cost would be mitigated to the extent that the AAEU spurs additional investment and generates dynamic benefits.

20. How do the transitional costs in the case of Tunisia compare with those for Mexico under NAFTA and those resulting from agreements concluded between the EU and Central European countries? Two differences stand out. First, Tunisia had higher levels of protection at the outset. While this enhances the net benefits of trade liberalization, it also raises the costs of transition. Rodrik (1997), in analyzing the impediments to trade liberalization in Africa, emphasizes that the political economy difficulties rise with the gross costs of liberalization, notwithstanding the presence of significant net benefits, owing to the difficulties of compensating those who lose out. Second, the conditions for so-called “open regionalism” or “deep integration” are less prevalent in Tunisia than in these other countries. Thus, the extent of transitional unemployment will be influenced by factors such as: the degree of labor market flexibility; the existence of safety net provisions for redundant labor; the availability of modern financial services at internationally competitive costs to allow economic agents to react swiftly and freely to the new incentive structure for reallocating resources; and the role of market forces and absence of government intervention in resource allocation which requires privatization including in the provision of basic services such as transportation and communication.

21. The cost of upgrading Tunisian industrial enterprises and the environment in which they operate in order to enable them to confront increased foreign competition in their home market and abroad (*mise à niveau*) has been estimated varyingly. A broad definition, which includes recapitalization of enterprises, modernization of their equipment, and a portion of public sector infrastructure investment came as high as 2 percent of GDP annually during 1996–2000. A more narrow definition, comprising specific public programs aimed at facilitating technology transfers, vocational training and retraining, and diffusing knowledge about technologies and export possibilities via sectoral “technical centers” is being financed through a combination of own resources of the enterprises, foreign grants, and budgetary expenditures. A program granting subsidies of 10 to 20 percent of the cost of investment

projects aimed at technological upgrading, for a total of 1 percent of GDP, is being implemented.

22. To help mitigate the fiscal revenue and transitional adjustment costs and in exchange for the increased market access for European firms, the EU committed to provide financial assistance. Thus, over the 15-month period through March 1998, Tunisia received financial aid from the EU amounting to ECU 130 million—about 0.5 percent of GDP on an annual basis, only slightly more than Tunisia received from the EU during 1992–96. For all Euro-Med countries combined, about ECU 1 billion has been assigned in grants on an annual basis during 1995–99.

### III. AGREEMENTS WITH OTHER MEDITERRANEAN COUNTRIES

23. Agreements with the EU were subsequently signed by Morocco in 1995, and Jordan in November 1997. To a large extent, these agreements follow a similar outline. Nonetheless, country specific circumstances warrant highlighting one or more features that take on additional importance in assessing the costs and benefits of the AAEUs for these economies.

#### A. Morocco: The Issue of Agricultural Trade

24. Although the agreement with Morocco includes issues not covered with Tunisia (such as fishing), in many respects, the core economic aspects of their AAEUs are similar. Equally, studies examining the likely impact on the economy give results broadly comparable to the findings on Tunisia. Thus, the static welfare gains were estimated in a range of 1.5–2 percent by Rutherford et al. (1993). The adverse budgetary revenue impact was projected at 2.0 percent of GDP after 12 years, somewhat lower than in the case of Tunisia.

25. The agreement with Morocco brought to the fore the issue of access of agricultural exports to the EU. When Morocco opened its negotiations with the EU in March 1992, a powerful motivation was that E.C. agricultural protection under the 1976 Trade and Cooperation agreement, although allowing privileged access in the form of tariff reductions and nontariff preferences such as seasonal quotas for selected products, still impeded Moroccan exports, notably in the areas of vegetables and citrus fruits.<sup>2</sup> The Rutherford study, undertaken prior to the final agreement, indicated that unrestricted access for Moroccan fruits and vegetables to the EU would yield additional benefits equivalent to about 0.25 percent of GDP, primarily by allowing higher export prices (of about 8 percent).

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<sup>2</sup>In the case of Tunisia, the issue of increased agricultural access appears to have been less pronounced. The allotted quotas for its main agricultural exports, namely olive oil, citrus fruit and wine, at the Union's support price (i.e., that are exempt from tariffs and variable levies) were not fully met, with the important exception of olive oil.

26. The agreement actually concluded provides some widening of Morocco's preferential access for agricultural products between 1997 and 2000, when the agreement will be reviewed, but restrictions still remain. The increased access comprises: (i) extending the list of agricultural products for which preferential access is granted; (ii) providing for more generous duty reductions within the various tariff-quotas, and (iii) increases in access for some quotas or beyond the quotas or during certain periods of the year of up to 12 percent. (Maciejewski, 1996). However, the specific duties the EU levies on certain items over and above the ad valorem duties were not reduced. Also, for certain products, Morocco undertakes not to export more than the agreed tariff quotas. A further consideration is that the agreed entry prices and quantities that apply to these products will inevitably be reduced at the pace bound by the EU under the WTO. Thus, the benefits are more limited than estimated in the above mentioned study.

27. Under the AAEU, Morocco's protection of its own agricultural sector is also not reduced significantly. Whereas Morocco used to provide MFN treatment to agricultural imports from the EU, under the AAEU preferential maximum import duties ranging from 2.5 to 215 percent apply on a list of products (mainly edible oils and fats, cereal, dairy and meat products). In most cases the tariff reductions apply only for specified amounts, essentially consolidating existing access conditions. These tariffs will be lowered if necessary to ensure that quotas are fully used up. Thus, the static welfare gains of the Rutherford study which applied to full import liberalization of all sectors (including Moroccan agriculture) vis à vis the EU will also be lower. In particular, the cereal, meat, dairy, and sugar sectors which are most vulnerable to reduced protection remain broadly unaffected.

#### **B. Lebanon: Liberalization of Services and Right of Establishment**

28. The draft agreement (October 1996) under negotiation with Lebanon raises interesting points. One weakness in the AAEUs of Morocco and Tunisia is that they essentially refer the liberalization of services to the adoption of the General Agreement on Trade in Services (GATS) under the WTO, under which both countries made very limited commitments. By contrast, the liberalization of services was central to the discussions with Lebanon.

29. Owing to the structure of Lebanese economy, the benefits of liberalization of commodity trade with the EU are lower than in the case of Tunisia or Morocco. In a study by Martin (1996) the losses from trade diversion were found to exceed the gains from trade creation, resulting in a net welfare loss of 0.3 percent of GDP. Trade diversion is larger because the share of Lebanon's imports originating from the EU is only about 50 percent. Trade creation is smaller because of the limited size of tradable goods production relative to imports in Lebanon, as reflected in its large structural trade deficit. Thus, the impact of an AAEU will be more to raise consumption than to stimulate commodity production. Consideration of dynamic welfare gains for commodity exports do not change this conclusion: even if not smaller in percentage terms than in the case of Tunisia and Morocco, they still apply to a smaller base and are therefore less significant in absolute value. Only if the

agreement were to generate substantial new investment, including in export-oriented activities, and stimulate the services sector would it be favorable.

30. A key government goal is to restore Lebanon to its earlier position as a regional hub for services, including through substantial inward foreign investment. Lebanon already has a significantly more liberal regime than other countries in the region. The AAEU under discussion builds on this strength. Thus, Lebanon and the EU are prepared to grant MFN treatment in all services covered by the GATS, except in transportation. As regards the right of establishment (i.e., the freedom to engage in foreign direct investment and be treated as a national without limitations in regard to maximum equity stakes or operations), Lebanon has wisely given up its earlier insistence on reciprocity: EU companies will receive national treatment in Lebanon while Lebanese companies will enjoy MFN treatment in the EU. How important are these benefits for the Lebanese economy? The gains of freeing up services can be very substantial, if difficult to measure given that protection of services is not based on tariffs and therefore does not have a price equivalent. The additional liberalization in services and right of establishment and its impact on enhancing foreign direct investment from Europe, lowering costs, and gaining competitiveness through technology transfers should be the main benefit of the AAEU.

31. The fiscal revenue cost to Lebanon is higher than in any of the other countries. It has been estimated that Lebanon would lose 4.2 percent of GDP in revenue after 12 years, not taking into account the indirect effects. The high cost stems from the fact that about half of budgetary revenue in Lebanon is obtained from custom duties, about half of imports originate from the EU, and industrial goods with higher tariffs constitute a large share of imports from the EU (Abed, 1998). With this in mind, proposed import tariff reductions are back loaded, with most of the reduction taking place in the final three years of the envisaged 12-year period, providing Lebanon time to build up a broad-based consumption tax such as the VAT. The benefits from reducing effective protection on commodity trade would also come correspondingly late.

32. The AAEU with Lebanon has added to the debate on the distribution among the different SEM countries of the total envelope of Euro-Mediterranean assistance. The Lebanese authorities feel that the three criteria for financial assistance proposed by the EU: population, per capita income, and willingness and ability to undertake economic reforms put them at a disadvantage. They stress the financial cost of reconstruction of their country, the costs of trade diversion, and their efforts in liberalizing services.

### **C. Egypt and Jordan: Need to Offset Cost of Trade Diversion**

33. The cost of trade diversion is substantial in the case of Egypt and Jordan, mainly because the EU accounts for only 45 and 32 percent respectively of imports. As a result, Konan and Maskus (1997) calculated that free trade between Egypt and the EU—elimination of tariffs on EU imports combined with an assumed one percent increase in the prices of Egyptian exports because of reduced incidence of testing and certification costs in the EU, as

well as an 8 percent increase in export prices of agricultural produce and clothing owing to increased access—would result in a welfare gain of only 0.2 percent of GDP.

34. Accordingly, to raise welfare significantly, the AAEUs with those countries need to have considerable leverage effects in improving the cost structure of doing business and thereby indirectly enhance prospects for inward foreign direct investment. If it is assumed that the AAEU also reduces administrative costs incurred by traders and eliminates the implicit tax inherent in an inefficient service sector in Egypt—due to poor customs procedures, lack of quality control, and “red tape”—and that this reduction applies to all international trade, the welfare gains rise to 1.8 percent of GDP. Also, the EU agreement could be used as a catalyst for reducing government intervention in the service sector. Egypt has been advised to surpass the commitments made by Tunisia with respect to liberalizing services and foreign investment.

#### **IV. IMPROVING THE BENEFIT/COST RATIO OF THE AGREEMENTS**

35. A challenge facing policy makers is to sustain the initial momentum created by the appeal of closer linkage with Europe through the AAEUs. The agreements should be implemented in a manner that secures their full benefits while limiting the costs. While the benefits vary from country to country, investment and growth can be expected to respond positively to the lowering of protection and the reduced cost of trading brought about by stepped up cooperation with the EU including in harmonization of standards, customs, and services, as well as the greater credibility of economic policy reform. Nonetheless, the specter of import substitution sectors being dismantled without sufficient investment taking place in the export-oriented sectors cannot be dismissed. How can the AAEUs be implemented and employed as a tactical vehicle to foster comprehensive supply enhancing reforms and thereby achieve the hoped-for optimal effects? While answers will need to be country specific, the remainder of this paper proposes some general recommendations.

##### **A. Within the Overall Time Frame of 12 Years, Elements of the Agreements and Supporting Measures Should Be Accelerated**

36. The 12-year transition period, the maximum allowed under the GATT, is relatively long, considering that several of the countries, including Tunisia, have been engaged in trade liberalization for many years. While the long transition permits adjustment to be spread over time, it also delays the benefits and could be counterproductive. Mussa (1997), partly taking into account the rapid multilateral liberalization experience of Latin America in the 1980s, recommends comprehensive import liberalization for African countries in not more than 5 years—an adequate period for putting in place the alternative fiscal revenue systems. Also, the EU agreements with Central and Eastern European countries limited the period of transition to seven years. Given their earlier start, their transition will soon be completed, while most SEM countries still have to begin. With this in mind, Page and Underwood (1996) advocate shortening the transition period.

37. At this stage, however, shortening the 12-year period could undermine public support for the AAEUs or reopen other aspects. In addition, given the comprehensiveness of the agreements and the supporting measures they require, the full 12-year period may be needed. A preferred strategy would be for governments to reaffirm the final date and take all measures necessary to ensure the credibility of timely completion without having to invoke safeguard clauses that open room for extension beyond the 12-year period, thereby reducing concerns about policy reversals.

38. Thus, within the 12-year period, governments could advance some of the provisions of the agreements which are back loaded. The sequencing of tariff reductions, with capital goods and inputs eligible first and tariff reduction on locally produced consumer goods only later, lowers effective protection only in later years and enhances it in the earlier period. By sending perverse signals to potential investors this could delay domestic and foreign investment in export-oriented industries. Some tariff reductions could be advanced with a view to reducing effective protection sooner, in particular if accompanied by other measures that cut costs to affected producers by raising efficiency.

39. Governments could unilaterally advance some of the more difficult supporting measures, thereby dispelling a false sense of generous time availability: financial services, social safety net provisions, increased labor market flexibility, regulatory framework to attract foreign direct investment. In particular, the implementation of long-gestation institution building measures such as reforms of the judicial system should start early. In the case of Tunisia, increased domestic competition earlier in the agreements through stepped up privatization and a redefined role for the government would help prepare industry more effectively now for the more severe adjustment expected later in the transition period. Governments could also take advantage of the easier initial five-year period to broaden the tax base sooner.

#### **B. Enhance the Multilateral Dimension of Trade Liberalization**

40. The preferential trade arrangement at the heart of the AAEU both liberalizes and distorts trade. Discriminatory free trade arrangements are a second-best solution and should be viewed by the SEM countries as a mechanism for their integration into the world economy—not only the European economy. Multilateral liberalization in parallel with the implementation of the AAEUs would yield several benefits:

41. First, the cost of trade diversion would be avoided. As they stand, the AAEUs divert imports away from more efficient non-EU sources to higher cost European suppliers, thereby reducing the benefits of trade liberalization. Trade diversion is significant in the case of Tunisia because of the high protection that remains on third country imports and in the case of the Eastern Mediterranean countries because of the relative low percentage of imports originating in the EU. By contrast, unilateral reduction of tariffs from all geographical sources on a most favored nation basis would allow the full benefits of the competitive impact. In the case of Tunisia, this has been calculated to raise welfare further by the equivalent of

0.7 percent of GDP annually. The net additional cost in terms of labor dislocation would be small because the adjustment costs deriving from trade diversion are avoided under this scenario.

42. Second, liberalization on a most-favored-nation basis, either unilaterally or within the WTO framework, is a practical way of lowering trade barriers among the various SEM countries themselves. This is important to counter the “hub and spoke” phenomenon. The sooner regional and global protection approaches levels prevailing vis à vis the EU, the more likely that investment will take place in SEM countries. Several among them are engaged in renewed efforts to liberalize trade among themselves following a long history of disappointing results. MFN liberalization by each country is likely to be less complicated than seeking to establish comprehensive free trade agreements among themselves.

43. As a further advantage, multilateral liberalization avoids incentives for transshipment to the free trade partner country with the lower external tariff. It therefore obviates the need for the customs office to verify the application of rules of origin, which are becoming increasingly complex owing to the proliferation of regional trade agreements. The result would be lower costs to exporters, more efficient customs administration and better governance.

44. Generalizing trade liberalization to non-EU sources would have the drawback of requiring further compensating fiscal measures. In the case of Tunisia, multilateral liberalization would raise the revenue loss by 22 percent. However, the additional fiscal burden would be lower to the extent that EU exporters no longer capture a portion of the economic rent made possible by the continuation of import tariffs on non-EU sources. The higher income growth also increases the taxable base of the economy.

45. Tunisia has already implemented on a multilateral basis the tariff reductions scheduled for the first three years under the AAEU. This strategy permits greater diversification of technology by not discriminating against suppliers of machinery from outside Europe who might have adapted their equipment to skills and factor endowments more closely parallel to its own. SEM countries should build political consensus for reducing their non-EU tariffs *pari passu* with the implementation of the AAEU. Empirical evidence (Vamvakidis, 1998) confirms the greater growth impact of broad based liberalization over regional trade arrangements. Even maintaining rates of 10 and 5 percent in addition to zero would reduce distortions substantially while still leaving room for a parallel free trade agreement in the region. The AAEUs should enhance the political feasibility of MFN liberalization. The public announcement of a timetable would provide an important signal to investors.

### **C. Strengthen Regional Trade Integration**

46. Failing substantial multilateral liberalization, further regional trade integration among the SEM countries would help lower the cost of trade diversion and enhance prospects for attracting foreign investment. In the case of the EU agreements with central European

countries, the subsequent creation of a free trade area among these countries averted the risk of "hub-and-spoke" diversion of investment. A free trade agreement between Tunisia and Morocco is already under discussion. Nonetheless, attempts at regional trade integration among the SEM have had a disappointing history (Finaish and Bell, 1994).

47. The experience of SEM countries typifies that of many failed regional integration attempts in the developing world as regional trade liberalization was based on import substitution and state planning, not export orientation and market-based decision making. Participating countries saw it as a means to surmount the inherent scale limitations of their protected domestic market for manufacturing. As noted by Lawrence (1997) the bilateral protocol trade arrangements in the Middle East, in which countries selectively determine specific products and quantities to be traded, are examples of politically driven trade that fails to yield much benefit. The failure of the Arab Maghreb Union can be attributed in part to attempts to reduce protection on a product by product basis rather than across the board with minimal exception lists, and to the policy of maintaining high tariffs to outside countries instead of establishing a globally open environment (Hufbauer 1997).

48. The various bilaterally concluded AAEUs enhance the need for integration among the SEM countries. Interestingly, they also facilitate further regional integration by: (i) reducing protection in the SEM countries over a 12-year period, thereby improving competitiveness on a sounder basis than the existing bilateral trade agreements among these countries which are not necessarily consistent with comparative advantage; (ii) enhancing transparency e.g. in the context of competition policy; (iii) harmonizing regulatory aspects and procedures bilaterally with the EU, thereby providing the SEM countries de facto with common standards they might otherwise find difficult to negotiate among themselves; (iv) through EU assistance for infrastructure linkages among the various countries; and (v) in the agreements with Tunisia and Morocco, by allowing cumulation of rules of origin for trade with any other SEM country with which Morocco and Tunisia conclude free trade agreements. The EU encourages the conclusion of free trade agreements amongst its Mediterranean partner countries.

49. Further regional integration will be important, particularly for the Eastern Mediterranean countries. Other SEM countries account for a significant share of total trade of Jordan, Syria, Egypt, Turkey and Lebanon. Although the existing intraregional trade is driven to some extent by barter deals and protocol trade agreements that specify preferential tariff rates on specific lists of goods of Arab origin, there is room for further expansion of intraregional trade. The clearest case is trade between Israel and its neighbors which should grow very substantially, under the proper political circumstances. However, the dismantling of tariffs on imports from the EU will put imports from other SEM countries at a disadvantage. Thus, exporters and importers involved in intra regional trade that see their trade replaced by imports from the EU will be powerful voices in favor of lowering tariffs on trade among themselves to levels applying to imports from Europe.

50. The rules of origin in the AAEUs and in possible intraregional agreements are important as they will help determine the potential for trade diversion resulting from the free



trade agreements (Hoekman and Djankov, 1996). The cumulation of rules of origin in the Morocco and Tunisia agreements may foster backward and forward linkages between the North African countries and enhance the potential for intraindustry trade. Cumulation of rules of origin does not apply in the AAEU of Lebanon and Jordan, as only goods “largely of Lebanese/Jordanian origin” qualify for duty-free export into the EU. The extension of cumulation to the Eastern Mediterranean countries would be beneficial to participants. This requires that barriers to intraregional trade be eliminated, and that existing commodity specific preferential trade agreements be converted into full-fledged free trade agreements. As noted, this will also ensure that the emerging hub-and-spoke nature of the EU’s web of trade agreements is reduced. The EU envisages to eventually introduce uniform origin rules with improved cumulation provisions in all its Euro-Mediterranean Partnership Agreements.

#### **D. Macroeconomic Policy Response**

51. By lowering import prices, the impact effect of the AAEU is to stimulate overall demand in the economy. In order to prevent a deterioration of domestic and external balances—a key condition for higher foreign and domestic investment—policy makers are advised to implement compensating fiscal policy measures and to allow the real exchange rate to depreciate in response to market forces. An adequate policy response further requires a monetary policy stance aimed at consolidating the low levels of inflation currently prevailing in most SEM countries.

52. Trade liberalization has often foundered on the adverse budgetary revenue implications. In turn, expansionary macroeconomic policies have often led to reversals of trade liberalization. Macroeconomic stability and trade liberalization go hand in hand. As a general guideline, the adverse budgetary impact of the AAEUs, and of broader based trade liberalization, should be fully offset through alternative high quality revenue sources or expenditure reductions. This is important to give the AAEUs credibility. In fact, given the back loaded profile of the tariff reductions, a strong fiscal adjustment stance up front would strengthen perceptions that the agreements will be implemented in full. While several authors stress that the undertaking is “manageable,” closer observation of the budgetary policy process in the SEM countries indicates that the task is demanding, both technically and politically, even for countries other than Lebanon (Abed, 1998). Trade liberalization takes place alongside other structural developments that may also add to medium-term budgetary pressures in SEM countries such as the gradual deterioration of pension and social security systems with the declining trend in population growth or the interest burden from earlier bank and public enterprise restructuring. These come in addition to all the usual pressures for increased government expenditure and leave little room for trade liberalization to act as a further source of demand expansion.

53. Maintaining external stability is also important, as many of the SEM countries are still in the process of lowering their external debt in relation to GDP to more sustainable levels. What is the impact of the AAEU on the trade balance? In the case of Tunisia, it has been estimated that a real exchange rate depreciation of 4 percent would be required to dampen

import demand and help encourage exports sufficiently to leave the trade balance unaffected. In the absence of an exchange rate adjustment, the trade balance could deteriorate by up to 15 percent of exports. Additional balance of payments financing on this scale may not be sustainable in the long run, and pressures could develop eventually either for a disorderly exchange rate adjustment or to reintroduce formal or informal exchange or trade restrictions on European countries or third partners. Admittedly, increased foreign grants or private capital inflows triggered by the AAEU could provide needed financing, but recent experiences in Asia should warn against excessive trade imbalances combined with fixed nominal exchange rate anchors. Although the agreement will help strengthen the supply response of the export sector, the authorities are advised to lean toward letting the exchange rate respond to market forces. While productivity gains are essential to strengthen competitiveness, exchange rate flexibility also has to be part of the strategy. This recommendation further underlines the importance of maintaining tight fiscal and monetary policies in support of exchange rate policy.

#### **E. Deepen Structural Reforms**

54. The dismantling of import protection foreseen under the AAEUs makes it crucial to strengthen the supply response of the export sectors in the SEM countries. At the same time, the agreements facilitate this process by incorporating several reform measures explicitly and through policy conditionality more generally. Are the provisions for structural reforms in the agreements adequately ambitious to achieve deeper integration? Are they being implemented? Most observers concur that the SEM countries should accelerate and deepen economic reforms, building upon and exploiting the principle of liberalization that is inherent in the AAEUs. Moving expeditiously will advance the benefits which otherwise risk coming late while the transitional costs are felt early.

55. Early implementation of the numerous provisions in the AAEUs for close economic cooperation in streamlining export sectors with those in the EU would appear particularly valuable. Measures that could be accelerated include upgrading testing labs and concluding agreements for the mutual recognition of certification of product standards and the establishment of binding regulations in this regard. The easing of burdensome port and customs procedures at an early stage, for example through the introduction of the EU's single administrative document, would appear promising.

56. Numerous studies (e.g., World Bank, 1994) have illustrated the drag on efficient production and export expansion that is imposed by high service and transactions costs. These include excessive insurance fees, high port service costs, losses caused by wastage and breakage of goods due to low quality transportation and storage, and the unavailability or excessive costs of telecommunication services. Easing external restrictions on services and foreign investment should enhance competition in banking, advertising, and management consultancy, and help export sectors compete abroad. Unlike the Central and Eastern European countries, the SEM countries except for Lebanon have not fully exploited the opportunity of committing to the right of establishment in their AAEUs. While it may perhaps

not have been realistic to expect negotiations on an already bold initiative to have gone much further, the SEM countries should seek in upcoming reviews to adapt their AAEUs and strengthen the liberalization of services and right of establishment. By opening most activities rapidly and indicating that they are open to FDI and willing to lock this in, these countries would increase the incentives for foreign firms to establish and transfer much needed know-how. Enhanced competition in banking markets would give banks more incentives to expand services. Further development of bond and equity markets would spur banks to become more competitive.

57. Other complementary policy reforms are needed to help ensure the attainment of the important dynamic gains, minimize transitional costs, bolster the credibility of the authorities' strategy, and make the SEM economies more globally competitive. Increased foreign direct investment has rightly been identified as the key element that will determine the success of the AAEUs. Which further structural reforms can SEM governments undertake to induce European and other corporate entities to locate in their countries and take advantage of lower labor costs for exporting to Europe and the world? A bold privatization program and deep administrative and judicial reforms are considered among the most effective means for bolstering FDI. A major privatization program provides immediate opportunities to foreigners for direct or portfolio investment. It helps confirm with investors the government's seriousness about reducing its role in the economy—a prerequisite in many SEM countries for ensuring that trade liberalization yields the expected benefits of greater competition on product markets. Privatization of key input and service industries lessens investors' concerns about the availability of these inputs. Opening up telecommunications, ports and electricity to foreign investment makes world class technology available and avoids bottlenecks, thereby supporting the export sector.

58. Improved administrative and judicial procedures governing private activity will further facilitate foreign investment. Clearer interpretation and tighter enforcement of laws on collateral and on financial disclosure would greatly improve the functioning of financial markets. Investors want security of rights and quick, transparent, and consistent judicial decisions. Red tape and administrative discretion have been identified as important constraints by foreign investors. Although the AAEUs do not address these concerns directly, they could spur policy makers to accelerate these reforms. The agreements do provide for the adoption of basic EU competition policy rules with respect to collusive behavior, abuse of dominant position, and competition distorting state aid to the extent these affect trade with the EU. Given the prevalence of state-owned enterprises, this could have important benefits.

59. Another area of structural reform is increased labor market flexibility. Combined with stepped-up social safety net provisions this should help reduce the transitional costs.

## **F. Financial Assistance**

60. EU financial aid to the SEM countries extends a tradition of development assistance. It also should be seen in the broader context of the strategic objectives of the MEDA

partnership, which aim at strengthening ties and cementing mutual relationships. Migratory pressures, security cooperation, respect for human rights and political considerations all play a role. More narrowly connected to the free trade agreements, financial aid by the EU responds to genuine need and also to political economy considerations. It has been justified as: compensation for the fiscal revenue loss and the adjustment costs incurred, support for industrial upgrading, and as an incentive to encourage governments to implement the agreements and the structural reforms needed to ensure their success.

61. Aid disbursements under the AAEUs are conditional on the implementation of programs of structural reform agreed between the authorities and the EU in close cooperation with the World Bank. Structural reforms have been piecemeal and gradual in the SEM countries. Can conditionality attached to EU grant money accelerate and deepen the reform process? Two currents of thought can be distinguished. The standard view holds that aid can have an important catalytic impact on policy reform, particularly under special situations of crisis and when new rules of policy setting are formulated (Dixit, 1996). The Marshall Plan, the debt crisis in Latin America, and the demise of socialism in Eastern Europe come to mind. Against this, the recent literature on foreign aid stresses the limited leverage of financial assistance in coopting governments to assume ownership of structural economic reforms. Another question relates to the design of the conditionality: aid disbursements are conditional upon the implementation of the preferential tariff reductions, less so on the implementation of the deeper integration policies, and not on other complementary measures such as extending liberalization to the multilateral level.

62. SEM governments prefer to receive grant aid for general budget support and invoke the fiscal revenue loss to that effect. Nonetheless, the question arises whether earmarking a portion of these funds for specific budgetary expenditures can help ensure the ultimate success of the AAEUs. What is the optimal form and amount of outlays for industrial restructuring, labor training and social safety nets for retrenched workers? The design and implementation of effective programs for assisting modernization and restructuring in the SEM countries are still being developed. Experience indicates that the central feature of successful technological upgrading programs is the provision of diagnostic information to firms regarding product, process, marketing and technological changes required to meet the quality and price standards of export markets. (Page and Underwood, 1996). This differs from more traditional support programs such as interest rate subsidies. Havrylyshyn (1997) advocates a "sunset law" for restructuring assistance so as to limit rent-seeking behavior by business interests: setting a termination date for special assistance with restructuring would help minimize the risk of these programs being mistaken for another form of entrenched state-support and protectionist strategies. A vigorous privatization program would help reinforce this signal.

63. To a significant extent, the success of the AAEUs will depend on the quality and magnitude of economic and technical cooperation from the EU. Strong cooperation could be important to make the regulatory and judicial environment of these societies conducive to foreign direct investment. The SEM countries should take greater advantage of the opportunity offered by the agreements to accelerate deeper integration by speeding up the

harmonization of national practices and they should strengthen the agreements and their enforcement mechanisms. The EU has a lot to offer. Its extensive experience with harmonization of diverse regulations among its own member countries should be valuable to SEM countries. The availability of pretested and internationally accepted rules and procedures e.g. in customs and documentary requirements saves the SEM countries the cost of reinventing these. The AAEUs also provide a framework for direct linkages through transfer of know-how and close cooperation between the private sectors in both regions. On the minus side, not all policies and practices of EU member states, including labor market regulations or social security systems, can be considered best practices for the SEM countries to emulate. Also, there are undoubtedly sensitivities related to judgement about the ultimate compatibility of local customs and preferences in regard to property rights and permissible behavior of firms and governments with the requirements of global integration. Nonetheless, there is room for further expanding and accelerating a comprehensive, focused and carefully prioritized program of cooperation aimed at deeper integration.

#### **G. Improving Market Access and Broadening the Agreements to Agriculture**

64. An important limitation of the benefits of the AAEUs is the absence of a significant increase in access for exports to the European market. This largely reflects the fact that SEM countries already enjoyed nonreciprocal preferential access under the 1976 trade and cooperation agreements. The current AAEUs have the advantage for SEM countries of affirming by international treaty their nearly duty free access. Nonetheless, increased opening of European markets would enhance welfare for the SEM countries and EU consumers alike. From a political economy point of view, it would be a powerful signal of "reciprocity" that SEM countries could use to justify before their own constituencies various measures of deeper economic integration.

65. Exports of manufactures, for most SEM countries, were already admitted free of duty either for unlimited amounts or as in the case of textiles for specified quotas under bilateral voluntary agreements, which often exceeded actual exports. However, the AAEUs leave room for protection through nontariff barriers such as the administration of antidumping. As in the case of Central and East European countries, antidumping provisions constitute a continued impediment to market access. Under the AAEUs, while the adoption of European competition policy will bring relief from countervailing duty actions, SEM exporters will still have to be concerned about antidumping. Egypt and other SEM countries have been advised to seek relief from antidumping in exchange for the adoption of European competition policy (Hoekman and Galal, 1997).

66. The deferment of substantive negotiations of liberalization of trade in agricultural products until the year 2000 in the case of Tunisia and Morocco and 2002 for Lebanon and Jordan is largely explained by the political difficulties of reforming the EU's common agricultural policy and resistance on the part of European agricultural interests who compete with SEM exports. European agriculture is clearly a case of trade diversion. Morocco and Egypt in particular have emphasized their concerns for increased access for agriculture. The

limited additional access offered to these SEM countries stands in contrast with the agreements concluded between the EU and the Central and East European countries. For Morocco, continuing restrictions on access to the agricultural market in Europe limits the potential welfare gains of the agreement. Tunisia would benefit from increased access for olive oil at EU support prices, although this advantage could be eroded as a result of closer correspondence in the future of the EU support price with world market prices.

67. Agricultural production in the SEM countries is also heavily protected through tariff and nontariff barriers, and liberalization would require major adjustment e.g., in the cereal sector. Reciprocal liberalization of agriculture would provide further benefits to consumers on both sides. SEM countries could also reap dynamic gains in agriculture that should be no less than those in manufacturing. Including agriculture in the agreements should provide a powerful sign of full, open and outward oriented free trade. At the same time, faster liberalization of agriculture in the SEM countries, even unilaterally (only limited steps are programmed under the WTO rules), would help avoid new distortions that may result if resources flow from the relatively unprotected industrial sector into agriculture.

## V. CONCLUDING OBSERVATIONS

68. From the perspective of the EU, the association agreements are a new effort to deepen relations with the Southern and Eastern Mediterranean countries with as ultimate objectives enhanced prosperity and security on both sides of the Mediterranean. For the SEM countries, the agreements provide a major impetus toward an open trade regime over the next 12 years and constitute a powerful catalyst for overall economic reform. Their governments have boldly committed to a course that can be completed successfully only by adopting far-reaching reforms. The benefits of the agreements could be substantial, but they are uncertain, will come relatively late, and will be forthcoming only if major supplementary reforms are implemented consistently and early on. Another challenge for the authorities is to ensure continued macroeconomic stability while overseeing a socially acceptable transformation of the productive structure of their economies. Ultimately, the SEM countries took the gamble because it represented the best and possibly only attractive choice for their small open economies in the rapidly changing world of globalization.

69. Having signed on, the SEM countries now really have no viable alternative but to integrate the EU agreements in a comprehensive development strategy. They should make full and early use of the 12-year transition period provided. To do so, the trade liberalization aspect of the agreements need to be completed through multilateralism and extension to agricultural trade both in the SEM countries and the EU. Ultimately, the success of the agreements hinges on their ability to generate a critical mass of foreign investment in labor intensive export-oriented sectors. This will require substantial further transformation of these societies. Trade in services, the right of establishment, privatization, a newly defined role for the government, and deep changes in judicial and administrative practices will all be needed. The macroeconomic policy response will need to combine firm fiscal discipline with high quality social safety net provisions, thus allowing room for exchange rate flexibility while

**maintaining financial stability. The movement toward free trade in goods, services and capital will also require broad and enlightened public discourse in the SEM countries. All along, pressures for migration toward Europe will continue unabated. Clearly, this will be very much an ongoing partnership between the EU and the SEMs, with plenty of challenges for all involved.**

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