Working Paper

Internal Economic Reforms as a Precondition for Free Trade: The Case of Tunisia

Abdessatar Grissa

Comment:

George Joffé

Research Group on European Affairs, University of Munich

August 1996

The Project „Europe and the Middle East"

Due to the increasing importance of the Middle East and North Africa (MENA) for Europe, the Bertelsmann-Foundation and the Research Group on European Affairs set up the Project „Europe and the Middle East". Its mission is to develop European policy models vis-à-vis Europe's neighboring region across the Mediterranean. Following the Middle East peace process the question most thoroughly investigated is how the states in the Middle East and North Africa can organize regional cooperation among themselves as well as with the countries of the EU. Furthermore, it is designed to contribute to a better understanding of the transformation processes in the MENA-region in terms of its international relations, its economic development, and the transformation processes of state and society.

To implement this concept, the co-operation partners organize on a yearly basis workshop-meetings and the „Kronberg Middle East-Talks" which should contribute to a better understanding between both sides of the Mediterranean.

Abdessatar Grissa was Professor of Economics at the University of Tunis, and is a consultant to The World Bank.

George Joffé Deputy Director at the School of Oriental and African Studies, London.

Executive Summary

Until 1986 the economic policy of the Tunisian government was based on a vigorous protection of domestic markets and the encouragement of exports, which eventually caused a high deficit of current accounts. Therefore, the state had to approach international financial institutions such as the IMF for funding, but was obliged to adjust its economy to liberal economic policy principles, which included the devaluation of the Dinar, the tightening of its credit policy, and the acceptance to privatize public enterprises, when possible.

Subsequently, the Tunisian economy reacted positively in terms of growing exports, the improvement of current account balances, the external debt situation, and diversification of its production structure. The main problem of Tunisian economic policy, however, remained in the survival of large domestic enterprises formerly protected and subsidized by the state.

The Tunisian economy today is highly dependent on exports of goods and services. Among the trading partners, the European Union is the largest one with over 80% of the Tunisian exports being imported into Europe. Only 9.1% of its exports are going to Arab countries, 6.7% of its imports are coming from its Maghreb neighbors. However, the emergence of free trade structures as envisaged by Europe and its southern neighboring countries does not confront the Tunisian economy with unsolvable problems, as the country has already implemented most of the necessary adjustment steps.

Inefficiencies remain in many of the following areas: the labor market is highly inflexible, despite recent legal modifications. The fiscal system relies for over 20% of its revenues on customs duties. Given the goal of free trade with its economic environment, the state has to rearrange its financial system. The basic infrastructure is still poorly developed. Private incentives are affected negatively by state enterprises, as they execute a monopoly over specific production areas, followed by high prices for these goods. Still, only a very small proportion of state enterprises has been privatized. One reason for the moderate incentive of the state to privatize its assets is to be identified in the well established relationship between economic and political elites, who only hesitantly give up their monopolies.

1. Introduction

The strategy of economic development pursued by the Tunisian authorities up to 1986 was based on: (a) a vigorous protection of the domestic market; and (b) an active encouragement of exports, which were undertaken mainly by enterprises totally excluded from selling to local customers. This strategy rapidly led, however, to the crowding of the domestic market with generally small and poorly equipped producers, who suffered in addition from the employment of insufficiently qualified labor and frequent breakdowns. The cost of producing domestic goods and services became, therefore, progressively inflated, particularly when considered in relation to their degraded quality.

What is of more importance, however, is that the effect of this growing inefficiency of domestic market producers and of the rising real cost of labor and other common inputs could not be prevented from being transmitted to exporting enterprises. The consequence of this contagion must either be the aggravation of the current deficit of the balance of payments and, therefore, of the external indebtedness, or the repeated devaluation of the national currency. Whatever the outcome in each of these two cases, the process is bound to become self-sustaining. In the first case, it is a result of the rapidly rising cost of servicing the debt and, in the second, through the inflationary effect of the rising cost of imports on domestic prices and nominal wages.

In the case of the Tunisian experience, it was essentially the first of these two outcomes which was allowed to develop between 1975-1985. Consequently, the external current deficit rose, relative to GDP, from an annual average of 0.9% in 1971-1974 to 5.5% in 1975-1981, and to 8% in 1982-1985. As for the foreign debt it rose from 30% of GDP in 1974 to 33.2% in 1981, and to 46.5% in 1985. As to the cost of living, it increased by an annual average rate of 8.4%. But, given that the average yearly depreciation of the Tunisian Dinar against the SDR[1] was limited to 4.8%, the Dinar became progressively overvalued. It was this overvaluation which was mainly responsible for the aggravation of the current account deficit between 1982 and 1985. The result was a marked slowing down in the growth rate of the exports of goods and services from an annual average of 28% in 1978-81 to 7% in 1982-1985. Moreover, although the decline of the value of petroleum exports from 657 million

1 The use of the SDR is justified by the fact that the foreign exchange rate of the dinar is determined essentially in relation to the currencies included in the determination of the value of this accounting unit.

Dinars in 1981 to 573 million in 1985 contributed significantly to this reduction in the growth rate of exports, we find that the exports of other products, including tourism, were in effect more directly affected by the overvaluation of the Dinar. The annual growth rate of non-petroleum merchandise exports fell from 25.1% in 1978-1981 to 10.5% in 1982-1985, while the growth rate of receipts from tourism declined from 21.8% to 9.5%.

It should be noted, however, that the aggravation of the current account deficit in 1982-1985 took place despite the intensification of government intervention to contain the expansion of the country's imports of goods and services. As a result of this containment, the annual growth rate of these imports declined from 24.3% in 1978-1981 to 6.9% in 1982-1985.

2. The structural adjustment program

The reaction of the authorities to the aggravation of the current account deficit, as a result of decline in the growth rate of exports, was not only to restrict the growth of imports, but also that of investment, which fell relative to GDP from 32.3% in 1981 to 26.6% in 1985. However, with the rise in foreign debt in relation to GDP from 34.8% in 1981 to 46.5% in 1985 and with the increase in its servicing cost from 12.1% to 21.6% of current foreign exchange receipts, the situation became difficult in 1985 to sustain any longer. The erosion of the country's external creditworthiness and the decline of its credibility to a dangerously critical point in 1985, particularly as its net foreign exchange reserves fell in July to a negative position, forced the authorities to adopt less expansionary monetary policy. In addition, despite the raising of the official discount rate in April, 1985 from 7% to 9.25% and the imposition of greater import and credit restrictions, the balance of payment situation deteriorated even more rapidly during the first half of 1986.

Thus, faced with a widening of the current account deficit and negative net foreign exchange reserves, the authorities had to resort to the facilities of the IMF and to the adoption and execution of a comprehensive adjustment program. The measures of this program included the devaluation of the Dinar, the tightening of the credit policy, the progressive liberalization of prices, of imports, of investment decisions and of the allocation of credit by banks. Moreover, the authorities started to privatize state enterprises whenever this is made possible by the development of adequate domestic or external competition.

The results obtained from the application of this program were not only rapid, but also exceeded optimistic anticipations. This is particularly true with regard to the growth of the exports of goods and services, the improvement of current account balance and the amelioration of the foreign debt situation.

*Table 1: The economic results of the adjustment program (in percent)**

Variable	1986	1987	1988	1989
Growth rate of GDP	-1.4	6.7	0.1	3.7
Rate of increase in retail prices	5.8	7.2	6.4	7.4
Exports of goods and services (% of GDP)	30.8	35.0	41.9	45.4
Investment relative to GDP	23.5	20.6	19.4	22.6
Current account balance (% of GDP)	-7.0	-0.6	2.1	-1.2
Budget deficit relative to GDP	-7.3	-4.7	-3.8	-4.3
Foreign debt relative to GDP	60.0	56.0	57.0	55.0
Service of the debt relative to external current receipts	27.2	26.0	23.7	24.3
Net foreign exchange reserves at the end the period (millions of dollars)	53.6	176.2	532.2	667.8

Sources : Ministry of Planning and Central Bank

(*) These results should be considered in the light of the fact that the harvests of the agricultural years 1987-1988 and 1988-1989 were among the worst experienced since 1950.

What should be, however, of more significance from the point of view of the Tunisian experience is the capacity of adaptability revealed by the economy. Prior to the adoption of the adjustment program most Tunisians who were in a position to estimate its chances of success were not only skeptical, but outright hostile to its application. These objections were based on the untested assumption that the pertinent elasticities were too low.[2] This meant that the application of this program would aggravate the external current account deficit, deteriorate the foreign debt situation and intensify the domestic inflationary pressure, possibly to the point of undermining the country's social and political stability.

2 Early in 1984, I wrote an article in Arabic published in a local newspaper in favor of the devaluation of the dinar, the opening of the economy to domestic and external competition and the gradual withdrawal of the state from commercially oriented activities. My argument was that the pretended low elasticities of supply of exports and of demand of imports were more the results of the imposed protection and monopolization of domestic production and trade than the consequences of inherent underlying factors.

What is most surprising most about the development of the Tunisian economy since 1986 is the increased diversification of its production and exports. The composition of the country's merchandise exports experienced a profound transformation as the proportion of manufactured goods rose from 45.2% in 1986 to 67% in 1989 and to 77% in 1994. In this development the sectors which were the most protected before 1986 and which were considered the most vulnerable to the effects of liberalization, such as the footwear, and the electrical and mechanical industries, realized the highest rates of growth of exports. The share of these products in merchandise exports rose from 3.8% in 1985 to 4.6% in 1989 and to 9.5% in 1994 textiles have, however, become the principal exportable products. Their share rose from 19.6% in 1985 to 43.3% in 1994, while the share of those of petroleum declined at the same time from 41.8% to 9.4%.

It is evident from the results of the Tunisian experience that the development of its economy prior to the application of the adjustment program was considerably handicapped by excessive protection against foreign competition, heavy-handed bureaucratic controls and widespread chartered public and private monopolies. Nevertheless, without the external payment crisis of 1985-86, the authorities could not have dared to take the risks of adopting and applying the liberalization measures of this adjustment program.

The authorities must, therefore, proceed with caution, the success of each successive step being crucial to the adoption of further economic reforms and liberalization measures. The liberalization of prices, imports, foreign exchange transfers, exchange rate determination, the privatization of state enterprises, the reform of the fiscal system and of the labor code, have all progressed by stages. The process has in effect to demonstrate its validity in order to be convincing and, therefore, be able to solicit support and discourage opposition.

The main problem facing the public authorities in the application of their liberalization policy was the survival of a large member of enterprises created under the impetus of protection and subsidization. The growing petroleum receipts and the easy access to international credit at relatively low cost induced the authorities in 1975-84 to adopt extensive programs of investment and subsidization, either directly or through promotional low interest rates. This approach resulted in raising the level of investment, relative to GDP, from 21% in 1970-74 to 30.6% in 1975-84. External financing accounted for 23.5% of this relatively high rate of investment.

But as this investment was mostly destined to serve the needs of the narrow domestic market, despite its rather limited economies of scale, the investors had to be induced, in addition, to direct subsidization, by protection against imports and often also by the granting of exclusive monopolistic privileges. In effect, the inefficacy of this investment was aggravated by the fact that the enterprises of the public sector, for which the profit motive is not considered a compelling factor, realized a predominant share.[3] It was, therefore, inevitable that the inefficiency of this investment should be the main contributing factor to the increasing overvaluation of the Dinar and the acceleration of the growth of country's foreign debt in 1975-1985. The effective rate of profit realized from this investment, net of its depreciation charges, was generally markedly lower than the rate of interest paid in foreign currencies. In other words much of this investment, though it may be rewarding to the private investors, was either totally wasted or undertaken at considerable loss to the economy.

The emphasis was put, during these years, not on efficiency but on the number of jobs to be created. The authorities have in fact developed the habit of congratulating themselves on the number of jobs created annually while they totally disregard the real cost of their creation and their efficiency.

In order, however, to limit the exploitation of consumers who became captives of the producers and the traders of the protected domestic market, the authorities had to intervene through the process of price fixing and control. But this intervention has to be abandoned with the progressive liberalization of imports and investment decisions. Currently, only the prices of public utilities, pharmaceutical and basic food products continue to be determined by authoritative decisions. Moreover, about 90% of imported goods are freed from licensing and quantitative controls. This liberalization started with capital equipment and raw materials and progressively extended to intermediate and finished goods, including those destined for consumption.

The positive effects of this liberalization on the continued improvement of the country's economic performance is quite evident from the data of Table 2.

As in the case of 1986-89, this improvement is particularly strong in the external sector, noting that here too the rate of economic growth is hampered by the effects of the Gulf crisis of 1991 and the bad harvests of 1993-94 and 1994-95.

3 The share of the public enterprises amounted in this period to 40.2% of the country's gross investment and to 60% of the investment realized by all enterprises.

Table 2: The performance of the Tunisian economy in 1992-1995

Variable	1992	1993	1994	1995
Growth rate of GDP	8.0	2.3	3.3	3.5
Rate of increase in retail prices	5.8	4.0	4.6	6.0
Exports of goods and services (% of GDP)	39.5	40.5	44.6	45.5
Investment relative to GDP	26.4	28.9	26.7	25.3
Current account balance (% of GDP)	-6.6	-6.8	-2.5	-2.6
Budget deficit relative to GDP	-3.0	-2.4	-1.9	-1.7
Foreign debt relative to GDP	49.6	53.5	53.9	52.5
Service of the debt relative to external current receipts	19.5	19.5	17.5	17.0
Net foreign exchange reserves at the end the period (millions of dollars)	547.3	563.2	884.5	843.0

Sources : Ministry of Planning and Central Bank

The success of these liberalization measures to improve the balance of payment and foreign debt situation was crowned by the announcement, at the end of 1993, to render the Dinar convertible for current transactions and transfers due to foreign capital, debt, as well as direct investment. However, as this conditional convertibility had in fact progressed in fact *pari passu* with the liberalization of imports and external borrowing, the main aim of the announcement of December, 1993 was to give a wide publicity to what should in effect be a legal recognition of a working reality.

3. The Tunisian economy and its international environment

The progressive liberalization of the Tunisian economy from state intervention and bureaucratic manipulation and controls did not take place in isolation and independently of external influences. Rather, every reform or liberalization measure introduced in the Tunisian economy during the period 1986-1994 was a direct reflection of the transformation of its international environment. The implications for the Tunisian economy of the disintegration of the Marxist regimes of Eastern Europe, the globalization of production activities, the rapid development of international means of communication, the lowering of international trade barriers, the phasing out of discriminatory trade agreements and the reduction of the role played by public authorities in the shaping of economic decisions should not be underestimated or overlooked.

The dependence of the Tunisian economy on the exports of goods and services is relatively high. The share of these exports in GDP rose to 45.5% in 1995.[4] But what concerns Tunisia most in this relatively high dependence on exports is that over 80% of it is with the members of the European Union. The dependence on the Union is particularly heavy in the case of manufactured goods, agricultural products, tourism and the remittances of migrant labor. The main exported agricultural products, namely olive oil, citrus fruit and wine, profit under the 1976 trade and financial agreement from export quotas at the Union's support prices; while the exports of manufactured goods are admitted duty-free either totally or within, as in the case of textiles, specified generous quotas.

The prospect, therefore, of loosing these export privileges, especially under the GATT agreements, signed in April, 1994 meant for Tunisia the infliction of a mortal blow to its foreign trade and national income. The consequences of this loss become particularly serious when considered in light of the fact that most of the exporting enterprises were established by European entities on the basis of the opportunities offered by the relatively easy access to their home market. This concerns, in particular, textiles, footwear, electrical and mechanical equipment, which constitute the principal vulnerable sectors of the Tunisian economy, but which accounted in 1994 for 54% of its merchandise exports.

Tunisia has, therefore, no valid or serious alternative to its trade relations with the European Union. For example, against the 80.6% of its current foreign exchange receipts originating with the Union members in 1994, the Arab countries accounted for only 9.1%, of which 6.7% was with the Maghreb neighbors. Given, however, that in accordance with the latest acts of GATT, the 1976 agreement which regulates the

4 Compared with Morocco and Egypt, the shares of the exports of goods and services in GDP and of manufactured products relative to merchandise exports, have evolved as follows between 1970 and 1993.

	Exports of goods and services in % of GDP		Exports of manufactured goods in relation to total merchandise exports	
	1970	1993	1970	1993
Tunisia	22	40	19	76
Morocco	18	23	10	57
Egypt	14	25	27	33

Tunisian trade relations with the Union should come to an end in 1996, this country has no other choice but to accept being integrated in a free trade zone with its most important trading partner. This step, which is taken despite the marked differences in the levels of economic, technological and social development, is considered from the Tunisian perspective much more as a challenge than as an insurmountable obstacle. The country has proven, by the relative success of its adjustment program, that its enterprises and institutions are capable of being readapted to the exigencies of the free trade zone. The reasons for this assertion are the following:

- Much of this adaptability has already taken place as a result of the application of the structural adjustment program in 1987-94.

- The twelve years of transition should be sufficiently long for the enterprises of the weaker sectors to reinforce their productive capacities.

- Most of the manufacturing enterprises have already been included in this free trade zone in choosing to produce exclusively for the export market, which meant, in reality, the European Union.

- The conviction of domestic market producers that they have to improve their level of efficiency, particularly through the amelioration of their quality, o risk the chance of dissolving, is in itself a powerful incentive to enhance their chances of survival.

- The increase in the flow of financial resources from the Union members and its institutions and from direct private investment. The latter should have greater significance for the improvement of the performance of Tunisian enterprises. This should be true, particularly in case that this private investment replaces the state in the privatized enterprises.

The adaptability of the Tunisian economy could, however, be easily handicapped by certain insufficiencies whose solution depends essentially on the willingness and the determination of the public authorities. These insufficiencies concern in particular: The labor market, the state enterprises, the fiscal system and the country's basic infrastructure. The Tunisian labor market is noted for its lack of flexibility, as employers find themselves generally incapable of modifying the structure of their employment in accordance with the changing needs of their activities; of their lines of production; of the techniques and equipment they employ; of the efficacy of their location; and of the structure and volume of their demand.

In order to convey some flexibility to this market, the law was recently modified in the sense of permitting employers to resort to contractual labor whenever they see fit. However, though employers may find this type of employment more flexible and less costly in the short-run than non-contractual labor, it is basically less efficient for the economic development of the country. The main drawback of the contract-based employment is that it does not encourage employers to train what they may consider as temporary employees. Training requires time and financial support and it should, therefore, be difficult to expect employers to incur such sacrifices on employees who may not remain with them once their training contracts have come to an end. Moreover, the workers themselves may not find it advisable to acquire specific skills for which it may not be easy to find rewarding contracts. It is generally for these reasons that most of the seasonal workers tend to be generally untrained and, consequently, rather lacking in specific technical skills.

The problem of the insufficiency of labor mobility in Tunisia remains one of the principal obstacles to the introduction of a more efficient productive environment. Both the authorities and the trade union leaders are currently aware of the detrimental effects of this lack of mobility, but an effective solution is, in addition to being difficult to come by, not easy to implement. «Redundancy» and «unemployment» are the cries incessantly repeated against any effort to reform a labor code drawn in the image of that of France, which is also currently unable to cope with the problems inherent to its labor legislation.

4. The state enterprises: evolution and perspective

The sector of state enterprises started to expand soon after the declaration of the country's independence in March, 1956. The early expansion was the result of the nationalization of foreign-owned entities, particularly in public utilities and mining. The intervention of the state was rendered imperative at first by the exodus of European settlers who controlled the capital, the management, as well as the technical operations of the enterprises that were operating in the modern sectors of the economy. But as the Tunisian private sector lacked the necessary financial and human resources to fill the vacuum created by this exodus, the state found itself compelled to step in and save the relatively important enterprises from complete breakdowns. The intervention of the state was, therefore, initially motivated not by ideology or the possibility of gaining revenue, but by the obligation to stop the degradation of the nation's productive capacity.

This initial state incursion in market-oriented activities was followed in 1964-67 by the creation of several important enterprises in textiles, tourism, steel, paper, fertilizer, sugar and petroleum refining. These creations were essentially induced by the desire to accelerate the country's economic development. These enterprises were, therefore, assigned two important roles: to be poles of attraction for the creation of complementary activities; and to act as institutions for the formation of entrepreneurial and managerial capabilities. In their latter capacity, they have in effect made a significant contribution to the development of the Tunisian economy.

This expansion of the state sector, which raised its share in the country's gross capital formation from 24.2% in 1961-63 to 36.6% in 1964-67, led to an external payment crisis and to the adoption of an adjustment program whose effect lasted until 1973-74. The public sector experienced, however, another wave of expansion particularly in 1975-82, financed first by the windfalls brought about by the successive increases in petroleum prices, and secondly by a resort to external borrowing. Consequently, the share of state enterprises in gross domestic investment rose to 44.6% in 1976-79. This share, which was stabilized at 37.7% in 1980-84, declined steadily after 1985 as a result of the application of the structural adjustment program to 29.6% in 1987-90. However, although separate data for the state enterprises are currently lacking, the available information indicates that their share in gross domestic investment rose in 1991-95 to approximately 33%.

Nevertheless, despite the fact that the number of state enterprises has been markedly reduced since 1985 as a result of successive changes in the legislation defining them and the 43 or so that have been privatized so far, there are still over 160 of them in activity. This number is, however, far from reflecting their effective importance, as they are responsible for about 25% of GDP at factor cost and employ over 20% of the salaried work force. They retain absolute monopoly in water supply and other public utilities, in mining, cement, metal processing, petroleum and sugar refining, tobacco, matches and salt, wholesale trade in cereals, edible oils, sugar, coffee and tea; and they hold predominant positions in transport, chemicals, pharmaceuticals, flour milling, banking and insurance; and also have important market shares in practically every other area of the country's production and commercial activities.

Moreover, with the exception perhaps of the Ministry of foreign affairs, all government departments have under their tutelage state enterprises, for which they have the authority to name the managerial personnel and the power to survey their activity. This power of tutelage and guardianship gives the government bureaucracy considerable stake in these enterprises, particularly as possible outlets for nominations to their relatively lucrative and influential managerial posts.

The passage from the upper levels of the bureaucracy and these managerial posts is not only continuous, but is also considered a legitimate right and it is rare to find a person in charge of these enterprises who does not have some connections to the government bureaucracy. In fact, it happened at one time that all the members of the government, including the Prime Minister, have at one time or another occupied managerial posts in state enterprises. Moreover, since it is considered that that which is suitable for administrative posts in government is suitable for managerial responsibilities in business, the question of competence and aptitude is not considered to be serious enough as to hinder this practice.

However, though the privatization of the state enterprises is inscribed as one of the principal objectives of the economic reforms included in the adjustment program, so far, only a limited number of generally insignificant units, have been privatized. The main opposition does not come from the consumers or the workers. The former are now aware that, given the quality of the products, including their punctuality and rapidity of delivery, the prices of state enterprises are far from being competitive; while the latter are no longer sure that employment in these enterprises is more advantageous with regard to both salaries and job security. Currently, it is the bureaucracy which is the main responsible organ for the decelerated process of privatization.

This privatization remains nevertheless indispensable for the capacity of the economy to readapt its production structure to the competitive pressure of the free trade zone. This should be so for the following reasons:

- The enterprises of the private sector cannot avoid being negatively affected by the inefficiency of the state enterprises: through the effective high cost of their products, particularly where they control supply, and through the impact of their deficit on the availability and cost of credit, and on the effect of their subsidization on tax rates and budget deficit.

- The limitations they impose over the areas left for the generally more productive private investment.

- The rigidity they impart to the labor market and the wage system.

- The privileges they obtain over state purchases.

- The limitation of the areas open to foreign direct investment and to its possibilities of introducing product, managerial and technical innovations.

- The detrimental effect of an environment dominated by competition of state enterprises on the confidence of private enterprises to take risk and invest.

As it is difficult for state and private enterprises to coexist in a harmonious and unbiased competitive environment, it is inevitable that one of them should exploit the other, with the sure loser being economic efficiency and development.

It should be noted that during the period 1975-1986, when the country's foreign debt experienced its most rapid expansion, the transfers and subsidies granted by the government to state enterprises amounted relative to GDP to an annual average of

7.3%, against an external current account deficit of 6.4%. At their face value, these figures imply that without the deficit of the state enterprises the economy would have realized in 1975-1986 a current account surplus amounting to 0.9% of GDP.

The Tunisian public sector most probably has made a positive net contribution to the country's economic development, but this contribution declined progressively with the growth and maturity gains of the private sector.

Consequently, as the enterprises of the public sector could not have survived, let alone expanded, without the protected monopolistic positions they held and the government subsidies they received, their privatization have become a necessity for the acceleration of the future economic development of the economy. This privatization has become even more urgent in light of the prospective opening of the country's frontiers to the competition of the free trade zone. Article 36 of the Agreement signed between Tunisia and the European Union stipulates, however, that all monopolistic positions and privileges as well as other forms of direct and indirect state protection, financial assistance and market favoritism, should disappear. This meant in effect an eventual disengagement of the state from market-oriented production and commercial activities.

This implies that the country's governing authorities should privatize the existing state enterprises and concentrate their effort and resources on the improvement of the educational system, the development of the country's basic infrastructure and the reform of the administrative apparatus. These are the fundamental determinants of the competitive capacity of the economy. But we find the resources absorbed in the past by the subsidization of the state enterprises and certain consumers' goods have been mobilized mainly at the expense of those that should have been devoted to education. The part of the government budget devoted to education fell between 1970 and 1985 from 26% to 17%, while the part spent on subsidization increased from 6.5% to 12.5%.

The reform of the fiscal system is another important task facing the Tunisian authorities of the free trade zone during the transitional period 1996-2008. The Tunisia budget depends on customs revenue for about 20% of its fiscal receipts, of which the major part is paid on imports from European Union. But, given the twelve year transitional period and the division of these imports into four lists, the main effect of the tariff reduction is supposed to take place in the first year of this period and from the fifth year onwards. The importance of the first year arises from the fact that the imports of list 1 have to be freed from duty payments immediately, while those of lists 2 and 3 have to be reduced by 15% and 8% respectively.

However, as the relatively heavily taxed imports are reserved to list 4, the second, third and fourth year of the transitional period will be associated with rather limited effects on the budget. Consequently, the authorities have before them ample time to rearrange their finances.

The dependence of the budget revenue on taxes from personal incomes and profits has been equal up until now to that of its dependence on import duties. However, considering the effect of the tariff reduction on the amelioration of real purchasing power of money incomes and that the normal growth of the economy is expected to increase per capita incomes by about 60% during the transitional period, it should not be excessively difficult to transfer the anticipated fall of revenue from imports to direct taxes. In this way Tunisia should pass during the transitional period from a tax structure of an underdeveloped country to that of a relatively developed one. Without this effect on the country's economic development, the growth of its incomes and the transformation of its institutions and fiscal system, the free trade zone would have no significant importance.

5. Comments and conclusions

The liberalization measures applied in 1986-94, in the context of the structural adjustment program, have considerably transformed the Tunisian economy. The consequences of this transformation is particularly evident in the sectors of the economy which have been progressively opened to external competition. Exports and imports have not only increased more rapidly than GDP, but their composition has also experienced profound transformation. On the side of exports, it is the growth of manufactured products that has been particularly rapid, while on the side of imports it is that of intermediate and consumer goods which grew more rapidly.

The growth of the imports of consumer goods from 19.8% of merchandise imports in 1985 to 34.4% in 1994 is highly indicative of the intensification of external competition during this period; while the growth of manufactured relative to merchandise exports from 45.2% in 1985 to 76.9% is clear evidence of the importance of the restructuring that took place in the production capacity of the country. As a consequence of this transformation, exports have become the determining factor, not only of the country's economic growth, but also of the composition of its production and the orientation of its development.

During the period 1986-94, the country has gone through a period of apprenticeship which has the effect of preparing it for the inevitable consequences of GATT's Uruguay Round, and eventually to the integration of a free trade zone with the

European Union.

This defying step is taken by Tunisia with the full knowledge of its implications. It is a step similar to that taken by Portugal fourteen years ago, when it was at an economic and social development stage comparable to that of Tunisia today. A priori, therefore, there is no fundamental reason why Tunisia should fail where Portugal has succeeded.

But in order to succeed, Tunisia will have to use the transitional period; 1996-2007, in reforming its administration, in overhauling its educational and training system, in restructuring its fiscal revenue, in transforming its infrastructure, and in shrugging off the shoulders of its economy its burdensome and inefficient state enterprises.

All this is not impossible to achieve in twelve years and given that there is no valid alternative to the course taken, and as the dies are cast, Tunisia has no other choice but to accept this challenge with will and determination.

However, in Tunisia some people still worry about the fate of the artificially created enterprises during the generous period of 1975-84. Although it is understandable that an effective effort should be made in order to save what could be saved of these units, this ought to be done within the limits permitted by economic rationality. Nevertheless, it is imperative that the progress of the economy should not be hampered for the sake of saving some of these basically inefficient producers.

Having a bad egg cannot be considered as having an egg. Worse still, a bad egg is a cumbersome liability that needs to be rid of at a disposal cost.

George Joffé: Comment - The Curate's Egg

One of the problems in evaluating the implications of the proposed changes in the economic structures of the Mediterranean, particularly those in the future relationships between the Middle East and the European Union, is that much of the agenda is imposed by structural realities. Europe is the largest trade partner for all Middle Eastern and North African states by far and its own agenda is thus, inevitably, going to be the most powerful influence on the structures and institutions of the future. To a large extent, therefore, it will be European priorities in what has increasingly become the European geo-economic zone - both to the East and to the South of Europe's boundaries - that will determine the final outcome.

Many of these assumptions are necessarily inherent in Professor Grissa's analysis of Tunisia's experience. Indeed, as he points out, the Tunisian authorities, even before the economic crisis of 1985-86, had opted for close commercial links with Europe in certain sectors, even to the exclusion of the domestic market in some cases - an option taken only by one other state (Malta) before the end of the 1980s. To that extent, the Tunisian experience is virtually unique. However, in one other respect, its reliance on the state as promoter and controller of much of national economic activity, it is not. Inevitably, therefore, it had to face the consequences of domestic protection when the external account moved into secular deficit and foreign debt threatened to rise out of control in 1987. It is to the credit of the Tunisian authorities at the time that they initiated corrective measures, rather than waiting for the crisis to break, despite the implicit warnings they had received of the possible political implications of economic reform in January 1984. The wisdom of their choice is reflected in the macro-economic indicators that define the economy today.

We should, however, be careful before taking the Tunisian experience as a standard example of what can be achieved:

(1) First of all, the structure of the Tunisian economy differs from that of most of the economies along the South Mediterranean rim. This has meant that it is not so vulnerable to the vagaries of climate, for example, as the experiences of 1987-88, 1988-89, 1993-94 and 1994-95 have demonstrated. GDP growth still reached 3.3 per cent in 1994 and 3.5 per cent in 1995, for example, whereas, in Morocco, GDP growth was negative at 6.5 per cent in 1995, because of the catastrophic harvest.

(2) Secondly, it has also been far more successful in expanding its exports relative to GDP and, more significant in view of the proposed European free trade area, the growth in manufactured exports has risen from 19 to 76 per cent of the total in the past twenty-three years. Although Morocco may have enjoyed a similar proportional increase - from 10 to 57 per cent during the same period, according to Professor Grissa's figures - the absolute figures are far less impressive, since exports only reached 23 per cent of GDP in 1993, compared with 40 per cent in the case of Tunisia. The example of Egypt is even more depressing, with manufactured goods only reaching 33 per cent of total imports which, themselves, only totaled 25 per cent of GDP by 1993, compared with 27 per cent and 14 per cent in 1970 respectively. The concept of an industrial free trade area thus makes far more sense in Tunisia than elsewhere in the South Mediterranean rim, except Israel.

(3) This conclusion is reinforced by the fact, as mentioned above, that Tunisia - again almost alone in the Mediterranean region - has actively sought integration into the European economy since the 1960s with a policy of an enclave export sector attracting private foreign direct investment for exclusive export production by capitalizing on preferentially low labor costs. Admittedly, problems elsewhere in the economy before 1986 may have damaged this competitiveness in labor costs, but, nonetheless, the pattern of serving the European market with production up to European standards was established as part of the entrepreneurial ethos, in ways which have not been true elsewhere except Malta, Israel and Turkey. Nor is the validity of this experience undermined by the fact that much of this experience was originally in the textiles sector where the voluntary restraint agreements imposed by the European Union did little to hamper the preferential growth of trade, but which now has to face the implications of the end of the multi-fibre agreements as part of the Uruguay Round process and the consequent competition from even lower cost producers in South Asia and South-East Asia.

In two important respects, however, Tunisia's experiences do parallel those of other countries which have or are about to enter into new bilateral free trade area agreements with the European Union as part of the Barcelona Process and the construction of the new Global Euro-Mediterranean Partnership. The first is the pressure on the Tunisian authorities to reduce the role of the public sector in the economy. Although this requirement was originally formulated in the Structural Adjustment Program proposed by the IMF, it is also implicit to the Barcelona process because of the required liberalization of trade regimes for goods and services which will eventually require the removal of monopolies. Of course, the primary official justification for privatization policies is to introduce commercial transparency and to reduce economic inefficiency, but it is difficult to avoid the conclusion that, underlying these motives, is a strong pressure from outside for reforms of a kind which correspond to economic theory advanced in the developed world, whether or not it is appropriate for the developing world.

The second parallel is the issue of transition periods and conversion costs before the free trade area comes into full operation. Although the European Commission believes - as does Professor Grissa - that this can be achieved without undue economic pain and points to the example of Portugal in this respect, national authorities do not seem to be quite so sure. Both Morocco and Tunisia had requested fifteen-year transition periods before the free trade area was completely installed, but this was refused and twelve-year periods were imposed instead, despite the threat to domestic industry in both cases. The Tunisian government has claimed that conversion costs will reach TD 2.2 billion, 80 per cent of which must come from foreign sources. Even with such aid 2,000 companies face bankruptcy, 2,000 others face severe difficulties and only a further 2,000 enterprises can contemplate the free trade area with relative calm. Although the European Union is offering Ecu 4.7 billion in grants, with a similar amount in soft aid over the next five years, the actual amounts available to Tunisia fall far short of its targets. Morocco faces a similar, albeit more severe, situation with a threat to 60 per cent of its industrial base and reconversion costs estimated at 45 billion Dinar.

There is a third issue which also affects the probable outcome of the proposed free trade area as far as southern Mediterranean states are concerned and which undermines the oft-quoted parallel with Portugal. This is that the Partnership proposal, in economic terms, is far more restrictive than was the arrangement in 1986 for the advent of Portugal and Spain to the European Economic Community. No provision has been made for the integration of South Mediterranean agricultural economies into the free trade area, although promises have been made that arrangements, due to come into force in 2005, will eventually be discussed. In the case of Tunisia, once again, this may no longer be so important - a factor which is also true in Israel where declines in water availability have forced a 50 per cent cut in irrigation use and a consequent decline in the role of agricultural goods within the export profile. Elsewhere, however, particularly in the cases of Egypt and Morocco, this is not the case and the potential for economic development is bound to be adversely affected as a result.

The second aspect of this problem is the failure of the new agreements to allow for the free movement of people alongside that of industrial manufactures and services. Of course, since one of the major reasons for the Euro-Mediterranean Partnership proposal was to minimize the assumed threat of massive migration from North Africa, this is hardly surprising. At the same time, however, for most states in the South Mediterranean rim, their growing inability to export surplus labor, particularly to Europe implies, in the short term at least, a serious social and economic problem. Although birth-rates have fallen in recent years towards a regional average of around 2.3 per cent per annum, whereas in the 1980s they were often close to 3 per cent per annum, most North African states will still face severe strains on their social and physical infrastructure for several decades to come, with populations in which the majority will be below 25 years-of-age. Indeed, according to a report presented to Morocco's King Hassan in late 1995 by a ministerial group, average growth rates of 6-7 per cent will be necessary if economic growth is to be sustained - simply because of the demand that such youthful populations will place on national resources.

What is true for Morocco is certainly true for other South Mediterranean states and Middle Eastern states, such as Turkey, Syria, Egypt and Algeria, where birth-rates are still elevated. In the case of Tunisia, the pressure is not quite so intense because of the success of birth control programs begun in the 1970s which have meant that population growth rates have been restrained. Nonetheless, the GDP average growth rates of recent years, of between 3 and 4 per cent are barely sufficient to counter the intense call on services and provide sufficient slack for overall growth, not to speak of the debt overhang in states such as Morocco and Egypt. Elsewhere in the region, the picture looks very bleak for, during the past decade, GDP growth rates have averaged only 1.5-2 per cent per annum. Nor, ironically enough, is Israel a significant exception to this pattern. Up to 1990, its economic indicators were also unimpressive and, although growth rates and the inflow of direct private foreign investment in the past two years have been highly impressive, there is no guarantee that this will continue in the future. The recent elections may well see a decline in economic growth as a result of a generalized collapse in business confidence if the Middle East peace process is interrupted.

Against this background of restricted foreign aid from the European Union and the growing pressure on national resources for services from burgeoning populations, the outlook for the South Mediterranean states from the new European Economic Area which should result from the Global Euro-Mediterranean Partnership is not quite so encouraging as Professor Grissa implies it will be in the case of Tunisia. The picture is worsened by the fact that direct private investment and portfolio investment flows to the region have been consistently disappointing in recent years. Although Israel has seen a massive increase - its peace dividend, now running at about $2 billion annually - and Morocco and Tunisia have achieved significant increases in net direct private foreign investment flows since 1991, this has been largely because of the major privatization programs under way in each country and, even then, the funds received have been far below expectations. The Middle East and North Africa, in short, have been at the bottom of the list of private capital inflows in recent years and there is little reason to believe that this prospect will change in the immediate future. The problem is not only economic, although much of the talk of a new wave of economic "tigers" or "dragons" in the Middle Eastern and North African regions is misplaced. It is primarily political, for no rational investor will be prepared to risk significant investment when inter-state and intra-state relations continue to be so poor. And there is little evidence now that this will change in the near future.

In fairness, it must be said that Tunisia, together with Jordan, is probably far better placed than are other states in the region to take advantage of what meager benefits there are in the Global Euro-Mediterranean Partnership proposals. As Professor Grissa suggests, the Tunisian industrial sector is comparatively well-placed to exploit the new industrial free trade area and much of the ground work of economic restructuring has been done. Even though problems may still exist in terms of labor market flexibility, the outlook is modestly promising and even his state sector egg may turn out, in reality, to be a curate's egg - good in parts. Yet, even if this is true, there seem to be two fundamental questions that need to be considered, both in the case of Tunisia and within the wider Middle East and North African economic region - except for the oil-rich states of the Persian Gulf, with their small populations which depend on oil rent and thus fall outside this discussion.

The first has already been answered in part and relates to the micro-economic effects of the proposed industrial free trade area. The unrestricted arena of competition it involves is bound to have serious implications for the relatively small and formerly protected industrial sectors of South Mediterranean countries. Since several South Mediterranean countries have joined or intend to join the World Trade Organization, they already have to face the implications of the Uruguay Round of the GATT, now subsumed into the World Trade Organization. Thus, as Professor Grissa points out, the relative inflexibility of the labor in the South Mediterranean will mean that the consequent adverse effects on employment, at least in the short-to-medium term, will be amplified by such unrestricted competition, despite the transition periods which have been agreed. Yet, quite apart from the issue of employment, it also is not clear quite what implications the free trade area agreements are likely to have for the structure of industrial sectors in the future. At best, they would stimulate the development of fully diversified economies with integrated industrial sectors as generators of employment and future investment, essentially by creating a viable *mittelstand* or PMI sector, although such firms will be most at risk from competition through free trade. At worst, they could transform South Mediterranean economies into satellite economies of the European Union, supplying European industry with inputs as result of their advantageous factor costs - but not enjoying genuine internal diversification - along the pattern of the Mexican *maquilladora* industries along the American-Mexican frontier. This, in turn, would also imply that those sectors engaged in export-related activities would become enclaves within an undeveloped or under-developed national economy.

In other words, it is by no means certain that the benefits of competition - which are usually seen in terms of macro-economic indicators and the external account - will necessarily "trickle down" to the micro-economic level. Yet this is of crucial importance, for economic development will only produce prosperity and thus resolve the social and political problems which Southern Mediterranean states face if the real achievement is massive employment creation. In Morocco, for instance, unemployment is officially admitted to be 16.5 per cent and un- and under-employment is estimated at up to 50 per cent of the workforce. Even allowing the supposedly beneficial but unregulated effects of the unofficial economy - conventionally set at 40 per cent of the size of the official economy - this represents a major problem of delayed and disappointed expectations. These, in turn, amplify the risk of social and political conflict which themselves discourage investors, thus rendering the problem of economic development ever more difficult to solve. Tunisia may have avoided the worst of these consequences because of wise government action, but the underlying problems still remain and the conventional path to development, too, threatens to be no more than a curate's egg in which the good is increasingly outweighed by the bad.

Working Paper

INTERNATIONAL COOPERATION, ECONOMIC REFORMS AND STABILITY IN ALGERIA

Arslan Chikhaoui

Research Group on European Affairs, University of Munich

August 1996

The Project „Europe and the Middle East"

Due to the increasing importance of the Middle East and North Africa (MENA) for Europe, the Bertelsmann-Foundation and the Research Group on European Affairs set up the Project „Europe and the Middle East". Its mission is to develop European policy models vis-à-vis Europe's neighboring region across the Mediterranean. Following the Middle East peace process the question most thoroughly investigated is how the states in the Middle East and North Africa can organize regional cooperation among themselves as well as with the countries of the EU. Furthermore, it is designed to contribute to a better understanding of the transformation processes in the MENA-region in terms of its international relations, its economic development, and the transformation processes of state and society.

To implement this concept, the co-operation partners organize on a yearly basis workshop-meetings and the „Kronberg Middle East-Talks" which should contribute to a better understanding between both sides of the Mediterranean.

Arslan Chikhaoui is Managing Director at Transactions Nord-Sud Trading Consulting, Algiers.

Executive Summary

This paper comments on current political, economic and social developments in Algeria. Against this background this analysis tackles the questions arising around the effects of its bilateral relations with European states and international institutions. In particular, it discusses the impact of external resources on the political stability of the country.

Algeria's society is politically and socially disintegrating and divides itself into regional solidarity-systems. Nevertheless, the presidential elections confirm the willingness to execute political power by democratic means. However, in order to reestablish political stability, the socio-economic well being of the various groups of society has to be improved. But the Algerian economic system is bound to be highly inflexible, as the external debt gives very little space to maneuver, inflation remains a lingering threat, as do a negative balance of payments and unemployment, especially for the young.

The Algerian government reacted with an economic reform-program to these challenges in order to facilitate economic initiatives and re-establish market mechanisms: the easing of restrictions of international trade, reform of the banking sector, modernization of customs and tax administration, privatization and others. Thereby, it redefined the role of the state in the economic system. The state should now be left with objectives such as the redistribution of national income and should perform a mediation function among the several members of society.

1 Introduction

This document is intended to shed some objective light on the present situation in Algeria. It gathers reports, facts and comments, supported by technical arguments. With the objective to consider the effect of the mobilization of foreign financial resources, this document will deal with the following issues:

- Algeria's position in the Mediterranean Basin;
- a brief survey of political, economic and social realities in Algeria;
- the state of bilateral (countries of the European Union) and multilateral cooperation;
- the important contribution of foreign resources for the stability and the security of Algeria.

2 Algeria's position in the Mediterranean basin

In the image of countries belonging to the Mediterranean South Bank, Algeria is confronted with challenges and exceptional opportunities. The integration into the world economy, the peace process in the Middle East, and the European Union's recent initiative in favor of the Mediterranean Basin are real opportunities to seize. However, the expected advantages will only take shape if Algeria is capable to achieve effective macro-economic and structural reforms and political democratization. The latter are part and parcel of the same thing. The most important task of the reforms process is the resurrection of political stability which is inevitably expressed by the concept of popular sovereignty through universal suffrage.

In terms of comparative advantage, Algeria has at its disposal economic assets that are appreciable for the world economy, such as the following:

- A great potential in **human resources**, composed of well-educated youth and qualified executives benefiting from outstanding experience acquired through development (wages are highly profitable: Algerian engineer = US-$ 400 per month; qualified worker = US-$ 125 per month).
- Diversified and numerous **natural resources**, among which hydrocarbons represent an important source of financing.
- An important stock of **mineral resources**, of which only a small portion has been utilized.

- A dense **industrial potential** offering opportunities of high valorization.
- An agricultural sector with enormous production capacity and productivity with unexploited deposits.
- A great **transportation infrastructure** represented by an important road, port and airport network as well as a telecommunication network.
- A diversified tourism potential which is still inadequately exploited as well as a rich craft heritage.
- Important geopolitical assets inherited from its history, its privileged geographical position by belonging to diverse and numerous groups (Maghreb, Arab World, Mediterranean Basin and Africa) and by its proximity to significant markets (Europe and continental Africa).

3 A brief survey of the political, economic, and social realities of Algeria

Today Algeria is subjected to a near collapse of its political, economic and social structures. The analysis of the conditions of our state, our society and our nation will allow us to outline the various situations.

3.1 The socio-political situation

Starting from the events in October 1988, followed by the various significant political "alarms", Algeria is still paying for the mistakes of all past authorities and their successive governments. The latter have underestimated the real causes of the Algerian crisis. They went without a new constructive political discourse. As for the governments, they did not move towards a real changeover of political power and to a true political option, with an effort to counter suspicions and to increase trust between the governed and the governing. This occurred despite the high expectations and appeal of the Algerian people for the new government.

Today the Algerian society has lost many of its traditions. It is disintegrating and is becoming divided into clans, tribes and regional "solidarities". The social cohesion is undermined by all modes of exclusion. The potential dismantling of the society is not only due to a crisis of trust and legitimacy, but to the consequence of a fierce struggle for power. The Algerian people are seized by a violent repulsion reaction. They do not wish to accept the current path any longer. The riots of October 1988 were a revolt of the Algerian youth whose unrest and rivalry symbolized the rising of an unstructured counter-power calling into question the one-party system while asking for more social justice and rights.

Smothered for a long time, the political claims became more and more precise with time.

Since the beginning of the eighties, Algeria has entered into a phase of tensions and convulsions. This can be explained by the fact that Algerian rulers had governed through compromise between the different clans. The ruling system was built on personal relationships and regional antagonisms. The party in power suffered from a chronic legitimacy "deficit". The power division in numerous small groups dates back to the seventies. The clashes at the top opposed the different tendencies of the ruling party. The differences of opinion among the party's fringes concerning foreign policy issues, especially on the Maghreb (Western Sahara and the Union project with Libya), have intensified the political confrontation. Since then, Algeria has experienced an acute political and social crisis in comparison to its economic situation.

The October 1988 upheaval provoked disruptions that have continued to modify the national political balance to this day. The one-party political system, inherited from the country's independence, was weakened. The entire Algerian system was not only affected, but also called into questioned. The Islamist forces publicly emerged on the front scene with their claims. The trust that the Algerian people had in their ruling government was broken up and its credibility was impaired. The disruptions that we are witnessing right now are the mere result of the transition from the one-party system, in force for a long-time, toward an era of political pluralism.

The introduction of universal suffrage on November 16, 1995 can be interpreted as the people's expression in favor of peace and stability. The presidential elections that recognized the accession of Liamine Zeroual to the presidency indicate a timid willingness to move toward a changeover of political power through democratic means.

3.2 *The economic and social situation*

The Algerian economy characterizes itself by structural inflexibilities, which has hindered positive economic developments in the last few years. Among those inflexibilities are the following three most obvious ones:

- An undiversified economic basis.
- A vulnerability to external clashes. As hydrocarbons represent 95% of Algerian export, fluctuations of the oil prices not only have a direct impact on the export revenues and budget receipts, but have equally indirect repercussions on the markets of employment and capital. At the same time, because of a high

dependence on food imports, Algeria is also sensitive to fluctuations in rates on the international market.

- In a dominating public sector, public firms have not been exposed to competition and must depend on transfers and state subsidies.

3.3 *The Algerian foreign debt and its causes*

One of the most revealing symptoms of the economic and social crises in Algeria is surely its foreign debt. Initially considered a pure trading problem, the foreign debt has become an eminent political problem, as Algeria is dependent on foreign saving. Among the main monetary, financial, economic and even social indicators, the impact of the foreign debt is a major handicap for the country's economic growth.

3.3.1 The evolution of the liability of the foreign debt

The amount of the foreign debt in Algeria on December 31, 1993 was US-$ 24.7 billion. Since 1988, the foreign debt has increased. See the following chart:

Table 1 *(in millions of US dollars)*

Categories	1988	1989	1990	1991	1992	1993
Debt in the medium and long-term	24,218	25,019	26,460	26,435	25,423	24,012
Debt in the short term(*)	1,621	1,840	1,791	1,239	792	700
TOTAL	25,839	26,859	28,251	27,674	26,215	24,712

Source: Central Bank of Algeria
(*): debt of one year or less

As far as the expected liabilities of the foreign debt in Algeria are concerned, some important factors should be noted:

- The continuous drop of this liability since 1990;
- The reduction of the short-term debt and its relative share in the total debt of the country.

3.3.2 Evolution of the debt indicators

The evolution of Algeria's main debt indicators can be seen below in table two:

Table 2

Categories	1988	1989	1990	1991	1992	1993
Liability of the debt (in % of GDP)	43.6	48.4	47.7	64.8	61.7	53.4
Liability of the debt/annual revenues induced by goods and services exports	3.09	2.66	2.10	2.15	2.16	2.26
The service of the debt in % of goods and services exports	78.4	69.5	66.4	73.9	76.5	86.0

Source: Central Bank of Algeria.

According to this chart, one can notice that the stock of the Algerian debt is far from excessive, for it represents, since 1990, a little more than twice the country's annual revenues in currencies, and on the average since 1988, a little more than half of its GDP. However, since 1988 Algeria has faced problems of liquid assets. We notice that the service of the foreign debt, as a percentage of the goods and services exports, has amounted to 75% during the last six years.

The falling oil rates in 1985 provoked a 40% decrease in the country's export revenues and led to serious problems concerning the balance of payments. This is why the structure of the Algerian foreign debt went through a significant change. This modification led to the deterioration of the schedule of repayments, worsened by falling oil rates.

3.3.3 Evolution of the service of the debt

The analysis of the chart below shows the scope and the extent of the debt. The latter has gone through a continuous increase, since 1988, and reached US-$ 9.25 billion in 1992 or an increase of 41.3%. However, the most alarming fact is not the absolute significance of the service amount, but the fact that:

- The amount of this service in respect to the one of the foreign global debt is relatively high (35.5%).
- The comparisons of the amount of the service of the debt and the one of the economic aggregates reveal that:
    - The foreign debt service in 1990 absorbed almost 59.4% of the export revenues dealing with goods and services (less than 36% in 1985).

- The evolution of the ratio service of the debt/exports revenues of goods and services reveals the excessive weight of the service of the debt which is constantly increasing. This ratio reached 86% in 1993.

Table 3 *(in millions of US dollars)*

Categories	1987	1988	1989	1990	1991	1992
Principal		4,465	5,001	6,721	7,290	7,110
	3,840	4,481	5,121	6,156		
Interest		2,080	2,004	2,162	2,320	2,140
	1,641	2,083	2,035	2,100		
Total service of the debt		6,545	7,005	8,891	9,610	9,250
	5,481	6,564	7,156	8,256		

Source: Central Bank of Algeria

line 1: report from Lazard & Co

line 2: World Debt Charts 1991-1992 "External Debt of Developing Countries".

3.3.4 The causes for debt

The reasons that have pushed Algeria to have foreign loans are numerous and diverse. There are those that are viewed as "external", which means they have been imposed by the outside and cannot therefore be controlled by public authorities.

a) The external causes

We can summarize them as follows:

- The continuous fall of oil and gas prices, especially starting from 1985-1986;
- The depreciation of the exchange rate of the American currency in respect to other currencies more utilized in international trade which can even be considered as reference currencies as far as imports and loans are concerned.;
- The increase of interest rates at the international level.

a) The internal economic causes

The foreign debt has initially been carried on in order to finance ambitious industrial and social programs, notably in the fields of hydrocarbons and infrastructures. However, it is generally admitted that:

- The quality of techno-economic studies led to oversized projects followed by problems of technological expertise.

- The cash-flows released by the projects realized through currency resources have been extremely rare, and hence it was not possible to proceed to consistent reimbursements.
- A portion of the foreign debt was not being used in an optimal way; let us take, for example, certain projects which had the vocation of producing foodstuffs and consumption goods and benefited from financing, although they were known to be rather unproductive.
- The objective of the production and maintenance of the existing industrial fabric led to a considerable increase in the import of raw materials and spare parts. Hence, this situation created "irreducible needs".
- The debt increase is also due to the demographically sustained growth and to the continuous increase in the food-bill.

<u>a) The management causes</u>

Finally, there are the causes that fall within basic management, namely:

- The relatively exaggerated resort to short-term credit, due to the complete shut-down of international markets toward medium- and long-term capital and, to a lesser degree, toward financing difficulties concerning certain foodstuffs and consumption goods (beyond 12 months).
- The quality defiling of Algeria's trustworthiness. This situation is revealed by the rise of some rates concerning different commissions and margins of interest rates. These additional costs have artificially increased the foreign debt by at least 20%.
- The difficulty in controlling the foreign debt at the level of statistics as well as estimates.
- The non-utilization of new monetary and financial instruments that could surely be used in a positive manner on the service of the debt.

3.4. *Inflation*

The inflationary upsurge dates back to 1982, the year when the monetary supply had an increased rate of 26.3% and a production rate of 20.3%. The monetary creation evolved more rapidly than the production increase. In other words, the solvent supply increased more rapidly than the demand. Moreover, the increase of the money supply between 1989 and 1991 emphasized the risk Towards a generalized hyperinflation (rapid and unlimited growth of prices). The absence of an economic recovery makes firms more dependent on banking credits. Primary banks are bound to finance themselves by the Central Bank, which creates at the same time a new need of "monetary creation". See the following chart:

Table 4

Categories	1989		1990		1991	
	Amount Bill. DA	Variation %	Amount Bill.	Variation %	Amount Bill. DA	Variation %
Credit to the economy	209	+8.8	2.47	+18.2	330	+34
Refinancing to the banks	30.7	+82	65.7	+114	111	+69
Money supply	308	+5.1	343	+11.3	418	+22
Inflation		+10.2		+17.6		+30

Source: Central Bank of Algeria

3.5 *Balance of payments*

Since 1989 the Algerian economy has experienced a serious problem concerning its balance of payments, mainly due to the highly unfavorable volume and structure of the foreign debt. In 1989, 1990 and 1991, 70% of the export receipts were absorbed. In 1991, for instance, the service of the debt reached a record of US-$ 9.35 billion. Moreover, Algerian food dependence cost an annual sum of US-$ 3 billion. These two factors are a real constraint to the production industry, since the latter depends to a large extent on foreign supplies. Half of the financial needs for the balance of payments has been covered, according to the Central Bank of Algeria, thanks to "special assistance" mainly composed of multilateral credits and governmental credits.

The 1993 fiscal year closed with an estimated deficit of DA 180 billion or almost 13% of the GDP. The 1994 budget deficit has been estimated to be DA 125.3 billion, that is to say 9.6% of the GDP according to the figures of the 1994 finance law.

3.6 *Employment*

The history of the Algerian population has been marked more by significant changes in the attitude about procreation than in the functioning of family structures.

According to the national census, the Algerian population went from 11.821 million to 22.601 million inhabitants from 1966 to 1987. That is an annual increase of 3%. In 1995, the population has been estimated to be 28 million inhabitants. The rising birth rate is still dominant in the rural areas. This acknowledged fact might deteriorate the quality of life in Algeria and might decelerate durable growth, thus breaking the balance between a population that has been estimated to become 31 million by the year 2000 and the insufficient rhythm of the economic growth (lower than 2% since 1986). This would certainly jeopardize stability.

75% of the Algerian population is less than 30 years old. In absolute value terms, the illiteracy rate is currently 43.68%. Although the illiteracy rate has greatly diminished since independence, the number of illiterate, on the other side, continues to increase. Unemployment mainly affects young people. It reaches 25% among the working population. Two out of three are first-time job-seekers.

The number of job-seekers is currently estimated at 250, 000 per year and is bound to reach 300, 000 by the year 2000. 26% of the unemployed are between 16 and 19 years old; 83% of the jobless are under 30. The low education level combined with a lack of qualification is a real handicap for a seamless integration into the working world: Two-thirds of the young unemployed have less than a high school education and 72% have no professional training at all. The exclusion and the marginalization of these groups appears to be a destabilizing factor for the society.

4 The new economic policy

Economic depression, characterized by a more significant unemployment rate and a series of hyper-inflationist dysfunctions and a balance of payments deficit have pressed the Algerian rulers to conceive of a program for resolving the crisis.

Algeria is actively involved in huge economic reforms whose irreversible characteristic is unquestionable today. A process of important transformations in the economic system has been initiated to achieve better structural and institutional coherence. The objective is to facilitate economic initiatives and to re-establish market mechanisms.

In this framework, the rulers' approach targets:

- The stabilization of the economy, the gradual re-establishment of the macro-economic and financial equilibriums through a more restrictive monetary policy, the easing of restrictions on foreign trade, the restructuring of the exchange policy and price policy reforms.
- To increase the efficiency of structural reforms and consolidate the market economy regulations through measures which tend to facilitate the economic initiatives and to strengthen the market mechanism in the conduct of the economy and to boost the national production growth. These measures will essentially affect banking restructuring, the inducement of national and foreign private investment, the modernization of the customs and tax administration, the organization of competition as well as a more adapted real-estate policy to the new context.
- Relaunch the economy on the basis of renovated sectorial strategies, relying on the more dynamic sectors of the economy and meeting the population needs in the area of housing, employment and the production of foodstuffs. Despite an unfavorable international environment and a difficult social situation, Algeria is determined to carry out the reform process and to resume strong and durable growth as soon as possible.

The reforms objective is mainly sustained by the redefinition of the role of the public sector.

Giving up the development approach, which was enforced until recently, forces the state to work for economic automization; that is to say, the country must make a distinction between the logics of accumulation and regulation and the logics of social welfare. Consequently, the state should fully utilize its role as public power, leaving to the market the chance to organize its efficiency. The state has been the main actor of the Algerian strategy of development. Being the direct promoter and entrepreneur of the development, it retains a major part of authority, being either national or public, the distinction being not always clear between what belongs to the nation and what the state manages and what actually belongs to the state. The private local authority is reduced to insignificant portions and is often even due to state contributions. This situation explains the absence of consistent trade relations and the absence of institutions and regulations ruling those relations.

It is as a public power that the state will continue to be present in the new economic system. It will continue to carry on three essential functions:

- The administrative function of organization and arbitration;
- The redistributing function of national income;

- The organizational function of dialogue and of economic and social consultation.

The stabilization of the macro-economic framework is the efficient development of a real market economy, in the true sense of the word. Moreover, the weakness in productivity and the partial use of its production capacities are currently the characteristics of the public sector. Facing this double situation, privatization becomes inevitable.

The state's disinvolvement from the economic sphere becomes, hence, a necessity. Algeria cannot afford to maintain an "excessive" public sector, knowing at the same time that resources are limited. The current tendency has moved toward reform and toward the economic structural duality between the "modern" sector and the "traditional" one, thus creating a "two-speed economy" which deals both with the formal sector and its modern functions and the informal one with obsolete functions. This is why the new trend should be set up within the framework of new economic policy and should also fit in a positive dynamic. Reconstruction opens up new perspectives for Algeria's development. Its enforcement will progressively lead to a basic restructuring of the country's economy in order to take up challenges set out by unemployment, foreign debt, export diversification and integration into the world market. In addition to this, restructuring favors the emergence of creative power meant for the development of an efficient economic potential.

In other words, restructuring appears to be an indisputable option.

Amendments were introduced to the legal and institutional framework of investment and trade. Algeria entered a process of reform and changed its economic legislation in order to set up an institutional and a legal framework appropriate to a market economy.

The promulgation of a new code of commerce, of a stock-market, the modification of the civil code for international arbitration, the modification of the Investments Code as well as joining the Mutual Agency for the Investments Guarantee in 1992 and the International Center for the Settling of Controversies related to investments confirm this approach of liberalization of the Algerian economy.

4.1 The commerce code

A new code has not been introduced, but a reform of initial texts and the addition of amendments has been worked out as follows:

- Legal regulation and corporate bankruptcy;

- The restructuring of corporate law;
- Improved protection for creditors;
- An introduction of new commerce procedures (warrant and transport passes);
- Introduction to a new activity.

The most outstanding innovation is the one related to the patrimony status of Public Economic Enterprises (P.E.E.), regulated by private law involving two changes:

- The P.E.E. patrimony can be transferred and legally taken over by any person having the appropriate status;
- The P.E.E. can be declared bankrupt.

4.2 *The investment inducement*

All the decisions for the inducement of investment made imperative the creation of an appropriate legal framework, as the existing judicial tools proved to be inefficient, given the current requirements of the granting of guarantees and incentives as far as investment is concerned. No real global framework supported the investment promotion, except for some specific and diverse measures. This situation led to the promulgation of the legislative decree on October 5, 1993 for the inducement of investments.

The Investment Code has the same logic as the Code of Commerce. The Code of Investment in perfect harmony with the Code of Commerce enables foreign and national private investors to replace the state or to enter deals with it through new creations, restructuring and capacity extension.

The investment code is defined by these following fundamental principles:

- The freedom to invest for national citizens and foreign citizens;
- A simplified procedure limited to an investment declaration;
- The designation of a unique authority the Agency for the Promotion and Inducement of Investments, and backing up the investors through the main operational department.
- The confirmation of transfer guarantees (capital and benefits) and international admitted guarantees, notably the appeal to international arbitration.
- Different modes of incentive: general mode, specific mode and investment convention.

Concerning the advantages granted to investment projects which benefit from the general mode, complete exemptions in matters of property tax, V.A.T. for goods and local or imported services, company tax, and reduced rates granted for registration fees, customs fees required for goods and services, imports linked to the project, the tax on reinvested company profits and the contributions to social security have to be emphasized.

Specific modes present advantages granted, according to cases, to investments carried out in specific zones (to be promoted or already existing) in the area of development or to investments carried out in duty-free zones. The complementary finance law for 1994 authorizing the transfer of corporate assets belonging to the public sector completes the institutional mechanism allowing for:

- Free foreign investment;
- Association of different types of capitals: public, private and foreign.

4.3 *Organizational policy of the public economic sector*

Algerian rulers have currently decided upon the adoption of a new organizational policy of the public economic sector, whose main goal is to lessen dramatically the role of the bureaucracy and to improve efficiently the utilization of national production. This new organization of the economic public sector essentially aims:

- To renew the structure of P.E.E.;
- To insert public capital in the market favoring capital transfers ;
- To encourage the entrepreneurial spirit;
- To facilitate operations of public capital privatization.

The adoption of this policy will allow the establishment of a new economic system obeying the market mechanisms. This approach translates into a break with past economic options.

5 The state of bilateral (EU-countries) and multilateral cooperation

5.1 *With the International Monetary Fund (IMF)*

After the conclusion of the "stand-by" agreement during the first quarter of 1994, Algeria has demonstrated its determination to completely restructure its economy.

Consequently, in May 1995, the last negotiation talks with the Club of Paris and the Club of London led to the finalization of an agreement with the Steering Committee on the Algerian debt. Among the members of the Committee were the

Sakura Bank, the Long Term Credit Bank and the Japan Leasing Corporation. These two agreements enabled Algeria to reschedule US-$ 15 billion and to decrease the debt payment from 85% to 43%. However, the debt-stock went up from US-$ 26 billion to US-$ 30.5 billion. Hence , the IMF Administration Council agreed upon a US-$ 1.8 billion loan in the course of a three-year payment program.

This program is meant to guarantee a transition due to a series of structural adjustments, notably through a reduction of the budget deficit, the continuation of the price policy and the liberalization of foreign trade. The IMF Administration Council favored the finalization of this agreement, proving the international credibility of Algeria, and its desire to boost its economy insuring at the same time its institutional stability. However, we have to point out that the objectives of economic restructuring agreed by the IMF have not been completely achieved.

For reasons of social cohesion, the Algerian authorities could not start massive lay-offs. In 1995 the inflation rate reached an all time record of 28%. The foreign currency stocks have tremendously decreased since the beginning of the year 1995 to US-$ 1.9 billion. In 1994 it reached 4 billion.

The decline of currency supplies cannot only be explained by the decrease in oil-prices but also by the fact that Western countries have refused for more than a year to offer their financial support. Neither Germany nor Japan has granted lines of credit.

Furthermore, in order to finance its imports, Algeria has been forced to dip into its foreign currency supplies. Algeria does not have access to the international financial market because of the reluctance of some insurance and credit institutions such as Coface (France), Hermes (Germany) and Sace (Italy).

5.2 *With the European Investment Bank (EIB)*

The loan agreements with the EIB. essentially concern the financing of socio-economic infrastructures. Hence, the fourth protocol (1991-1996) that has reached ECU 350 million was used for the building up of large scale projects (such as dams and highways). This amount is composed of ECU 280 million coming from the EIB. reserves, and ECU 52 million as a donation from the EU and ECU 18 million considered as ventured capital for partnerships.

Moreover, the EIB. has granted a complementary loan of ECU 280 million in compliance with market requirements, of which ECU 200 million has been assigned to the project of the Maghreb-Europe gas pipeline and ECU 80 million to water-purification projects.

5.3 *With France*

In July 1994, France granted a credit of FF 6 billion including:

- A credit line of FF 2 billion in conformity with market requirements assigned to the purchase of medicine, equipment goods and vehicles.
- A credit in conformity with the market requirement covering for the supplying of 1.5 million tons of grain.
- A mixed credit (75% loan of the treasure) of FF 1.025 billion at a bonified rate. This assistance credit is assigned to the balance of payments and development assistance.
- Private credits amounting to FF 2 billion in compliance with market requirements in order to finance various projects. Those credits are guaranteed by the Coface.

Moreover, France intends to set up a new loan agreement of FF 5 billion, for which negotiations should start very soon.

5.4 *With Spain*

In January 1996, Spain granted a loan of US-$ 900 million, of which 100 million was transferred through the Development Fund for Assistance for the financing of social development projects. A portion of this loan amounting to US-$ 400 million is allotted on a short-term basis for the financing of commercial transactions and the same amount is assigned on a medium- and long-term basis for the acquisition of equipments.

In addition, the Spanish Insurance and Credit Company for Export covered commercial transactions in Algeria.

5.5 *With Italy*

The financial relations between Algeria and Italy can be summed up by the following credits:

- Lira 40 billion allotted to medium- and small-sized firms. This credit ran out at the end of 1995.
- Lira 18 billion assigned for the promotion of young entrepreneurial employment; 85% of the credit has been used and is managed by the Ministry of Labor.
- Lira 11 billion donated by Italian non-governmental organizations meant for agricultural and sanitary projects.

It should be noted that the credit line opened by the Sace has been suspended and is to be renegotiated. A new line of credit of Lira 30 to 40 billion to be assigned to the medium- and small-sized companies is under negotiation.

6 Foreign Trade

On the European continent Algeria enjoys its highest foreign trade transactions: 70.07% for imports and 77.99% for exports. Hydrocarbons represent the largest portion of exports with 95.85% while other products represent only 4.15% of the volume. The following chart shows the suppliers' positions. The analysis shows the trend over the four last years. The reference year is 1985. The last four years represent the various aspects of the Algerian crisis.

The chart shows that France has maintained its first position and Italy the third one, while Spain has come up from rank number 10 to rank number 4. Germany has fallen from rank number 2 to rank number 5.

During that crisis period, some partners reduced their commercial and financial cooperation: France has maintained its privileged position as the first supplier for Algeria. Bilateral relations with Spain have improved during the same period of time. The foreign trade volume is bound to increase with Spain, as the gas pipeline Maghreb-Europe is expected to be functional by the end of 1996. We have to point out that Spain adopted an offensive policy during the crisis period maintaining open diplomatic and consular representations in Algeria with the purpose of promoting its bilateral contacts in the Euro-Mediterranean partnership. It has to be pointed out that despite the interest that same countries are showing toward Algeria, the financial resources granted are mainly used for the promotion of their exports. In terms of investment, the European partners tend to focus on hydrocarbons.

Energy represents a major asset in the negotiations with Europe. The dependency of the European Community is increasing rapidly to bring up the current import rate from the current 40% to 60% by the year 2010. By year 2000, the European demand for gas has been evaluated to reach 41% corresponding to 147 billion cubic meters (in 1994, Algeria exported nearly 32 billion cubic meters of gas to six European countries, including Turkey).

Table 5

	1985	1991	1992	1993	1994
TOTAL	7789	7608	6994	6983	8326
France	2440	2181	2225	2104	2414
%	31.3	28.7	31.8	30.1	29
Rank	1	1	1	1	1
United States	410	726	674	897	1178
%	5.3	9.5	9.6	12.8	14.1
Rank	5	4	4	2	2
Italy	950	1106	1066	843	936
%	12.2	14.5	15.2	12.8	14.1
Rank	3	2	2	3	3
Spain	160	649	714	787	857
%	2	8.5	10.2	11.3	10.2
Rank	10	5	3	4	4
Germany	990	739	538	372	464
%	12.7	9.7	7.7	5.3	5.6
Rank	2	3	5	5	5
Canada	240	209	147	180	335
%	3.1	2.7	2.1	2.6	4
Rank	7	8	8	8	6
UEBL	340	310	309	277	315
%	4.4	4.1	4.4	4	3.8
Rank	6	7	6	6	7
Turkey	NA	206	108	82	238
%		2.7	1.5	1.2	2.9
Rank		9	9	11	8
Japan	430	366	269	247	230
%	5.5	4.8	3.8	3.5	2.8
Rank	4	6	7	7	9
Indonesia	NA	78	42	65	186
%		1	0.6	0.9	2.2
Rank		13	13	14	10

in millions of US dollars.

Source: COMTRADE/CFCE.

7 The importance of foreign resources for the stability and security of Algeria

The debt, the trade exchanges and the financing and nature of the economic growth are elements for maintaining stability. The definition of a policy of stability is based on the need to identify possible risks and threats. In the case of Algeria, the first threat is a social one. As a matter of fact, the risks of instability ensuing from the socio-economic development are extremely numerous.

7.1 *The socio-economic collapse*

Algeria is still suffering from a sustained economy and from an absence of a real long-term economic policy. Despite the few initiatives undertaken by some firms in order to revive an ossified economy, incomes continue to be affected by inflation. Social disparities have continually increased and the number of unemployed is getting larger and larger. The programs that deal with efforts to boost the economy are out of proportion with the socio-political stakes.

7.2 *Unemployment among the youth*

Whatever its technical and legal restructuring, whatever its daring political will, the Algerian economy cannot face the unemployed population. A real curse for society, unemployment sustains social exclusion. The idle Algerian youth has continued to threaten the stability and still cherishes the dream of the "European El Dorado".

7.3 *The perverse economic risk of restructuring*

Despite the diverse and numerous economic reforms starting in the eighties, a significant threat still remains. Algerian rulers are still living from an economic doctrine instead of from consistent economic management, adapted to national realities. The free market economy, an irreversible option, is liable to develop particular vulnerabilities. For, if the latter is not well-thought out, strategic sectors could weaken and the other adjoining sectors could become disorganized. The dogma of the free market economy, which has triumphed over the doctrine of a centrally-planned economy, has an equal chance of confining political freedom once again.

In deciding upon debt management, Algerian leaders have opted for a "shock therapy" in order to speed up the transition toward a free market economy. The absence of a real policy of economic relaunching through investment has high chances of provoking an increase in unemployment, an increase in inflation, a decrease in the standard of living and job insecurity. New social layers will appear on the social scene and will modify the already shaken political landscape. The "new outsiders" will come to feed general discontent.

7.4 *Illegal regional immigration*

Immigration from neighboring countries to Algeria can represent a serious threat. It can generate unemployment and foster the arms trade.

Added to the economic and political aspects of the social Algerian crisis, other social crises are altering the social fabric. Corruption, for instance, created, encouraged and sustained by the previous power, has developed and has spread over all the spheres of society. It hinders the ability of institutions to function and their stability.

8 Challenges and perspectives

Considering all political, social, economic and financial aspects of the internal and external Algerian environment, we will note that Algeria will experience a "certain respite" until 1997, allowed by foreign financing provided mostly by European creditors. By the end of its debt remanagement, Algeria will have to face constraining financial settlement dates during the period between 1998 and 2010. By that time, the country will be forced to develop its reimbursement capacities while lessening the threatening risks for its stability. This task can only be achieved through foreign financial resources, which depend on the exports, relying on an export-oriented internal production.

The internationalization of trade and the emergence of a global economy will force Algeria to adopt a new approach toward a progressive international employment distribution. Algeria has to endow itself with efficient means to cooperate with the international community in order to obtain all the foreign financial assistance needed to strengthen its economy.

This new approach has to be conducted through political stabilization, which depends upon the set-up of an economic policy sustained by foreign financial assistance oriented toward the field of small- and medium-sized enterprises and industries, the development of agriculture and country planning.

The Mediterranean Basin is considered to be a "highly strategic area for Europe" by the Commission of European Communities and the stability and security conditions will shape the Euro-Mediterranean partnership. The relations between the EU. and the South Mediterranean countries, and particularly the countries of North Africa, should go beyond purely economic matters.

As Algeria's objective is to favor stability, European financial support should be oriented toward the adjustment and the reforms that favor structural measures which mean to improve the adaptation capacity of the productive apparatus. In order to guarantee durable growth, the creation of jobs and development in general is necessary.

Moreover, since human resources are the major asset in the area, the training and reorientation of manpower are the best means to increase productivity. The most outstanding efforts to be performed are in the fields of education and demographic growth. Those particular measures will improve the local investments opportunities as well as direct and indirect foreign investments. These investments will allow for job creation, a better environment for the young generation, a socio-economic stability and consequently political stability.

③

Working Paper

Recent Adjustment Steps in Jordan: Breaking Old Structures or Paying Lip-Service to External Investors?

Ali Anani

Comment:

Benjamin Navon

Research Group on European Affairs, University of Munich

August 1996

The Project „Europe and the Middle East"

Due to the increasing importance of the Middle East and North Africa (MENA) for Europe, the Bertelsmann-Foundation and the Research Group on European Affairs set up the Project „Europe and the Middle East". Its mission is to develop European policy models vis-à-vis Europe's neighboring region across the Mediterranean. Following the Middle East peace process the question most thoroughly investigated is how the states in the Middle East and North Africa can organize regional cooperation among themselves as well as with the countries of the EU. Furthermore, it is designed to contribute to a better understanding of the transformation processes in the MENA-region in terms of its international relations, its economic development, and the transformation processes of state and society.

To implement this concept, the co-operation partners organize on a yearly basis workshop-meetings and the „Kronberg Middle East-Talks" which should contribute to a better understanding between both sides of the Mediterranean.

Ali Anani is Manager of the Anani Center for Studies, Amman.

Benjamin Navon is Daimler Benz Representative for Israel, Jerusalem.

Executive Summary

This paper asks what kind of investment opportunities exist for external investors in Jordan. In order to attract investors, the author argues that the government should take the main responsibility for external as well as internal political stability, the creation for competitive fiscal and tax structures, to work out the details of investment plans, support industrial development as well as development of specific economic areas, and finally for the privatization of state enterprises.

Figures on foreign investment in Jordan show an improving trend and future projects are gathering momentum: projects have been registered especially in the tourism sectors and some joint jordanian-israeli projects are under consideration.

However, there are some sectors which have to be further developed in order to attract more foreign investors: the infrastructure as well as the telecommunication sector is in need of improvement. The financial sector has to strengthened. Above all, the society has to adapt to the structural changes toward economic liberalization policies of the government.

The study then turns to a case study which should show the investment opportunities in the tourism-sector. But although Jordan witnessed a 25% increase in tourist arrivals from 1994 to 1995, only an increase of revenues of 3% could be realized. In consequence, especially the area around the Dead Sea should be developed in order to make higher financial gains possible.

1 Introduction

Jordan enjoys a strategic geographical location which connects Egypt, Saudi Arabia, Syria, Israel and Palestine. The response of Jordan to regional changes is as sensitive as it is to internal changes which result from the dynamism of the society and the induced mobility within its structure. However, Jordan has acquired an admirable acrobatic ability to maintain its equilibrium and social balance.

2 The regional and global dimension

The conflicting interests of neighbors cast their shadow on Jordan. Thus, Jordan has had to cope with two waves of war refugees from Palestine and a third wave from Kuwait. These waves of refugees had their impact on the Jordanian economy that had to undergo frequent interruptive adjustment phases. Nevertheless, the biggest wave that is blanketing its shadow on the Jordanian economy is the peace treaty with Israel. In October 1994, the Jordanian government formally endorsed peace with Israel. This development has forced Jordanian society to pass through a difficult transition period as Jordan must adjust to cope with this treaty. Simultaneously, Jordan also has to make economic, financial and social adjustments parallel to global developments that affect Jordanian life. Regional and global developments have shifted the Jordanian economy from a war economy to a peace economy. The establishment of the World Trade Organization (WTO), for example, became a reality. Jordan is taking the necessary economic adjustments to align itself with the requirements of the WTO. The government has proceeded to decrease duty on imported goods, to increase sales tax, decrease income tax, modify customs law, improve income taxes and decrease financial support to essential commodities. The government has also issued a new investment law. The impact of these laws in encouraging local and foreign investments are the main theme of this paper within the context of the aforementioned adjustments.

2.1 Constraints to regional cooperation

Economic disparity between Jordan and Israel is not the sole seed of unrest in the region. *Security concerns* are a major source of instability in the region as is failure to redirect military expenditures towards job-creation. The absence of buffering joint economic activities and the lack of trust among the warring parties will heighten the dependency on military supremacy and geological depths. However, this problem will ease gradually upon the completion of the multi-billion dollar regional projects in a few years. Conflicting historical rights and some misplaced religious beliefs will continue to separate the peoples of the region. Hard work and reorientation programs might lessen the magnitude of these beliefs, but will not remove them.

The differences in the level of democracy and the lack of positive involvement of people in peace developments will not be conducive to making peace most rewarding. I shall return to this point later.

The previous discussion highlighted some of the issues that destabilize the Middle East region and make it vulnerable to radicals. The solvency of these problems is a pre-requisite for the advancement of peace in the region and the attraction of foreign investment. Jordan is doing its role in this direction to the utmost of its ability. There are criticisms that Jordan is moving faster in this direction than it should.

2.2 Internal dimension:

This section dwells on the role of the Jordanian government, the private sector and masses in seizing new emerging opportunities.

The government's main responsibility is to create and maintain a healthy investment environment. This environment requires the government to provide the following:

- political stability;
- competitive fiscal and tax structures;
- structured and well-documented investment plans;
- industrial support including marketing and training;
- fiscal and grant aid to development areas. These include provision of labor and land grants, import duty concessions, tax concessions, holiday depreciation allowances and reduced sales, and operational subsidy such as local payroll;
- privatization policy that is sympathetic and balanced. The plan should clearly define terms of net sales to investors, private sector and management. Privatization methods should deal with stock exchange offering, sales of assets, regulations for new investments, management of buyouts, joint venture, lease terms and the freedom of negotiation.

2.2.1 Political stability

The Jordanian government's contribution to attract investment in Jordan is multi-faceted. The government must ensure internal stability and Jordan is a stable country. Israeli tourists for example, have not been harassed in Jordan. They feel safe. The crime rate in Jordan averages between 75-80 crimes per 100,000 citizens. This ratio is far below the global average. However, internal security is not enough: regional security is equally important. Any regional instability has a spill-over effect on Jordan. The suicidal attacks on Israeli citizens during January and February, 1996 prompted Israel to enforce a siege on the Palestinians living in the West Bank and Gaza. These regional unrests and conflicts are attractive news for the international media. The widespread coverage of these events retards international support to investment in the region. Roth Harkin, the president of EPIC in the USA voiced the opinion that such developments would retard investments in the Middle East. EPIC's fund of US-$ 250 million aims at prompting investment in the Middle East by the private sector in the USA. EPIC provides seed money and insurance against risks of political unrest. Making the risk high increases its insurance premium and, therefore, discourages investment in general.

These intrinsic risks are not the making of Jordan. Unfortunately, it is not expected that these risks will disappear or lessen in a short time. The disparity of income, industrial activities, standard of education and water quota per capita between Jordan and Palestine on the one hand, and Israel on the other hand is so marked, as it is in many other economic and social sectors, resulting in a "heterogeneous" region. The strength of the region is dictated by the strength of its weakest country. This is an unquestionable scientific fact. Regional stability will be dictated by this law until all countries reach a higher standard level that also reduces disparities among them.

2.2.2 General investment climate

There have been strong complaints about the investment climate in Jordan that have limited its international competitiveness. These complaints have centered mainly on the perverse tariff regime, cumbersome import and export procedures, lengthy, intransparent and non-competitive foreign investment laws, strong barriers to investment, an ineffective investment regime and a shortage of term finance to expand export capacity. The fragmentation of responsibility and non-transparent investment tax and customs laws have further compounded these problems.

2.2.3 Improving investment climate

The present situation is still not very encouraging. In 1994 the Bank of America published a listing of countries according to their investment risks. The Bank used a set of criteria to evaluate the risk of foreign investment using a 25-point scale. The higher the score is, the riskier the evaluation is. Jordan was placed in the middle for the year 1995. However, the evaluation report predicted that in the year 2000 foreign investment in Jordan will become riskier and score 16 points. At the time of publishing the above report, Jordan's Investment law reflected a strong bias against non-Arab investors. The law was also discriminatory in determining eligibility for incentives; restricted foreign equity participation relied on a tax holiday which were costly, ineffective and vulnerable to abuse. The law also fell short of providing internationally recognized dispute resolution mechanisms or adequate guarantees.

The Investment Department was placed low on the hierarchy of the organizational structure of the Minister of Industry and Trade. The salaries and work incentives did not attract qualified staff to the low-profile Investment Department. These facts reduced the foreign direct investment in Jordan. In fact, investment in Jordan has been negative in the six years between 1989-1995.

The Jordanian government promoted the Investment Department to a full-fledged corporation. The Prime Minister meets regularly with the corporation's officials and has set a special unit in his office to follow up on complaints received from investors. The one-shop department within the Investment Corporation "Investment Window" is in charge of receiving complaints and pursuing their solutions. Almost 41 complaints were received within the first quarter of 1996. These complaints centered around shortage of water, electricity, telephone lines and the organizational structure of this "Investment Window". As of yet, there has been no clear definition of its role.

This situation has not improved. Table (1) compares the number of registered companies by sector for the two periods between October 94-February 95 and October 95-February 96. The table shows that Jordan has a negative score of -9% in numbers of companies registered and a leveraged drop of -36% in their capital investment. However, this situation is reversing its direction. An American company is building the Aqaba Refinery, the cost of which is US-$ 2 billion on a BOT basis.

Table (1): Compares the Number of Registered Companies from Oct. 94 - Feb. 95 and Oct. 95- Feb 96.

	Oct./94-Feb./95		Oct.95-Feb./96		Comparison between 1995 & 1996	
Sector	No. of Companies	Capital (J.D.)	No. of Companies	Capital (J.D.)	No. of Companies	Capital (J.D.)
Industry	226	112,550,072	140	21,950,000	-38%	-80%
Trade	1,010	81,874,188	1,032	58,564,628	2%	-28%
Agriculture	3	225,000	1	30,000	-67%	-87%
Contracting	67	5,312,265	47	3,299,005	-30%	-38%
Services	443	30,405,126	371	63,220,932	-16%	108%
Total	1,749	230,366,651	1,591	147,064,565	-9%	-36%

2.2.4 Tariff Regime

The Jordanian government made a big step forward in this direction over the last few years. Import restrictions and bans were reduced and the import-weighted tariff rate dropped from 34% in 1987 to 24% in 1994. The government reduced the tariffs for non-luxury goods from 70% to 50%. The government made tariffs more manageable through the consolidation of taxes, the reduction of the number of tariff coefficient of variation from 89% to 70%. The government also canceled all import licensing requirements. It also introduced a reference-based price list for valuation purposes and will later adopt the self-declaration policy in terms of the WTO-Valuation Code. However, the government should avoid piece-meal approaches. The introduction of incessant changes is perplexing to all parties concerned with the tariff regime.

2.2.5 Customs and administration

The duty scheme is lengthy, non-transparent and costly. The number of signatures required to clear goods is frustrating and boggling. A harmonized procedure has been introduced since 1994, but customs officials have not been properly trained to use it. The implementation of the Brussels definition of value is problematic, because valuation is discriminatory as customs set high value levels to compensate for expected underevaluation. The government needs to strengthen the confidence between the customs officials and traders and investors. It should also expedite the completion of formalities by automating the process of customs clearance and introducing the use of electronic databases, especially those related to the prices of goods. On site and same-day clearance of goods is a matter of paramount necessity. The organizational structure of the Customs Department is inefficient and requires better integration among the clearing branches distributed in different parts of Jordan.

The improved investment law should correct this situation. However, this law will not do it single-handedly unless other relevant laws like customs law and companies law have been finalized. The main features and improvement of the Revised investment law are discussed below:

Relevant Articles of the New Investment Law

Article (6):

1st. The fixed assets of the project are to be exempted from taxes and fees provided that they are imported within three years from the date of the committee decision of approving the lists of the fixed assets of the project. The committee may extend this period after realizing that the nature of the project and the size of the work need such an extension.

2nd. Spare parts imported for the project are exempted from taxes and fees if the value of these parts does not exceed 15% of the value of the fixed assets that need such parts, provided that they are imported or used in the project within 10 years from the starting date of production or work, and according to a decision taken by the committee approving the list of spare parts and their quantities.

3rd. The fixed assets needed for extending or developing or modernizing the project are exempted by the committee from fees and taxes if this resulted in an increase of not less than 25% of the production capacity of the project.

4th. The committee exempts the increase in the value of the fixed assets that are being imported for the purpose of the project from fees and taxes if this increase is resulting from the rise in prices of those assets in the country of origin or resulting from the rise of its freight charges or from a change in the exchange rates.

Article (7):

1st. The project in any of the following sectors or their branches is exempted from income and social services taxes by a committee decision for a period of ten years as from the date of starting the work in the services projects or as from the date of actual production for the industrial projects.

The sectors mentioned above are:

- Industry.

- The sector of agriculture (without any harm to the privileges stated in other laws).

- Hotels.

- Hospitals.

- Maritime Transport and Railways.

- Any other sector or its branches which the Cabinet decides to add according to a recommendation by the Council.

The exemption is equivalent to the following percentages based on the development area where the project lies:

25% if the project is in a class A development area.

50% if the project is in a class B development area.

75% if the project is in a class C development area.

The committee grants additional exemption if a project expansion, improvement or modernization resulted in an increase in the production capacity of the project. The exemption is for one year for each increase in the production of not less than 25%, provided that the additional exemption period given according to this paragraph does not exceed four years.

Article (8):

Projects of hotels and hospitals are granted extra exemptions from fees and taxes on their purchases of furniture and supplies for the purpose of renewal and renovation once every seven years at the least provided that their importation to the Kingdom or use in the project occur within four years starting from date of issuance of the committee decision approving the list of purchases and their quantities.

Article (9):

In case of transferring the project from one development area to another during the granted exemption period, the project for exemption purposes, should be treated through the remaining period like the projects located in the development area to which the project transferred to provided that the committee is informed about the transfer.

Article (11):

1st. A council called "The Higher Council for Investment Promotion" shall be formed under the chairmanship of the Prime Minister and the membership of the following:

Minister of Industry & Trade	Deputy Chairman
Minister of Finance	Member
Minister of Planning	Member
Minister of Tourism	Member
Minister of Transport	Member
Governor of the Central Bank	Member
Director General	Member/rapporteur

President of the Federation of Jordanian Chamber of Commerce	Member
President of Amman Chamber of Industry	Member
Three competent and experienced persons from the private sector appointed by the Chairman of the Council upon a recommendation from the minister for two renewable years	Members.

The council convenes when the need for a meeting may arise, by an invitation from its chairman or his deputy in case of his absence. The council meeting is considered legal if it is attended by two-third of its members provided that the chairman or his deputy, in case of the chairman's absence, is present. The council issues his decisions unanimously or by the majority of its attending members. In the event of a tie, the side supported by the chairman of the meeting will be favored.

Article (12):

One-The council shall take charge of creating a suitable environment for investment that leads to achieving the comprehensive development goals and for that it shall assume the following:

- Endorsing the national strategy of investment, including the development of the production sectors, and improving and following up its implementation.
- Endorsing the investment policies.
- Endorsing the promotion policy for investment and following up its implementation.
- Considering the regulations of investment.

Article (18):

The Board of Directors of the Corporation, shall take charge of the duties and authorities stated in this law including the following:

1st. Supervising and following up administrative affairs of the corporation.

2nd. Suggesting the investment policies of the Kingdom, determining their priorities, setting the programs and plans stemming from them, and submitting them to the council for approval.

3rd. Endorsing the corporation's budget, report of the auditors, and final accounts.

4th. Endorsing the financial and administrative instructions pertaining to the corporation.

5th. Defining the fees on the services rendered by the corporation.

6th. Appointing a certified auditor for the corporation and defining his dues.

7th. Establishing branches for the corporation in any locality inside or outside the Kingdom.

Article (24):

In conformity of what has been stated in any other law:

1st. The Non-Jordanian investor shall have the right to invest in the Kingdom by whole ownership or by partnership or by sharing according to the provisions of a by-law to be issued showing the projects, sectors and their branches and the percentage within its range the Non-Jordanian investor can share or participate and the minimum foreign capital which he invests.

2nd. In conformity of the paragraph (A) above, the Non-Jordanian investor in any project that is subject to the provisions of this law shall be treated the same way as the Jordanian investor.

3rd. The investor shall have the full right to manage his project in the way he sees and with the persons whom he chooses for this management where the concerned authorities shall offer the required facilities.

Article (25):

The dispossession of any project or subjecting it to any measures that lead to the same, are not allowed except for public interest provided that a just compensation is paid to the investor. In this case, the compensation paid to the Non-Jordanian investor shall be in a freely transferable currency.

Article (26):

The investor must perform the following:

1st. Notify the corporation in writing about the date of starting the work or the actual production, as soon as the installing of the fixed assets and equipping them for the project purposes is finished.

2nd. Have a regular book-keeping audited by a certified auditor in the Kingdom.

3rd. Keep a record of the fixed assets that actually entered to the project in which all their details are listed.

4th. Furnish any information, data, or documents, demanded by the corporation, that are related to the fixed assets of the project and allow any employee authorized by the corporation to have an access to the project to match data and information to reality.

Article (27):

If the ownership of the project was transferred during the given period of the exemption, the project shall continue to benefit from the granted exemptions, facilities and guarantees till the end of that period, provided that the new investor continues the work in the project and replaces the previous investor in the rights and obligations according to the provisions of this law.

Article (28):

A- The investor, with the committee's approval, may sell the exempted fixed assets or give them up to another investor and will benefit from the provisions of this law, provided that they are used in his project. The investor may, after notifying the committee, sell the exempted fixed assets to any person or to another project not covered by the provisions of this law after paying the fees and taxes due to them.

B- The investor, upon the approval of the committee, may re-export the exempted fixed assets.

Article (29):

If two or more companies or corporations merge, the new resulting company or corporation shall be required to organize separate accounts for each project that benefited - before merging- from applying exemptions and facilities provided for in this law throughout the remaining period of exemption.

3 Foreign investment in Jordan

The inspection of foreign investment in Jordan for the first quarter of 1996 shows an improving trend. A total of 103 projects have been registered. These projects fall into the following sectors: 86 industrial projects and 4 hotels, 6 agricultural projects and 4 hospitals. The total investment in these projects approximates US-$ 252 million, 20.5% of which are foreign investments.

It is noticeable that most of these projects (51.5%) fall into the area classified "A" in the new investment law. Even though the incentives provided by the investment law for investments in under-privileged areas are more generous than those provided for developed zones, they have not produced the expected results. The government has to give extra incentives to attract investors to remote areas. These include financial incentives and commitment to compensate investors for the extra establishment and running costs those investors endure.

As most of the investors are first cost- minded, they will initially prefer to invest in developed areas. The savings they get from the new law are "deferred ones" and will only materialize in the future. Only when investors make operational profits would they then pay fewer income taxes, and that is at present an intangible offer.

The cash flow dictates that the initial extra cost resulting from establishing the investment in under-developed areas is more tangible to the investor than the "intangible" savings he would get sometime in the future. The initial extra costs will be compounded because of the lack of infrastructure, communications, more-than-average maintenance, the lack of a skilled work-force and other unforeseen difficulties. These facts will mean that most projects will only enjoy 25% tax exemptions for a period of 5 years as they fall into areas classified "A". That is not enough if Jordan wants to compete with the rest of the region for international investments. The neighboring countries have accumulated experiences and developed their laws to lower initial costs. Unfortunately, there are no comparative studies between Jordan and other countries to place Jordan correctly on the "investment map". Jordan should consider developing several maps to encompass human resources mapping, incentives mapping and so on to identify weak areas that need enforcement and strong areas to make them noticeable.

Future prospects are broad. Investments worth US-$ 750 million to establish tourist villages on the east side of the Dead Sea start to become effective in the second half of 1996. These projects will employ almost 10,000 skilled laborers. The Al-Hassan industrial city had almost sixteen new industries on a joint-venture basis with leading international firms. These projects will employ 5,000 laborers by the end of the century. The more attractive the incentives are, the more they will bring in international investors.

Joint projects with Israeli companies are gathering momentum. Areas for cooperation include food industry, textiles and building materials. However, the trade and transport agreements have only been formally rectified. Their correct implementation within a healthy political environment is a prerequisite to have these prospects materialize into solid investments. The Aqaba Airport, the US-$ 58 million bromine project and the Dead Sea-Red Sea Canal are potential joint projects between Jordan and Israel that will be initiated upon the completion of feasibility studies. If found feasible, within the context of a healthy political climate, their implementation would be accelerated. The Qatari gas line, the provision of Israel by electricity from Jordan and other multi-million projects are also other potential projects that would enhance regional cooperation and induce economic and political regional stability. This stability will bring an increasing number of international investors.

3.1 Provision of infrastructure

It is not enough for Jordan only to adjust its fiscal policy, monetary policy and economy, as this adjustment has to be coupled with the availability of solid infrastructure to attract the international investors. I believe this is one of the most thorny problems facing Jordan. Water shortages, development of desert and availability of efficient telecommunication and transport systems are prerequisites if Jordan is to attract international investors. Likewise, the problematic water issues do not limit themselves to Jordan, but extend to the Middle East. Table (2) predicts water allocation per capita for selected Middle Eastern countries for the year 2025. The water share per capita is expected to be around 90 cubic meter. This falls far below the international requirement of 500 cubic meter per capita needed to sustain economic growth. Studies show that Jordan will experience a water shortage of 574 million cubic meter in the year 2000. Investments worth US-$ 2.2 billion will be needed to meet this shortage. Realizing that water allocation for the year 2000 will be as follows: drinking water 383 million cubic meter; industry 78 million cubic meter; and agriculture 1,081 million cubic meter. In light of these data, we are aware of Jordan's need to readjust its water policy. Agriculture, for example, is by far the largest consumer of water (70% of total consumption). However, the economic return of this consumption is meager. Estimations are that agriculture generates only around 7% of Jordan's GDP. The prices of water went up in April, 1996 to encourage water conservation. However, water is an essential commodity and its availability at acceptable prices is critical for the international investor.

Table (2): Renewable water per capita

(cubic meter)

2025	1990	1960	Country
354	737	1704	Algeria
645	1112	2251	Egypt
1032	5152	5788	Iran
2000	5285	14706	Iraq
311	467	1024	Israel
91	224	529	Jordan
809	1407	2000	Lebanon
55	154	538	Libya
75	75	100	Malta
651	1185	2560	Morocco
421	1222	4000	Oman
49	156	537	Saudi Arabia
161	439	1196	Syria
319	539	11036	Tunisia
113	189	3000	U.A.E.
72	214	481	Yemen

Source: International Resources Institution/ International Bank Projection

3.2 The telecommunication sector

This sector is also in need of improvement. Waiting times are alarmingly long and can reach more than 7 years for the residential sector. However, Jordan has allowed the private sector to invest in telecommunications. Mobile phones, pagers and the internet are examples of services now provided by the private sector, mostly on a joint-venture basis with international companies such as Motorola. However, the services are costly and this limits their widespread usage. As the number of subscribers increases, expectations are that rates will go down.

3.3 The financial sector

The Jordanian government is doing its best to stabilize the Jordanian Dinar against the Us-$. It has floated the interest rate, but this had an adverse effect on the economy. This is because of the high risk involved in lending. The sharp rise of uncleared checks in the period from January 95 to January 96 for example prompted banks to deposit their cash in the Central Bank at zero risk rather than lending it.

The high interest rate on lending approximating 14-15% over the last two years has made it expensive for investors to receive bank loans. Some of these investors have opted to invest in the Amman Financial Market (AFM) to realize profits. This expectation proved a failure partly because of the difficulty for investors to get loans from commercial banks to invest in the AFM. This has started a vicious circle of increasing supply of shares and decreasing their demand. This imbalance between supply and demand started a down-spiral for stock prices. The financial sector is sensitive to changes, in spite of the fact that it is well-developed because, on the whole, this sector is not sufficiently deep.

The banks cater mainly to financing trade and working capital requirements of the private sector. Interest rates are high and most deposits are short-term. This has limited loans to private companies. The very small size of the manufacturing sector which accounted for only 12% of GDP in 1994 is evidence of this. The inability of these companies to leverage internally generated funds (mostly from sources other than banks) with long-term borrowing, severely limited their expansion and exports. However, the newly-established Exports Bank with a paid-off capital of US-$ 30 million will lessen this problem. The Industrial Banks account only for 8% of the extended and outstanding credit by the financial system. However, Jordan is lagging behind. The Sultanate of Oman offers local investors zero-interest loans to go into joint ventures with international companies, especially if they bring to the Sultanate new technologies. High interest rates in Jordan are not serving the ambitious new investors in Jordan.

The capital of banks is mostly small and the new law forces them to raise their capital to a minimum of US-$ 30 million. This is still a small amount of capital and will severely restrict a bank's ability to participate in regional projects. Private investments are not in a better position as private contractual savings institutions are small and mutual finds do not exist mainly because *of the absence of the appropriate and regulatory framework.*

Jordan has made important strides towards capital deepening in the financial sector. All banks have to follow Basle norms relating to capital adequacy and most banks are in compliance. Lending guidelines are in conformity with international standards and provisioning for loan loss has been increased. Bad loans are now around 6% of all loans. The credit-deposit ratio has been eliminated by the Central Bank. There is a general movement towards universal banking and the government plans to reduce the difference between reserve ratios applied to commercial and investment banks to a maximum of 5% in 1996. Privatization of government and semi-government banks is also under preparation. Corporate law will also allow for the establishment and supervision of private mutual funds. Likewise, the Insurance Law will allow new entry under an independent regulatory body as well as the private management of social security and pension schemes.

The above discussion indicates the deep changes the financial sector is undergoing. The digestion and correctness of implementation of the new rules and regulations will require some time before they can be applied efficiently and come to substantial fruition.

3.4 Structural adjustment and the society

Jordanian society is undergoing deep changes that require deep adjustments. The government has to ensure the fair distribution of economic and social activities within the society. This task is further complicated by extra factors, namely: fighting corruption and channeling the public to accept the new regional and economic changes. Corruption will discourage foreign investments and the Jordanian government is fully aware of this fact. The government is busy rooting out corruption.

One of the biggest challenges to the government is to convince the public of its long-term policy. The cost of living, unemployment and poverty have reached unprecedented heights. Anani Center for Studies, in collaboration with *Al-Aswaq* (*The Market*) the leading financial newspaper in Jordan, conducted a public survey on issues that concern the Jordanian society. The results show that the people in Jordan (80% and more) concern themselves with economic issues pertinent to their standard of living. Some of the people put the blame on the government's policy in deregulating the economy. Some of the blame falls on the peace treaty with Israel. This is not an unexpected result. People are foremost results-minded. The immediate results deviate from people's expectations from peace. The government has to increase its campaign to streamline the public thinking with its medium- and long-term policies. It has to convince the public that initial sacrifices will bring results and that major changes will create real business opportunities. Unfortunately, thus far, international money has not poured in any substantial amount to create immediate job opportunities for the Jordanians. Tangible results speak louder than intangible ones. The lack of return for peace and economic adjustment make the public skeptical about results.

The problems of poverty and unemployment are epidemic and migratory in their nature. Curbing these problems is essential for Jordan to maintain a stable and safe society and attract international investors. The public behavior will be influenced by its attitude. The treatment of tourists is one lesson we learn from the Egyptian experience. It is unlikely that the citizen will welcome tourists whole-heartedly if the former is unhappy with his government's policy. In fact, the tourist might be an easy target for the unemployed and poor people who will rebel as a result of their misery.

4 Case study: investment in tourism

Tourism promotion is one available barometer to evaluate the government's role in promoting the investment climate of Jordan. Tourism and travel encompass several economic activities. These include transport, accommodation, catering, recreation, tourist industrial products and services for the travelers. Tourism is, therefore, the world's largest employment generator. In Jordan, where unemployment averages between 15-20%, there is a need to activate tourism to generate employment. Studies show that the Middle East is lagging behind in this important economic sector. The magnitude of this lag is apparent from table (3) below, where the basic economics of tourism are compared. However, this situation is currently showing signs of improvement.

Table (3): Basic Tourism Economic Data (1995)

TOPIC	GLOBAL DATA	MIDDLE EAST DATA
Total gross output	US-$ (3.5) trillion	US-$ (78.7) billion that is equivalent to (2.3) of world total.
% of GDP	10%	8.7%
Creation of jobs	World average around 10%	10.1%
Capital investment	World averages around 10%	8.5
Indirect business taxes	World averages around 10%	9.8%
Project growth over the next decade	50%	207% That is equal to four times the world average in real terms
Investment in infrastructure	703 billion	Generated 2.7% of global investment in infrastructure, plant and capital equipment. This is equivalent to US-$ (19.0) billion or (8.5%) of total capital investment in the region
Export potential		Generated about US-$ (6.4) billion

The peace development in the Middle East is encouraging more tourists into the region. Table (4) shows that the Middle East enjoyed a higher percentage of tourist arrivals in 1995 as compared with 1994.

Table (4): Statistics in Tourist Arrivals: Comparison Between 1994 and 1995.

Region	Tourist Arrivals (million) 1995	% Change over 1994	Tourism Receipts (US-$ Bn) 1995	% Change over 1994
East Asia and Pacific Africa	84.0	9.2	70.2	13.4
Middle East	11.1	12.6	6.7	30.2
South Asia	4,4	11.0	3.7	17.3
Europe	337.2	2.3	189.8	8.6
Americas	111.9	4.4	95.2	0.2

Jordan witnessed a 25% increase in tourist arrivals in 1995 over 1994. This is lower than the average for the Middle East 30.2%. However, this positive development in tourism did not reflect a parallel increase in revenues generated from tourism in Jordan. Data show that the 25% increase in tourist arrivals increased revenue by 3% only.

Realizing that tourists consume water, electricity and other subsidized commodities, the net revenue generated from the increase in tourist arrivals is effectively less than 3%. This is a lopsided affair. Jordan needs to work in different directions to correct this situation. The government, the private sector and the citizen have to concert their efforts to optimize the opening opportunities. This is a formidable task and is extensible to all emerging investment opportunities. The shore of the Dead Sea is enriched with sunshine that is filtered because of the low elevation of the area. This allows sun bathers to expose themselves to the sunshine without fear of over-burning. The nearby availability of spring water, the close proximity to the Amman airport and easy road connections make this shore ideal for tourism. For these reasons, the government is fully aware of the importance and seriousness of the shore's development in allowing only projects of high excellence to be established. The government announced in its official journals that it prioritizes projects involving tourism as outlined below:

- hotels of all kinds and categories;
- normal and tourist housing schemes;
- tourist villages for different uses and functions.

The priority list does not include service projects such as restaurants, fuel stations and commercial buildings as the government postponed review of the plan to a later date. The most relevant conditions of the loan guarantee for investment in the Dead Sea Eastern shore were outlined by the Jordan Valley Authority (JVA) as follows:

The investor shall be obliged to submit the loan guarantee to JVA in order to reserve the land intended for the allocation or renting. This guarantee shall be valid for one year from the date the investor is officially informed and the guarantee shall be issued within three weeks from the same date. The loan guarantee was at the rate of JD 25,000 for each donum (1000 m^2).

The investor shall complete the economic feasibility study and the preliminary drawings within six months from the date of his submission of the loan guarantee.

Upon obtaining the approval of the JVA and other concerned authorities, the investor shall do the following:

A. The investor is requested to proceed with the preparation of the detailed implementation drawings.

B. The loan guarantee is replaced by a valid one at a rate of JD 1,000 per donum instead of JD 25,000.

In case the investor did not start actual implementation during the allowed period (the three months), the JVA shall confiscate the loan guarantee, and shall have the right to give the land to another investor without any court or legal responsibilities.

The potential investors reacted strongly to the conditions of investment in state-owned land. Several meetings with the government officials resulted in reducing the lease of land from the annual rate of JD 2,500 per donum to JD 1,000. The investors were not satisfied as they pushed for greater incentives. They wanted yearly payments for the leased land instead of the sought-for bulk pre-payment for 10 years.

More than sixty project proposals were submitted--- for hotels, health spas, recreation centers and others. However, the investors' frustration became further aggravated as it took officials more than a year to approve proposals. The investors saw little logic in such long delays. The problem was not always land ownership or lease as some investors owned their land; yet their proposals were placed on a waiting list with others. Even though some investors built their own roads, brought in their own power generators and made arrangements for water, approval of their projects lagged behind for more than a year. The slowness of approving projects is retarding investment.

Nature and unforeseen events also contributed their share in delaying project approval. The Dead Sea has the lowest elevation. This fact has its positive and negative effects. Drainage from high neighboring areas naturally flows to these low-lying areas. Sewage systems are, thus, problematic and environmental concerns are high and difficult to overcome. This puts extra planning requirements and, therefore, causes unexpected delays.

The fact that the selected areas (Al-Suweimeh and Al-Zarah) were military zones before the signing of the Peace Treaty with Israel meant that these areas remained more or less "virgin" areas. They need huge developmental efforts at high cost. The share of those costs between the authorities and investors requires hard work and novel thinking. A formula has been designed to provide a standardized form of agreement between the authorities and investors. The terms of this agreement shall be available in the second half of 1996.

The authorities were propelled to freeze the master plan for the Al-Zarah zone. This resulted because excavations unearthed a hidden city underneath. The authorities are working to develop a new master plan for a neighboring area that is four kilometers away from the discovered city. Of course, this resulted in the cancellation of all former master plans for this location.

The privately-owned land is a thorny issues that authorities are now facing. These lands are small and are not enough to attract investments of international standards. Actually, there exists the possibility that they may turn these locations into slums serving the nearby international investments. The authorities need to develop a plan to allow investments in private land in such a way that will ensure fairness to all and that only first-class investments will be allowed. This is a heavy task because land acquisitions will be costly.

The previous discussion elaborated on the thorny issues that the authorities face in developing tourism in Jordan. Investors will only step in if terms are attractive and infrastructures are available. These facilities require huge investments by the government at a time when money is dear and hard to get on a soft-loan basis.

5 Conclusion

This study highlighted the positive steps Jordan is taking to attract foreign investments. Improvements in the financial and economic situation as well as improvements in legislation, infrastructure and management systems reflect the seriousness to which Jordan is addressing this issue. However, results have not matched expectations. Investors are seeking more incentives in Jordan.

The lack of infrastructure, shortage of natural resources, removal of red tape, empowerment of labor force and provision of more incentives are the remaining attributes to satisfying the goal of enhancing foreign investments.

The lack of infrastructure is a key issues. Wadi Mousa (The Valley of Mousa) hosts the city of Petra. However, the municipality of this valley is in debt. It is unable to control the sporadic development in the valley. Main streets have no lights, drainage systems are lacking, water shortage is severe, narrowness of roads is problematic, recreational centers are missing and sporadic development is accelerating. The government should do more to develop a master plan and provide an inviting infrastructure for foreign investors.

Natural resources are another problem that is not of Jordan's making. Water shortage is so severe in some tourist areas that hotels have to buy it at a high cost. Jordan is building dams, replacing old piping systems and improving water collection systems. The cost of water conservation and collection is staggering. The increasing number of tourists and water-consumption, construction and an overall increase in population call for more costly improvements. Jordan may enter into a water-desalination project with Israel. The project is still far in the horizon as it depends on using power from the Dead Sea-Red Sea Canal for desalination. This project will require approximately 20 years before completion. Meanwhile, Jordan needs to improve its water usage through recycling, replacing water-intensive agro-products and provision of incentives for improving the efficiency of water use.

The financial sector has noticed important improvements. However, the capital of most banks is under JD 20 million which reduces the capacity of these banks to those in regional projects. Comprehensive banking participation is still lacking, even though Jordan is moving towards this direction. Other relevant issues to this sector were also discussed.

Legislation, intellectual ownership and bureaucratic red tape still form a hurdle for foreign investments. Jordan improved the foreign investment law; however, its implementation is lacking because of red tape in the Customs and Tariff Departments. The "Investment Window" has not yet improved. There were a total of 41 complaints received by this window in the first quarter of 1996. These complaints centered around land ownership, availability of telecommunication facilities, water shortages and interruption of water supplies and bureaucratic hindrances. The report dwelled on the improvements Jordan has introduced so far; however, much more is still desired.

A quick visit to factors that impede foreign investment in Jordan reveals several facts. Privatization is moving ahead; however, it is too early to make judgments on the soundness of this process, particularly its correct implementation. Jordan's attempts to bring in investors have failed, to some extent, because of regional instability. Also, the fact that economic reforms have not yet improved the standard of living make some people critical of peace. Scandals of theft by some corrupted officials have also compounded the mistrust of foreign investment in the region. These developments come at a time when Jordan needs to accelerate the privately funded infrastructure developments as well as projects in power, gas, water and telecommunication, and improved posts and roads. The swelling chorus of anti-foreign investments by some "beneficiaries" aggravates this situation. These voices have cast doubts on the competitiveness of the Jordanian industry and some business people are turning more projectionist.

Jordan has done much to liberalize imports, slash tariffs, rebuild foreign reserves, reduce foreign debt and maintain a rather remarkable economic growth. However, the requirements by the foreign investor are beyond Jordan's economic capability.

Jordan does not stand alone. Europe is joining efforts to turn the Middle East into a "Lake of Peace". The Europeans have finally realized that their own security is tied to the Mediterranean security. This fact opens up many windows for cooperation between Europe and the Middle East, of which Jordan is an integral part. However, the "New Mediterranean" will undergo phases of profound political and socio-economic transformations, reforms, changes in the ground rules for trade, investment, business security arrangements. The management of these changes call for maximizing the cooperation between the Mediterranean partners. This cooperation is moving ahead and is gathering momentum.

Changes can lead to unrest. So can poverty and unemployment. The new Mediterranean's security and stability remain the prerequisites for the continuing development of the Mediterranean countries.

Poverty and unemployment make some people disinterested in the political life. This is not an extension of democracy and elaboration of human rights. Huge disparities in all aspects of life that exist in the "Mediterranean Lake" separate its northern part from the southern one. These factors continue to provoke major population flows from the south and east towards the rich north. These flows will create tension within the Mediterranean zone. European's involvement should extend to alleviate these problems by enhancing development in the under-privileged zones of the Mediterranean.

In conclusion the efforts of Jordan will not suffice to prepare Jordan for the "New Mediterranean". Europe's partnership should consolidate Jordan's efforts. Europe's investment in Jordan today means investment in Europe's own future tomorrow.

Comment: Benjamin Navon

The careful observation of Middle Eastern economic development shows that it is not solely determined by economic policies of governments and other economic variables, but also by political realities. Those realities, if not dealt with at an early stage, may eventually turn into huge obstacles for economic development.

One way of dealing with a whole array of potential political handicaps is to enhance a momentum in expectations toward a better economic future. By stating this, I do not mean to mislead our people with utopistic illusions. But shedding light on the economic potentials of the region can help to dwarf some of the political impairments that concern all of us. An example may be the list of the World Economic Forum of countries with the best chances of sustained growth. Leading the list are Singapore, Hongkong, New Zealand, and the USA; comfortably placed in the middle are Germany, Israel, Jordan, and Egypt; ahead of Spain, Portugal, China Greece and others. Closing the list are Brazil and Russia. If the countries are listed not only according to their growth potential, but also according to the size of their markets, Egypt would rank even higher.

The foundations of modern growth theory were laid in the 1950's by Robert Solow and Trevor Swan. Theirs was a model that describes an economy of perfect competition whose output grows in response to large inputs of capital and labor. The result of their combination is subject to the law of diminishing returns. This so-called neo-classical model has two crucial implications. First, as the stock of the capital expands, growth slows and eventually halts. In order to keep growing, the economy must rely on continuing technological progress. The second implication is that poorer countries should grow faster than rich ones.

Ten years ago Paul Romer published a paper "Increasing Returns and Long Run Growth", in which he showed that the law of diminishing returns does not apply if a relatively high proportion human capital is being used in the production process. Statistical analyses have shown that countries with substantial human capital relative to their physical capital are likely to grow faster than those with less.

Many economists argue that this was a factor in East Asia's success: in the early 1960's the Asian Tigers relied on relatively well-educated workforces and only low levels of physical capital.

A second point stresses the importance of government action in the economic system: countries that have pursued broadly free market policies - in particular, trade liberalization and the maintenance of secure property rights - have raised their growth rate. In a recent paper "Economic Reform and the Process of Global Integration.", Jeffrey Sachs and Andrew Warner divided a sample of 111 economies into "open" and "closed". The "open" economies have shown strikingly faster growth rates than the "closed" ones.

A more difficult issue is the importance of saving and investments. One implication of the neo-classical theory is that higher investment should mean faster growth (at least for a while). Empirical studies suggest that high investment is indeed associated with fast growth. But they also show that investment is not enough by itself. In fact, the causality may run in the opposite direction: high growth may even encourage higher saving and investment. Communist countries, for instance, had extraordinarily high investment but, burdened with bad policies in other respects, they failed to turn this into high growth.

Some parts of these economic discourses may indeed be substantiated by the early economic history of Israel. Excessive interventionism and ill-defined socialist principles slowed Israel's growth, despite tremendous influx of capital and skilled labor. It took decades to rectify those early mistakes and one can only hope that these mistakes are not being repeated by other countries of the region.

In sum, the growth potential of the region is very substantial and the peace process has motivated the US and the EU to boost this process that will bring political stability which is in everybody's interest. Major corporations like Daimler-Benz, Intel, VW and others are flocking into the region. It is almost a sacred duty of the governments of the region to maintain the peace momentum, to check inflationary trends, to seize the opportunities of intraregional trade, to invest in human capital and limit its own activities to an absolute minimum and above all maintain political stability in every aspect.

4

Working Paper

WHERE TO START WITH MULTILATERALISM - AN AGENDA FOR COOPERATION BETWEEN EUROPE, THE MIDDLE EAST AND NORTH AFRICA

Giacomo Luciani

Research Group on European Affairs, University of Munich

August 1996

The Project „Europe and the Middle East"

Due to the increasing importance of the Middle East and North Africa (MENA) for Europe, the Bertelsmann-Foundation and the Research Group on European Affairs set up the Project „Europe and the Middle East". Its mission is to develop European policy models vis-à-vis Europe's neighboring region across the Mediterranean. Following the Middle East peace process the question most thoroughly investigated is how the states in the Middle East and North Africa can organize regional cooperation among themselves as well as with the countries of the EU. Furthermore, it is designed to contribute to a better understanding of the transformation processes in the MENA-region in terms of its international relations, its economic development, and the transformation processes of state and society.

To implement this concept, the co-operation partners organize on a yearly basis workshop-meetings and the „Kronberg Middle East-Talks" which should contribute to a better understanding between both sides of the Mediterranean.

Giacomo Luciani is Deputy Director at ENI, Rome.

Executive Summary

In its introduction, the paper reminds the reader of numerous attempts to establish cooperative structures in the Middle East, as well as between Europe and the region - many of them did not produce sufficient success. However, around the successes of the peace process, multilateralism is given a second chance. But this new approach does suffer from the fact that multilateralism is not being generated from within the region, but proposed from extra-regional actors, such as the USA and the European Union.

Regional integration should be based on economic cooperation. The EU-concept of a free trade area in the Mediterranean area promises economic gains, as the MENA-region is opened up horizontally, as well as through the trade-agreements with the EU; in the context of the relations between the EU and World Trade Organization, the economies of the MENA-region will be further integrated into the world economy.

The following sectors promise specific gains from cooperation: the demand of energy will rise on a global level. In order to meet this demand huge investment efforts of the private sector and the privatization of state companies are necessary. The establishment for free trade will only be successful if shortcomings of regional transportation and communication-systems are overcome. The availability of water is another issue of concern, but creating a liberal water-market could help to use the water resources of the region efficiently. Private investment in general has to encouraged. This will be an extremely difficulties task as privatization-policies often are only an appropriate survival-strategy and not based on a free market-ideology. Finally, regional cooperation can only be meaningful when there is a possibility for people to migrate across borders. Progress should be made towards the eventual complete liberalization of personal movement.

1 Introduction

The year 1995 saw important developments in the Middle East and North Africa. The peace process achieved very significant progress, as agreement was reached on the transfer of responsibilities for a very broad spectrum of government tasks from Israel to the Palestinian Authority. This was despite of repeated attempts at scuttling the process, under the form of terrorist attacks, culminating in the assassination of Israeli Prime-Minister Rabin. The change in government in Israel may have created some delay with respect to previous expectations, but commentators almost unanimously agree that peace has taken root and is now irreversible.

At the same time, the European Union launched an initiative to establish a new Mediterranean Partnership with a number of riparian countries, culminating in the Barcelona Conference, which approved a Declaration and an Action Plan touching on a multiplicity of problems of key importance for the region.

And in Amman the second Economic Summit for the Middle East and North Africa took place with substantial participation from major international business companies; the Summit was the occasion for the launching of a regional Bank for the Middle East and North Africa, and for other regional institutions in the fields of tourism, and business cooperation.

2 Competing multilateralisms

Multilateralism is therefore now well underway - indeed a plurality of multilateral processes, which may compete with or support each other. Is this plurality of negotiating tables and institutional initiatives a problem? Does it result from major differences between the key actors?

Attempts to establish a multilateral frame of cooperation are not new to the Mediterranean Region. The Arab countries pursued political integration or even unification under the auspices of the Arab League and its various affiliate organizations, which include agreements for the establishment of free trade and various areas of cooperation - but implementation has lagged behind. The European Community has had a Mediterranean Policy since its inception, and talk of a <u>global</u> Mediterranean approach was there already in the very early 70s. Then came the Euro-Arab dialogue - but in fact only a set of bilateral agreements saw the light and was implemented.

It is not necessary to delve into the details of this rather frustrating past; yet it is clear that the mere existence of new attempts at multilateralism is not a guarantee of success.

The structural reasons which prevented multilateralism from taking roots in the region should be recognized. One important cause is the uncertain definition of the region - an uncertainty that continues to this date. Several organizing concepts have been tried (the Arab World, the Islamic Countries, the Arab East vs. the Maghreb, the Near East - different from the Middle East - and North Africa, the Mediterranean, and so on) but all have major shortcomings.

Today's attempts at multilateralism do not appear to mark a clear step forward. They trace a set of partly overlapping circles, a variable geometry with a rather small common subset or core, one comprising just three entities: Israel, Jordan and the Palestinian Authority. Indeed, the presence of these three entities is required almost by definition. Several multilateral fora exist which include most or all Arab countries plus some other countries in the region, and exclude Israel. These multilateral processes cannot be discarded and condemned indiscriminately: some have achieved significant if limited results. True, they are the product of the season of war, and symbolize the impasse that has suffocated regional development. Yet, it would be futile to attempt at erasing entirely the product of past efforts, and launch new multilateral institutions duplicating old ones: in some cases Israel may gain membership in the appropriate existing structure; in others this will prove difficult or altogether impossible, and Israel will probably have to conform to existing regional standards and realities.

New multilateral processes are therefore in need of focusing on new issues or issues for which past solutions have clearly failed - as is the case for trade liberalization. This is not an easy task, witness the debate preceding the establishment of the Regional Bank for Cooperation and Development and the final tally of its membership. A key consequence of this problematic transition from old to new multilateralism is that the region (whatever its intended definition) is not at present capable of generating a multilateral framework from within, and is limited to accepting or rejecting frameworks that are proposed to it from extra regional actors.

In this respect, we see two different approaches emanating from the United States and the European Union. The main concern of the United States is in promoting the peace process, by rewarding participants and isolating countries opposing it. It aims at diluting the national (i.e. Arab) undertones by encompassing countries from outside the region (Russia, Japan and a number of others) as well as non-Arab countries in the region (such as Turkey, in addition to Israel). Clearly, this strategy is applicable only to a limited set of issues, and favors a multiplicity of single-issue institutions or agreements with variable participation (multilateralism with variable geometry). It is not clear, nor maybe considered necessary or useful, that these autonomous branches to the multilateral process should eventually converge in one overarching framework. Presumably, as acceptance of peace becomes generalized participation in these multilateral frameworks may become more universal, but it is not clear that it should necessarily be so.

The European Union, instead, is aiming precisely at establishing a framework that is sufficiently universal. The simultaneous presence of Syria and Israel at the Barcelona conference was considered a success. And the spectrum of themes under discussion is extremely broad, including social, political and security issues, not just economic ones. But even the European-Mediterranean Partnership fails to achieve participation from all relevant countries: In the case of Libya, it is because of deliberate exclusion. In the case of the GCC-countries, it is the result of a mutual lack of interest which also reflects the frustrating climate in the parallel EU-GCC negotiations. But by excluding the GCC and Libya a very important group of regional actors - the major oil exporters - is excluded from the Partnership.

Other major weaknesses are not difficult to find. One gets the impression that many among the Partners of the EU are mostly interested in access to further aid, which they need to compensate for their dubious domestic legitimacy, and delay or dilute the solution to the fiscal crisis that grips them. The Union, on the other hand, is interested in encouraging economic reform - but does it have a chance to be any more successful than the World Bank and the IMF or indeed the United States have been in years and decades?

The Union is also interested in promoting democracy and individual rights, which, if words are true to their meaning, is tantamount to promoting revolution - albeit preferably a peaceful one. There is a degree of coherence in the Union's intention - it is not pretended that economic problems can be tackled and solved unless political and legitimacy problems are also tackled and solved. Yet one wonders whether the Partnership can be such a strong instrument as to in essence transform the entire region into a radically different economic and political reality.

In the final analysis, everybody seems to agree that regional cooperation will need to be implemented by the private sector, business enterprises and individuals. Multilateral diplomacy should serve the purpose of creating conditions appropriate for the private sector to engage in economic intercourse across boundaries.

This task is probably less daunting than one may a priori expect, because the private sector is generally quite keen to capture the potential benefits of regional integration, and resents having been barred from doing so for such a long time. It may therefore be sufficient to progressively abolish some of the anachronistic obstacles and prohibitions that have hindered its international expansion. Private sector activism is clear in the core group of participants (Israel, Jordan and the Palestinians) as well as in other countries, including those which maintain various shades of reservation or hostility at the official governmental level.

The nature of the required multilateral process is therefore permissive rather than prescriptive. Governments must commit themselves to lifting as many obstacles as possible, starting from the obvious ones concerning international trade, but progressively including all aspects of economic life.

3 Trade liberalization

The promise of a free trade area is the most important and concrete initial achievement of the Euro-Mediterranean Partnership. Establishing a wide-ranging regional free trade area is an important objective notwithstanding all the doubts and objections that are almost routinely raised in this respect:

- that MENA-countries do not trade with each other and are rather competitors than complementary;
- that MENA-countries do not at present take full advantage of the access which they already have to the European market, indicating that the lack of a free trade zone is not the primary obstacle to trade growth;
- that MENA-countries already enjoy significant access to the European market and the net effect of a free trade area would rather be to the advantage of European producers than of MENA export-oriented industries.

These objections are not different from the ones that are raised in all occasions whenever a major trade liberalization effort is launched. In fact, once trade is liberalized, trade patterns change and both industry and consumers benefit from it.

In the case of the Partnership, the likely major net benefit of the creation of a free trade area will come as a result of the liberalization of horizontal trade between the MENA-countries. Furthermore, because the EU is in parallel pursuing trade liberalization with other regions, as well as globally in the context of the World

Trade Organization, the free trade area is a mechanism for the progressive liberalization of MENA trade towards the rest of the world as well as with the EU.

A special advantage to be derived from a free trade area is the inevitable erosion of intervention mechanisms in the domestic economy, such as administered prices and monopoly positions. A free trade area is an effective tool against rent-seeking attitudes, which are paramount in the region.

Nevertheless, the question remains: will the private sector respond to trade liberalization? In the context of the narrowly defined Near East - that is for Israel, Jordan, the Palestinian territories, Lebanon and even Syria, if the Syrian economy is ever truly liberalized - it is certain that the response will come as soon as trade is really liberalized. For the rest of the region opportunities also abound, but a good many of the most obvious ones fall in the various categories of "sensitive" products for which liberalization is not at present in the cards. Among these, agricultural products directly affect the earnings of a large number of families. But problems also exist in other important areas, notably textiles and apparel and petroleum derivatives.

The envisaged free trade area will not be credible nor fully effective if it will not be complete - that is if the MENA-countries are not allowed access in those areas in which they hold a comparative advantage. Multilateral approaches excluding progress - possibly very gradual but material - in these areas run the risk of being mere *façade* exercises.

4 Energy

Energy is an area in which cooperation based on strong private sector involvement is both necessary and possible. Indeed, what characterizes the energy sector is the fact that cooperation between the energy enterprises of Europe and of the MENA-countries has existed for many years. This is of course especially true in oil and gas, but very significant cooperation also exists in the field of electricity. Such record of past cooperation translates into accumulated direct investment worth billion of dollars and trade flows that dominate regional economic intercourse. The vested interest in continuing good relations and further expanding the scope of cooperation is therefore very strong.

It is therefore not surprising that the energy companies of the Mediterranean promptly reacted to the opportunity that was offered by the Barcelona process and came forward with specific proposals and requests. Thanks to an existing association of all the major energy companies of the Mediterranean - the Observatoire Méditerraneén de l'Energie or OME - the CEOs of the Mediterranean Energy companies met in Paris in June 1995 and approved a declaration drawing attention to the need for cooperation specifically in the energy field.

The key innovation in the initiative of the energy companies was that the focus was not on North-South trade in energy products, but in satisfying the growing energy needs of the MENA-countries. It was underlined that the major challenge facing cooperation in the energy field was creating conditions allowing for the realization of the huge investment effort that will be necessary to meet rapidly growing energy demand in the MENA-countries over the next 20 years.

MENA-countries have experienced a very rapid increase in the demand for energy. Over the period 1971-91 energy demand increased more than fourfold, passing from 41 to 154 million tons of petroleum equivalent (Mtoe). The average growth rate of energy demand has been 6.8%, and massive investment has gone to the sector, yet conditions of supply remain fragile or unsatisfactory. Today the per capita consumption of energy remains very low, and is bound to increase substantially even in the absence of the kind of regional economic growth that we all hope and strive for.

Under fairly conservative GDP growth assumptions, total energy consumption is expected to increase from 164 Mtoe in 1992 to about 350 Mtoe in 2010 and well in excess of 450 Mtoe in 2020. As a consequence, the total requirements for investment in the energy sector of the MENA-countries by year 2010 is estimated to reach 274 billion US-$, that is about 18 billion US-$ per year.

Meeting such large investment requirements represents a major challenge. In most MENA-countries the provision of energy is the monopoly of state companies or agencies operating under the constraint of administered prices. The fact that these prices are kept artificially low contributes to denying these companies the cash flow that is needed to invest and expand capacity in line with demand. Privatization is therefore inevitable, to mobilize both domestic savings and foreign direct investment.

It is probably unrealistic to assume that states will opt for complete privatization. But participation from the private sector can be achieved in a variety of ways, including opening certain areas to private competition and transforming existing state monopolies into joint ventures with the participation of domestic and international investors.

The primary task for Euro-Mediterranean energy cooperation is to create conditions that will make private investment accepted and attractive. In a succession of meetings and international conferences during 1995 and early 1996, the European Commission (DG XVII), the OME and other international players such as The World Bank contributed to a progressive definition of an agenda to meet this challenge. The process culminated in the Energy Council of Ministers of May 7, 1996 and in the Ministerial Conference on Euro-Mediterranean Cooperation in the field of Energy that was held in Trieste on June 7-9, 1996.

The major conclusions of the Trieste Conference are as follows:

- "The Energy Charter Treaty could be considered as a reference instrument which would be able to promote investments and trade and create the conditions for efficient and transparent relations in the partnership. for the countries who have not yet signed this instrument, the accession to the Treaty may be considered as an appropriate form of participation..."

  This conclusion was reached following in depth consideration of the alternative hypothesis of calling for a Mediterranean Energy Charter, which was found to be impractical. It should be recalled that 3 out of 12 Mediterranean partner countries already adhere to the Energy Charter, and accession should not problematic for at least 3 other countries that are members of the WTO. There is agreement on the need for an international legal and institutional framework for energy cooperation and investment.

- "An effort should be made to harmonize legal and contractual rules applied to the energy sector in the Southern and Eastern Mediterranean countries, taking into account individual characteristics, in particular in the field of hydrocarbons, in order to favor investments by foreign companies"

  In view of persistent differences within the Union as to the best way to organize the energy sector (in particular the electricity sector), this conclusion is meant to encourage opening up to foreign investment and harmonization of rules in order to facilitate the task of foreign investors.

- "The development of a Euro-Mediterranean interconnected network in the gas and electricity sectors, including the Trans-European regional and local energy networks, constitutes a significant contribution to economic and social development in this area and strengthens the security of supply for all partners"

  In addition to this statement of principle, the preparatory work to the Conference established a list of projects that are necessary to complete electricity and gas interconnections around the Mediterranean. These projects will receive the needed support from the Union in order to ensure that the physical infrastructure is in place to allow for international trade in energy products.

- "An effort should be made to identify efficient ways to promote international investments, including methods of providing better cover of investment risks with the participation, where appropriate, of interested companies, to allow the financing of projects aiming at improving the energy situation in countries of Southern and Eastern Mediterranean countries"

  The energy companies of the Mediterranean have called for the creation of a special guarantee mechanism for energy investment, as existing alternative schemes are not sufficient in view of the size of most energy projects. There is support for this idea in the Commission and in many Union members, as well as in the Mediterranean Partner Countries, but also opposition on the part of some Union Member governments. The Commission was instructed to launch a major study of available alternative solutions to the problem of offering sufficient mitigation of political risk to the energy companies that are willing to engage in large scale projects in the Mediterranean Partner Countries.

- "considering the important interrelations between energy and environment, environmental objectives should be taken into account in the framework of the energy partnership, being compatible with the improvement of the supply security and the networks interconnection"
- "an effort should be made in order to improve energy efficiency, to develop renewable energy sources, in particular for thermal use and electricity production, and to provide electricity in rural areas"
- "The Euro-Mediterranean Energy Forum, which will constitute a flexible framework could ensure the continuity of dialogue amongst all the partners at political as well as expert level and could promote projects for regional interest"

  This last point is meant to institutionalize dialogue in the energy field and create a mechanism for advancing energy cooperation in the longer run.

In the light of the above, it may be concluded that a well defined agenda has been established for cooperation in the field of energy. If the various aspects of the agenda will be implemented - with particular reference to accession to the Energy Charter Treaty, implementation of interconnections, liberalization of foreign direct investment and establishment of an adequate guarantee system - investment flows of the order of several billion dollars annually will be realized.

5 Transport infrastructure and telecommunications

The establishment of free trade will have limited impact unless the shortcomings of regional transportation and communications are not overcome. It is not surprising that joint projects for the establishment of new roads and harbors, especially between Israel, Jordan and the Autonomous Palestinian Territories have soon been proposed.

Transport infrastructure is also an area in which large scale investment is needed and private sector involvement is well possible. Especially in the Near East, the limited distances involved and the intense traffic that may be expected create rather ideal conditions for the launching of infrastructure projects on the basis of commercial criteria.

The obstacle is at the political level, for in fact it is less than clear that all governments in the region are ready for the kind of freedom of movement that would justify the creation of modern transportation infrastructure. This points to the need for diplomatic initiative to facilitate border crossings in conjunction with the development of new transport linkages.

The paradox of private sector actors pushing for cooperation and governments resisting it is even more evident in the field of telecommunications. The importance of establishing modern telecommunications networks, fully integrated with international realities, hardly needs to be underlined. Also, the region offers a very favorable environment for the integration of telecommunications and the media, because of the almost universal knowledge of the Arabic language.

If integration has not gone farther, it is mostly because of opposition from national governments, due less to international conflict than to the desire of authoritarian and security-conscious regimes to maintain control over access to information and circulation of opinion in their respective countries.

Notwithstanding such opposition, the use of telecommunications and circulation of the media has made very important steps forward in the region. The most influential and widely read newspapers are published in London and then circulated throughout the region, to the extent that government controls permit. There is strong, practically irresistible demand for greater circulation and freedom of expression, and the governments are fighting a rearguard battle.

It may suffice to achieve privatization to see a quantum leap in telecommunications in the region; and privatization is almost inevitable because governments are unable to keep their telephone services in line with technological progress and international standards.

TV and radio services circulation is also restricted, yet the effectiveness of government control is rapidly eroding. In the case of radio, short-wave has always been there to guarantee a minimum of access to reliable information. But the turning point has been reached with direct satellite TV broadcasting. Dishes are everywhere, and attempts at limiting them have failed. They have become a hot issue dividing islamist from secularists.

In short, regional integration in telecommunications and the media is taking place and will continue to register progress, yet not at all because of intergovernmental cooperation, but mostly thanks to market forces and in the face of government resistance. The task of a multilateral cooperation process may be defined as overcoming national obstacles to private involvement and cooperation in communications and the media. The Euro-Mediterranean Partnership should set liberalization of the sector as a first priority objective in the short run, one failing which any talk of fostering democracy and protecting individual rights is pure pretense.

Telecommunications and transportation infrastructure were discussed at a Ministerial Conference on Euro-Mediterranean Industrial Cooperation that was held in Brussels on May 21, 1996. The conclusions, however, appear to be quite general, and little attention appears to have been devoted to increasing private sector involvement in these sectors. Consequently, the expansion of telecommunications and transportation is proposed with support from the MEDA program - which is bound to be limited and will not challenge the pattern of close political control over all forms of communications.

6 Water

Availability of water is a key concern for all MENA-countries and the danger of conflicts over water has been the subject of endless discussion and speculation. A recent World Bank report (Managing Water in the Middle East and North Africa) presented a very pessimistic evaluation of the potential for strategies to be undertaken at the international level. Yet, no serious multilateral approach to cooperation in the region can ignore water.

By far the most important issue for cooperation in the area of water is that it should be recognized as being a scarce resource carrying a price in line with its scarcity and value. Resistance to this simple principle is pervasive in the region (and sometimes in Mediterranean Europe as well) and is the root cause of the intractable nature of the problem. Yet recent research in the context of the Harvard Middle East Water Project has demonstrated that a policy based on appropriate pricing of water would be capable of solving essentially all problems, at a cost which is a fraction of that of purchasing sophisticated modern weapons systems.

Water is mostly consumed in agriculture. Civilian uses are important but quantitatively much more limited; furthermore, charging water for a price that is more closely in line with its cost and scarcity would not materially affect the standard of living of most households - it is possible to have a system of staggered water charges, progressively increasing the price for the largest consumers, to protect the poorer strata of the population.

However, for agriculture the introduction of water charges more in line with cost and scarcity may have very serious negative effects. There is a degree of romantic attachment to the image of the greening of the desert, or turning swords into ploughshares, and this would be all right if it came with acceptance of the fact that water should be paid for what it costs to procure. Unfortunately, it often turns into exaggerated water consumption, leading to conflict over water sources and turning ploughshares into swords.

Charging an adequate price for water would stimulate efficient use of it and check demand, on one side; and create economic incentives to increasing the availability of it, on the other. Water is no less easy to procure in the region than energy is - indeed there is considerable more water than oil and gas. Yet the main difference between the two is that water is not treated as an economic object.

Charging an appropriate price for water is obviously the key for participation of the private sector to managing water scarcity. Cooperation is possible in all aspects of the water cycle, from conservation and rational use to the development of new sources - yet cooperation will be contingent on the availability of public funds and subsidies as long as no economic incentive exists for conserving or improving the supply of water.

The close connection between water charges and the prospects for agricultural production suggests that the prospect of liberalizing access to the European agricultural market may be used as a bargaining tool to encourage water price reform. This would create conditions whereby countries in the region have a stronger incentive to pursue value added and quality in agricultural production rather than "food independence".

A multilateral framework for the pricing of water - establishing certain minimum agreed charges for different categories of utilizers, possibly an automatic formula for their progressive increase, and reasonable sanctions for non abiders - may create the necessary international pressure to convince individual governments to move in a direction that they will certainly dislike.

Unfortunately, it does not appear that discussion of the issue of water is making any significant progress in this direction. The Ministerial Conference on Industrial Cooperation (Brussels May 21, 1996) that was already referred to dealt also with the issue of water concluded that "additional water resources may, and in some cases will need to, be drawn from: search for new acquifers, dissalation plants, exploitation of fossil water resources, efficiency of utilization, of recuperation and in insulation of reservoirs and canalizations". How all of the above is to be paid for, it is not said.

7 Encouraging private international investment.

Most Mediterranean countries have experienced a long period of extensive direct state involvement in the economy. With the possible exception of Lebanon, whose private sector economy was destroyed by the protracted civil war, all other countries have seen limitations imposed on the role of their respective private sectors at least for certain periods of time.

Nevertheless the private sector is a significant economic force in the region, and should be called to play a role in the context of the new Euro-Mediterranean partnership. Indeed, it is clear that the state will be facing increasing fiscal difficulties, due to the combination of demographic growth fueling expenditure, an underdeveloped system of taxation, and excessive State involvement limiting the useful tax base. A retreat of the State is therefore primarily a fiscal necessity, and if a private sector did not exist it would have to be invented.

While abundant lip service has been paid for years to the role and benefits of the private sector, in fact state bureaucracies have proven extremely reticent in giving up direct control over the economy. Privatization has made very little progress, and most governments in the region view it as a distasteful step being imposed on them by negative outside circumstances rather than an opportunity for accelerated growth.

In this respect the conditions in the MENA-countries are radically different from the experience of Central Europe. In the latter, the retreat of the State from direct involvement in the economy came in the wake of political revolution, and most governments were convinced of the need for privatization. The same is unfortunately not true in the Mediterranean, where privatization is often just a survival strategy for entrenched political and economic elites.

Yet the private sector is in fact much more developed and vibrant in the Mediterranean countries than it was in Central Europe after the fall of communism. The "resident" private sector in most countries consists of small-scale activities, typically employing less than 10 people, whose contribution to GDP is probably underestimated. To this, the "non resident" private sector should be added, made of business entrepreneurs who migrated and established their business elsewhere in the world - most notably in the USA or Western Europe or the Gulf - but have not lost contact with their countries of origin and are keen to re-enter and invest if the appropriate conditions are put in place. And finally we must consider the substantial financial assets accumulated abroad by individual migrant workers, or business entrepreneurs which command extra funds in excess of what their business activities can fruitfully absorb - a case which is commonly found among business and merchant families in the Gulf.

The new Euro-Mediterranean partnership should therefore aim at creating conditions which will encourage the comeback of the substantial private financial and entrepreneurial resources that have left the region in the course of several decades, and are waiting the right opportunity to do so.

The Brussels Ministerial Conference on Industry Cooperation (May 21, 1996) that we already referred to devoted most of its attention to these aspects. It called for the establishment of an appropriate juridical and administrative framework, including specifically the freedom of establishment for enterprises and the liberalization of services. It also called for enhancing the respect of the rules of competition, and eliminating the disparity that still exist between privately and publicly owned enterprises.

The Conference also underlined the importance of supporting the diffusion of business culture and the establishment of business associations, and called for various initiatives for the formation of entrepreneurs.

Finally, the Conference envisaged various initiatives to support small and medium enterprises, and cooperation between enterprises in these categories belonging to different shores of the Mediterranean.

8 Movements of individuals

Notwithstanding political conflict, people have consistently moved across frontiers in this region, and will continue to do so. Governments on both sides of the flow, i.e. both in sending and in receiving countries, have generally had a negative attitude to migration, creating problems that migrants strive to overcome as best as they can.

This is clearly a very difficult area for multilateral cooperation: the European countries are not ready to open their doors to migration from North Africa; Israel is not ready to open its doors to Palestinian labor, and the right of refugees to travel back to the Palestinian territories is one of the issues regulated by the peace process; freedom of movement cannot be expected of authoritarian regimes. Yet, what meaning can there be in regional multilateral cooperation if progress is not made in the direction of greater freedom of individual movement?

The debate on this issue in Barcelona was especially deceiving. The European countries had a single and simple goal: obtain the cooperation of the countries of origin for the forceful repatriation of illegal immigrants. The countries of origin were understandably reluctant to agree to any such cooperation, and the matter was essentially referred to further bilateral negotiations.

This writer believes that an entirely different approach is necessary. It is not possible to launch a multilateral effort at guaranteeing freedom of movement for merchandise and capital and entirely deny it to labor. It is not possible to aim at fostering democracy and respect for individual rights and deny the freedom of individual movement across the region.

Multilateral cooperation between Europe and the Middle East and North Africa requires acceptance of the principle that progress should be made towards the eventual complete liberalization of personal movement, albeit in an undefined and distant future. Countries should undertake to abstain from making existing regimes more restrictive, and must accept a degree of international monitoring and recommendations. The concept of a parallel to the MFN clause (preventing discrimination by origin, at least within the region) may be explored, although it is unlikely that discrimination of individuals according to nationality can in fact be eliminated anytime soon.

What is most important is to establish a forum that will foster collective recognition of the fact that policies aiming at curbing migration purely with administrative and police tools simply do not work. The experience of countries in Europe and America is clear in this respect: prohibitionism leads to illegal migration, which in turn exacerbates social problems. An equilibrium must be found that is tenable in the long run and does not create an area of illegality that eventually becomes unmanageable.

This is difficult to achieve unless controlled migration is allowed within a set of recognized and internationally accepted rules. The establishment of cooperative programs to accommodate a viable level of migration and encourage potential migrants to stay legal while tackling the social problems involved with migration at both ends of the stream is necessary.

Preventing migration is not and cannot be the sole goal of multilateral cooperation in the Mediterranean. It is a legitimate goal, and no one would claim that migration is an ideal solution for any of the parties involved. The social displacement that is entailed by migration is universally recognized, yet migration takes place and will continue to take place. It is necessary to manage this process and especially to avoid considering all migrants as criminals, which they clearly are not.

9 Conclusion

Multilateralism is underway between Europe and the Middle East and North Africa. Its significance goes beyond consolidating the peace process between Israel and the Arab countries, although undoubtedly the peace process is a necessary precondition for Euro-Mediterranean cooperation to flourish. In this respect the European approach differs from the narrower American approach that is mostly interested in reaping the economic dividend of peace: but the two approaches are complementary rather than contradictory.

As progress is made in establishing a multilateral framework for economic relations in the region, it becomes increasingly apparent that the major obstacles to the process lie in the domestic politics of each of the participants. The Mediterranean countries will need to make substantial adjustment to the new international realities, touching areas of eminent national sovereignty such as the form and source of legitimacy of governments. It would be foolish to underrate the difficulty of making progress along this path.

Yet progress is necessary, and there are areas in which major benefits can be derived relatively easily. the analysis in this paper points to trade liberalization, energy cooperation and support to small and medium enterprises as areas that offer great promise. Progress is possible and in a sense easy in transportation and telecommunications, but it requires political adjustment that is possibly not ripe yet. Migration stands as the most difficult issue, one however on which the validity of the whole exercise will be judged in the end.

The broader global environment in which these attempts at multilateralism are taking place is not without significance. Countries in the Middle East and North Africa cannot fail to see that they are getting far poorer results than countries in east Asia or Latin America. The experience of other developing countries improves the acceptance of unpalatable solutions. And the "competition" between east and South for the attention of the European Union is under everybody's eyes.

One may get the impression that the task is made harder by the success of other regions of the world and by competition of other countries for the same pool of scarce resources. In fact, I believe that the positive experience of some companies and/or governments in other parts of the world encourages these and other actors to venture in similar projects and policies also in the MENA region. In this sense, barriers to entry are constantly being lowered, and the pool of scarce resources is not static, but constantly growing.

Will progress in multilateral cooperation be swift enough to cope with the challenge of a rapidly growing population and rising expectations? This remains to be seen.

(5)

Working Paper

TRADE IN THE MENA-REGION: TOWARDS EUROPE OR WITHIN THE REGION?

Peter Göpfrich

Comment:

Ercan Özer

Research Group on European Affairs, University of Munich

August 1996

The Project „Europe and the Middle East"

Due to the increasing importance of the Middle East and North Africa (MENA) for Europe, the Bertelsmann-Foundation and the Research Group on European Affairs set up the Project „Europe and the Middle East". Its mission is to develop European policy models vis-à-vis Europe's neighboring region across the Mediterranean. Following the Middle East peace process the question most thoroughly investigated is how the states in the Middle East and North Africa can organize regional cooperation among themselves as well as with the countries of the EU. Furthermore, it is designed to contribute to a better understanding of the transformation processes in the MENA-region in terms of its international relations, its economic development, and the transformation processes of state and society.

To implement this concept, the co-operation partners organize on a yearly basis workshop-meetings and the „Kronberg Middle East-Talks" which should contribute to a better understanding between both sides of the Mediterranean.

Peter Göpfrich is Executive Director at the German-Arab Chamber of Commerce, Cairo.

Ercan Özer is Deputy Director General at the Ministry of Foreign Affairs of Turkey, Ankara.

Executive Summary

This paper elaborates on the potentials and stumbling blocks of two approaches toward economic cooperation in the Mediterranean region: the one is being based on the idea to establish intra-regional free trade-structures, the other on the European initiative to first implement free trade-agreements among the EU and its southern neighbors, and then subsequently create a free market in the Mediterranean region.

The author argues that one obstacle to intra-regional trade is the lack of complementary production-structures of the Arab countries, which rely in most cases on the production of agricultural products, thus making benefit from trade only possible to a limited extend. Only when Israel comes into play, regional trade would produce gains for the partners involved, as Israel's economy - mainly based on industrial output - could exchange these products against agricultural products of its Arab neighbors. But the political obstacles are too large, as to realistically envisage the establishment of free trade-structures among the unequal partners. The concept of the TRIAD, which formulates the idea of the economic integration of the Israeli, Jordanian, and Palestinian economies and integrating in second and third steps Egypt, Syria, and Lebanon and then the Gulf countries, Turkey, Iraq and Cyprus, which is the most optimistic scenario, is being confronted with huge political difficulties.

The second approach under consideration is the initiative of the European Union and its Middle Eastern partners to establish a free trade-area in the Mediterranean area, as being agreed on the Conference in Barcelona. This approach has two major components: the first is the negotiation of bilateral trade agreements by the EU with each of its southern partners, the second should enhance free trade in the region itself through bilateral trade agreements among the southern countries.

1 Introduction

Regional integration has become the watch-word for the future of peace in the Middle East and - closely linked - of Middle East economic development. Despite political difficulties and setbacks and whether by natural conviction or by the persuasive hands of third parties, the nations of the region outwardly and publicly declare a need for rapid and comprehensive integration of their respective economies. The region's political and economic partners - especially those in the northern neighborhood of the European Union - are also unequivocally and unanimously in favor of such an endeavor and provide financial support, technical assistance and advice.

This common commitment was recently underlined by the regional as well as by the European partners during the Barcelona-Conference in November 1995. Trade is one, in not the key to the integration process. It is the most tangible and public medium through which successful economic integration will stand or fall. The subject of Intra-Med regional integration and its linkage to Euro-Med economic partnership is very complex and involves not only economic, but also a wide range of interrelated political aspects.

In this discussion paper we want to confine our remarks to the economic aspects of intra-regional economic cooperation and trade. We want to touch upon the question of whether or not the countries in the Middle East have potential for an increase in intra-regional trade.

If we find that this is the case, then the following questions must be posed:

- What are the impediments that currently hinder the realization of these potentials?
- What could be, in terms of trade policy, a possible scenario to create a conducive trade environment?

Finally we want to ask, - whether the increased intra-regional trade would be, in terms of size and value, an alternative or a logic corollary to Euro-Med trade under the envisaged Euro-Mediterranean free trade area to be completed by 2010?

2 Trade potential in the Middle East - the unequal neighbors

At the outset let me recall some facts and figures, highlighting some features of the current state of affairs of the region that we are speaking about: ninety million people are directly involved in the new political and economical developments;

two-thirds of these people alone live in Egypt. Far behind Syria, which is the second most populous country (14 million), come the others, ranging in population figures between four and five million (Israel, Jordan, Lebanon) or, in the case of the Palestinian Territories, about two million.

A completely different picture emerges when population is compared to economic performance. Here Israel, with a population share of about 6%, accounts for more than 50% of the Gross Domestic Product (GDP) of the region , amounting in 1994 to about US-$ 144 billion. This means that Israels per capita GDP is twenty times more than that of Egypt and more than ten times that of the countries in the region besides Egypt.

The unequal economic performance obviously reflects considerable differences in economic structure, especially labor productivity. Among the reasons for this state of affairs is certainly the fact that Israel, poor in natural resources and economically and politically isolated in the region, had to orient its economy to the needs of industrialized countries earlier and more urgently than some of its neighbors. At the same time intensive agriculture assured some degree of self-sufficiency and created a source of export- revenue.

However, as far as agriculture is concerned, trade statistics show that the famous Jaffa oranges and other agricultural exports no longer have the high rank in Israel's GDP. Currently, they contribute only about 2% to the GDP in Israel, whereas the contribution of manufacturing is around 20%, a figure well on par with developed industrialized countries.

In contrast to this, broadly speaking, the share of manufactured products for the GDP in the other countries under review is much less, if not almost negligible, such as in the Palestinian Territories. Agricultural products and mining (hydrocarbons in Egypt and Syria; phosphates, etc. in Jordan) have a comparatively much higher share.

3 No complementarity - no trade?

Based on these and other figures demonstrating the unequal level, structure and size of the economies of the Middle East countries, the wide-spread opinion among many experts (economists, politicians, industrialists) is that the current low level of regional trade in the Middle East - only 7-8% of overall trade - results primarily from the fact that the economies in question lack the necessary degree of complementarity. In addition, experts believe that, due to the great difference in economic structure and the very limited complementarity, regional trade enhancement, based on a zero-sum outcome, would be a futile mission.

Examples are given, for instance, regarding the trade of agricultural products. Here, the diversification of agricultural products between Egypt, Jordan and the Palestinian Territories have become so identical that neither side is interested in imports of such products from the other side. Or take the textile and clothing industry, which has achieved such an importance within the individual economies that all the countries have taken measures to protect themselves from foreign (which includes regional) competition.

Without going into details, one can state that in many sectors production structures in the Arab countries of the Middle East are so similar (and unfortunately in some cases so similarly uncompetitive and unproductive) that trade with reciprocal benefits is only possible to a very limited extent.

In view of the dissimilarities in the manufacturing sector of Israel vis-à-vis its Arab neighbors, many experts believe that, for the time being, intra-regional trade and economic integration of the Middle East region should not be facilitated, at least as far as Israel is concerned, due to its sheer dominance.

They argue that economic integration in the Middle East is capable of survival only between economies that have attained comparable degrees of development. Consequently, the removal of trade barriers would cause serious disadvantages for the economies of the Arab states in the region. The individual states must first undergo the painstaking exercise of building up their economies to reach a complementary strength with their partners.

According to this opinion, integration schemes, which neglect these economic facts, could be sustained only through establishing reciprocal trade conditions. The higher burden of such trade conditions could only be mirrored in the misallocation of valuable resources. Pure trade diversion, possibly substituting former extra-regional suppliers with regional suppliers, could be a result of regional trade enhancement in the best case. In the worst case, according to many observers, intra-regional trade would move on a one-way axis moving from the most dominant players in the market to the weaker ones and Israel might be expected to find its way to neighboring Arab markets, while possibly - apart from gas and oil - not much would be left to trade the other way around.

Another opinion claims that regional economies differ in form and structure which would create an unsurmountable obstacle for enhanced trade. This view is heavily disputed in general terms and particularly as regards intra-regional trade in the Middle East.

In a recent study, compiled under the auspices of Harvard University and entitled "Towards Free Trade in the Middle East: The TRIAD and Beyond" (Harvard University, June 1995), it is argued that, on the contrary, exactly these differences provide a basis for enhanced regional growth under the premise that advantages enjoyed in one country could be shared with another and, thus, increase overall output and employment. The authors of the study refer to the case of NAFTA, in which unequal neighbors with very different stages of development, the USA and Mexico, are also incorporated and appear to be doing business with one another quite successfully.

The study suggests a gradually implemented free trade agreement between Israel, Jordan and the Palestinian Territories and argues with some reason that the elimination of politically imposed obstacles (Arab boycott of Israel, security overkill of trade, and others) should increase intra-regional trade, create remarkable new trade and enhance substantially economic growth in the Middle East. The authors strongly deny that increased regional competition could wipe out entire industries. International experience indicates that liberalizing intra-regional trade and generally international trade provide stimulus for companies to find new market niches and strategies for competing.

4 The potentials of intra-regional trade - the IFO-Study

Similar optimistic results about the potentials of intra-regional trade - not just by substituting extra-regional suppliers by intra-regional suppliers (for instance, Israel after removing the Arab boycott and other trade barriers), but increased intra-regional trade to satisfy additional demand - are also the findings of the most comprehensive and most detailed empirical study up till now: „New potentials for cooperation and Trade in the Middle East", conducted by the reputable German Institut for Wirtschaftsforschung (German Institute for Economic Research), contracted by the German Federal Ministry of Economics.

The IFO Institute makes an in-depth analysis of Middle East intra-regional trade potential under the assumption that there are no distortions to trade, especially when imports from one country within the region are admitted on an non-discriminatory basis. The study bases its results methodologically on a detailed analysis of regional and international competitiveness (Revealed Comparative Advantage Index or RCA), concerning individual product groups. It then determines which products from which country have future regional trade potentials on the basis of present extra-regional trade flows and present regional trade links.

Some major results and likely developments derived from the research of the IFO-Institute are as follows:

- With the current production structures, the Arab countries in the Middle East surely have only limited prospects for a significant expansion of trade with each other.
- However, an inclusion of Israel in regional trade could introduce a new dimension in Middle East trade, although it must be expected that this will develop only gradually, due to established supplier-relationships, psychological barriers and other obstacles.
- The bilateral trade potential between Israel and the Middle East region is estimated at about US-$ 1.9 billion.

Israel's trade surplus in this area is estimated to be at a modest level of about US-$ 100-150 million which may even develop to an import surplus due to necessary higher raw material imports mainly from Egypt.

Generally, according to the study, Egypt will gain most of such regional trade liberalization in the long run. In regards to the future perspectives of intra-regional trade in certain product groups, some major results of the IFO research are as follows:

- Several product group areas reveal trade possibilities between all partners in the region, such as foodstuff, building materials, textiles and clothing. For these product groups, competitiveness will increase, leading to continuing specialization in line with individual capacities and cost advantages, on the one hand, and possibly force certain industries to move production (and/or subcontracting, outward processing etc.) to another country with comparative advantages, on the other hand. Israeli textile companies has already moved its production to Egypt (Delta Company);
- As for vegetable and mineral raw materials, including hydrocarbons, it will be more or less a one-way street from Arab countries as suppliers to Israel as a recipient country with opportunities for joint processing (like Midor-Refinery in Egypt).
- Many possibilities for multilateral trade relations and cooperation are seen in the chemical sector with the minerals of the Dead Sea and the hydrocarbon resources of the region serving as a basis.
- For products closely linked to raw materials, multilateral trade relations with the prospect of regional specialization are possible in terms of yarn, fabrics, iron and steel products and also unilateral regional export opportunities both for

Israel (such as rubber types, packaging material, tools and cutlery, machines and transport equipment) as well as for the Arab countries (such as building materials, leather and leather articles).

- Clothing and footwear are identified as manufactured products with a regional importance and potential future specialization.
- Israel might have some limited regional export prospects for high-value and specialized products, whereas labor/cost intensive production will concentrate on the Arab countries. Israel's strength will lie, also in terms of regional trade potentials, in fields where it has already gained a favorable international market situation, such as precision instruments, professional and scientific equipment and security devices.
- The IFO study also analyzes the trade potential between the Middle East countries and the countries of the Gulf Cooperation Council.

The present trade structures in the Middle East, with the exception of Israel, also reflect current potential, while the possible trade potential of Israel with the Gulf states is estimated at about US-$ 500 million. One must bear in mind that the hidden, indirect exports of Israeli-made products to the Gulf states are estimated to be about US-$ 1 billion per year.

5 Israeli studies: new trade potentials by regional trade liberalization

The study of the IFO-Institute is in line with another study by Israeli authors.

(A. Hirsch, Iqal Ayal, Gideon Fistelson: The Arab-Israeli Trade Potential: Methodological Considerations and Examples, Tel-Aviv University, March 1995)

In contrast to studies that derive their results from the countries with existing trade and possible trade diversion, this study tries to estimate potentials of the so-called „New Trade".

Such „New Trade" can be created in the following fields:

- Trade of goods sensitive to distance.
- This refers to products whose trade ability is strongly affected by geographic distance either because of transport costs (quarry materials, building material, etc.) or because of their perishability (fresh products) or because of their requirement for quick availability for maintenance or repair.
- Trade of goods based on new sources of inputs.
- This kind of trade is based on the availability of inputs from Arab countries (e.g. cotton, gas, oil, fruits, vegetables, chemicals) or from Israel (industrial products,

technical-marketing, administrative know-how) which may increase the supply of potentially competitive final outputs manufactured in Israel and/or the Arab countries.

- Trade of goods sensitive to scale.

The opening up of the Arab-Israeli borders will help to create a sufficient market of scale necessary for the establishment of manufacturing entities in many sectors.

According to the results of this study, the regional trade potential of the Middle East is to be considered much more promising than most of the actual calculations and expectations assume.

6 The „flying geese-scheme"

Potentials of increased intra-regional trade and cooperation can also be derived from the so-called „flying geese-scheme", a concept which was mainly applied in the context of economic integration of the Asia Pacific region up till now. (Fukasaku, 1992: Economic Regionalisation and Intra-industry Trade: Pacific-Asian Perspectives, OEDC Development Center).

This concept states that a technologically more advanced country shifts less technology-intensive and more labor-intensive industries to neighboring less developed countries. The economically and technically most advanced economy (the leading goose) flies ahead and leads the way for the less developed economies of the region to the next stage of industrial developments. The economics within a region advance together through intra-regional trade expansion based on shifting comparative advantages. Such a path could be experienced by several developing countries in the Asia-Pacific region.

Applying this flying geese concept to the Middle East could mean that Israel, being the technologically most advanced country in the region, could play the role of the leading goose directing foreign direct investments in labor-intensive and less technologically demanding activities to their neighboring Arab countries according to their comparative cost advantage. Egypt could be a major production-site for labor intensive industries. Due to higher labor costs than in Egypt, Jordan, Lebanon and Palestine must find their place in technologically more sophisticated activities that require higher skills.

Generally speaking, apart from Israeli foreign direct investment, the Arab countries could benefit from cooperation projects combining relatively low cost labor and natural resources with Israeli technology and know-how to upgrade technological capacity and increase international competitiveness.

7 Impediments to regional trade

The aforementioned studies and opinions, which draw a rather optimistic picture of the potentials of increased intra-regional trade and cooperation, are based on the assumption that there are no legal, political, administrative or other distortions to trade. Ideally, it would mean that preferential treatment or even free trade conditions would prevail, that all barriers to foreign direct investment would be removed, and that all kind of tariff or non-tariff barriers and impediments hindering economic cooperation and joint regional economic advancement would be abolished.

As we all know, this ideal scenario is far from the actual realities. This paper only touches on the topic of trade barriers and other impediments that currently exist between the countries of the Middle East.

The single most important impediment that impacts regional trade is the security element. In one way or another, this is characteristic of all countries of the region and it affects transportation and customs clearing. In additioin, it countinues to inhibit initiatives towards developing commercial relations within the New Middle East. The tariff regimes differ significantly between the countries of the region, which are sometimes designed to protect local industry against foreign (and regional) competition.

Bureaucracies and administrative impediments are still tremendous, many of them not explicitly designed to inhibit trade but rather constituting an outdated modus operandi of administration. Standards and specifications are mostly not up to date and constitute serious non-tariff barriers. The restrictions, controls, procedures for travel and transportation also represent a very important barrier to trade. This enumeration could be continued endlessly. For more details and suggestions on how to remove these impediments and enhance intra-regional trade, I would like to refer to the study entitled „Trade for Peace in the New Middle East. Measures to Enhance Trade Between Egypt, Israel, Jordan and the Palestinian Territories", conducted by the German-Arab Chamber of Commerce 1995 under the auspices of the Commission of the European Communities.

What is important is that all countries of the region have to actively engage themselves in removing the numerous trade restrictions still existing. This can be accomplished partly through the prescriptions in GATT. Several countries have already joined. Other restrictions must be confronted and removed via mutual consultations. In several bilateral agreements signed between states of the region so far, several trade restrictions have been effectively dealt with already.

8 Free trade in the Middle East - which scenario?

Among those who are in favor of enhancement of intra-regional trade and who see perspectives for a considerable increase, there is an unanimous opinion that at the end of the long road - which still has hurdles, curves and precipices - free trade in the Middle East should be considered the best contribution to prosperity and peace in the region. Among the many suggestions on how to reach this aim, I would like to mention two scenarios:

The first is to create a free trade agreement (FTA) that would evolve into a customs union, first between the Israeli, Jordanian and Palestinian economies - the TRIAD - later to be extended to include other countries in the region. The proposal is presented as a result of the aforementioned study of the Harvard University: over a five year period, all trade barriers between Israel and the Westbank and Gaza (WBG) should be eliminated. In addition, all Israeli barriers to Jordanian products should be removed and Jordan should grant Israel concessionary tariffs for selected goods.

By 2010, all barriers on Israeli exports to Jordan should be harmonized with those of Israel and the Westbank and Gaza. Simultaneously, the TRIAD should enter into similar arrangements with other nations who are willing to make similar commitments towards freer trade.

In the long term, it is envisaged that the TRIAD could form the nucleus for a broader regional trading group that adds Egypt, Syria and Lebanon, and, as the political situation and economic incentives develop, would include countries in the Gulf, Turkey, Iraq and Cyprus. This scenario is in line with earlier political developments: that is, the bilateral agreements between Israel and the Palestinian Territories, on the one hand, and the Israeli-Jordanian agreements, on the other hand, and also in congruence with the perception of many that the three countries constitute an economic sub-region and are the nucleus of the emerging Middle East Market. To a certain degree, this set-up continues to be the most probable or at least most-favored scenario for the economic integration of the region.

Recent developments in the region, however, suggest that this scenario will face some difficulties at least in the foreseeable future. The Palestinian Territories will most likely continue to be separated from Israel. No other Arab country is likely to step in unilaterally to complete the TRIAD again. Since this is probably the case, an alternative scenario shall be outlined in the following.

I am referring to a suggestion advocated by a representative in the Commission of the European Community, Eberhard Rhein (Director in DGI for the Mediterranean countries). The starting point of this plan is the commitment of 27 states at the Ministerial Conference in Barcelona to progressively establish a vast Euro-Med Free trade area to be completed by 2010. Such a free trade area has two major separate components: one links the EU (and, in a separate legal investment, the remaining EFTA-States) with each of the 12 Med-Parties themselves; the second (Intra-MED) has yet to be tackled in terms of methods and procedures. The first component is in full swing, with six negotiations completed (Turkey, Cyprus, Malta, Israel, Tunisia, Marocco), three under way (Jordan, Lebanon, Egypt) and three under preparation (Algeria, Syria, Palestine). Intra-Med Free Trade could theoretically be implemented through one jumbo negotiation involving each of the twelve MED-States, leading to one instrument (MED Free Trade Association - MEFTA -), thus following several familiar precedents like EFTA 1973, GCC 1980 and CEFTA 1993.

Alternatively, it could proceed in a more spontaneous fashion: certain countries might decide to enter into bilateral free trade; others may follow or maintain the status quo (MFN-status). Since neither of these two approaches seems practical (the first too ambitious, given various degrees of state-competitiveness, different levels of economic development, and different links to the EU; the second requiring 144 individual negotiations), a third approach is suggested by Rhein, guided by the following principles:

- Free trade between Israel and the Arab countries should be asymmetrical. While Israel dismantles its protection immediately, its Arab partners will start, at the latest, after 12 years;
- Turkey is obliged under its Customs Union agreement with the EU to align its EU trade policy. Therefore, it has to offer free access to its markets by about 2001, at the latest, in return for progressively free access to the MED-country markets
- The Arab countries in Maschreq/Maghreb, which all have a comparable level of economic and industrial development, should implement free trade among themselves within 12 years, at the latest, according to a uniform time-table applicable to all of them.
- Ideally, there should be three sets of negotiations in view of achieving intra-Med free trade. In a first step, the eight Arab Maghreb/Maschreq partners should decide to establish a Maghreb/Maschreq Free Trade Area (MEFTA) themselves, which will be put in force on 1.1.1999. If not every partner is ready to follow in the beginning, the others should not feel prevented to proceed. In a second step, the future MEFTA should then enter into negotiations on free trade

with Turkey and Israel. This would streamline their negotiations according to one basic pattern, with specific country protocols only on certain issues, e.g. on agricultural products.

- As soon as conditions are ripe, MEFTA could enter into free trade negotiations with the GCC. This would be a logical corollary to the ongoing FTA negotiations between EU and GCC. In the very long run, MEFTA might develop into an all-Arab Free Trade Area and realize an objective that the Arab League has attempted to pursue for more than 20 years. The first view outlined by E. Rhein, which separates the Arabs from Israel in the first step, seems breathtakingly logical and - in view of the difficulties, which currently the TRIAD scenario is facing - the more realistic one.

The second view, however, reflects the numerous futile endeavors between the Arab States in the Middle East in the past to reach economic integration. The third view reveals a sense of optimism, since the linkage of this process to the ongoing EURO-MED development makes it more likely, if not nearly inevitable, for the concerned parties to make such a step.

9 EURO-MED and/or intra-MED

If one follows these scenarios, the question put at the beginning as to whether increased intra-regional trade within the Middle East could be an alternative or a completion to European-Middle East Trade has already been answered. Intra-Med Trade is a natural and logical corollary to European-Middle East Trade. The suggested MEFTA could considerably enhance the negotiation power of the individual MED partners in their future relations with the European Union.

In terms of trade figures, it seems clear that currently and in the future the trade-flow between Europe and the Middle East overrides the intra-regional trade with the Middle East. Trade relations in the Middle East region have traditionally been strongly directed at countries outside the region within the EU (and with the US), thus dominating imports and exports between 50% and almost 70%. This structure will remain basically intact even if there is an increase in intra-regional trade.

For future trade between the EU and the Middle East, Israel - developing more and more into a high-tech country - will find growing markets for its industrial products, while the exports of the Arab countries, to a lesser degree and with fewer perspectives, are more concentrated on raw materials (especially oil), several intermediate products, agricultural products, clothing and several labor intensive manufactured products. An increase in intra-regional Arab/Israeli economic, especially industrial, cooperation will enhance and diversify the range of products eligible for export to the European Union. The EU, on the other hand, will also profit from increased intra-regional trade in the Middle East.

Even if Israel's potential industrial exports to the Middle East region and the Gulf states will be partially to the disadvantage of previous extra-regional - also European - suppliers, economic integration and growth in the Middle East will, grosso modo, enhance the EU's export potential to the region. And, to conclude with a sensitive topic in Euro-Med trade, the EU might also hope that intensified regional trade in agricultural products will ease (albeit not eliminate) the pressure to export these products to Europe.

10 Conclusion

The fundamental question underlining the issue of intra-regional trade strategies is: does it make economic sense? Not only for national economies, but for immediate business realization? Realistically, it is unlikely that pure trade redirection that does not tangibly offer substantial marginal returns over and above existing commercial links will work. Any form of increased cooperation in the Middle East region - particularly trade - must mark a net-added contribution to the prosperity of the people.

Even if some of the present circumstances - existing trade patterns, established production capacities and prevailing structures for manufacturing in the region - seem to indicate the contrary, there is, nevertheless, enough potential for new exports between the states in the region, stimulated by increases in efficiency and the creation of additional capacities that have developed from the growth of regional productivity (and not from existing patterns of production). The single most important factor in achieving increased, sustainable intra-regional trade is creating a synergetic environment within which intra-regional trade pays higher dividends than its alternatives. Furthermore, it is better to create a framework within which goods, services and capital flows are trouble-free as much as possible than to leave decision-making up to the individual entrepreneur.

Ercan Özer: Comment

Given the small markets of the economies of the region, economic cooperation and development should extend beyond trade and include the reduction of costs, increasing efficiency, greater mobility of capital and labor, dissemination of new technologies, introduction of more efficient payments systems, education and training and the establishment of modern infrastructures. Economic cooperation would have to start with concentrating on infrastructure and telecommunication systems as prerequisites of trade; trade links will then grow rather gradually.

We should bear in mind two caveats:

In speaking of trade, generally we mean trade in goods and not services. But, services account for roughly one-third of world trade. Second, in speaking of the Middle East, often we mean the so-called Arab Mashreq countries (Egypt, Jordan, Lebanon, Palestinian territories and Syria) adding to them Israel. Sometimes, MENA states (the GCC-member states, the states of the Maghreb and Turkey) are being addressed. This is a limited scope. The scope should cover all of these states not in some aspects but as a whole and I would argue that Turkey should be included for the following reasons:

- It has a pivotal position between Europe and the Middle East and considerable economic and political weight and potential in relation to the possible integration of that area. Turkey has the highest GNP in the region.
- It is the only neighboring state apart from Egypt to have full diplomatic relations with Israel. Israel established a very broad and diversified economic cooperation with Turkey. There is a free trade agreement signed between the two countries.
- The water supply question makes it essential in any case.
- Turkey is an important exporter of food which will increase with the realization of the GAP project.
- Turkey established a customs union with the EU, which provides joint production opportunities for the MENA countries.

Regional economic cooperation and trade potential

In the analysis of the trade potential, reference is often made to the low level of current intra-regional trade. The current low level could be indicative of, but it should not be decisive, in judging the prospect of regional integration.

When it comes to the judgment of "no complementarity-no trade", caution is in order. Unequal economic performance with differences in economic structures and productivity may not end up with a zero-sum game. The disparities, both quantitative and qualitative, in the factors of production may be a plus not a minus in the achievement of synergy effects through economic cooperation. Complementarity is where you find it or how you create it. Complementarity can also be achieved through joint ventures.

In the analysis of intra-regional trade, the outcome is usually measured vis-à-vis Vinerian "trade creation" and "trade diversion". I would like to draw attention to the fact that these trade effects are a matter of controversy among the economists as the academic arguments do not always coincide with the situation in the world.

In a world of globalized production and trade, trade creation may benefit third country firms operating in the region and trade diversion may harm member country firms with production facilities in the third countries and exporting to the region. Vinerian trade diversion is just one kind of terms of trade effect. Some economists argue that trade effects should be replaced by terms of trade and trade volume effects. Some even claim that whereas trade creation is competitive, trade diversion is complementary.

There are other factors which affect the trade analysis in regional arrangements: static and dynamic effects, taking into account the economies of scale, product specialization, skilled labor and innovation effects, price versus growth effect, demand and supply elasticity effects, inflationary effects, consumer effects, price equalization, and others.

A general conclusion which can be drawn from the results of the empirical studies done regarding the foregoing effects is that if the regional economic arrangement is not accompanied by more liberal external policies, it could lead to the distortion of international resource allocations through extra-regional trade suppression effects and becomes less attractive. In liberalized schemes, early negative price effects will be overcome by the positive growth effect in the long run.

Impediments to regional trade

How justified are the fears related to Israeli economic hegemony? Does Israel see the Arab world as a huge market to invade?

I am not here to talk about Israeli intentions; however, I can infer with relative accuracy that Israel is perhaps more interested in being associated with the European economic area than in economic cooperation at the regional level. Israel may prefer to build a high-tech industry producing for world markets and the EU, more than for Middle Eastern markets.

Some Arab circles hope to be able to counter the influence of the US with the help of the EU. It is not a matter of countering forces, but of uniting them. It is in the US interest to encourage the EU to assume greater responsibility in the Middle East.

The way I see it, the US and the EU have both interests and responsibilities in the region. The relationship is not mutually exclusive. The responsibility is complementary. The US has the political clout and decisive say on Israel. The EU has the economic card and influential position in the Mediterranean region. Both of them have the financial means to assist the regional efforts.

Maintenance of stability and security in the Middle East is of vital importance to the EU. The cornerstone of the EU's approach in the region is its new Mediterranean policy. The EU has an important role to play in the Middle East by creating improved access for the Middle Eastern firms to the EU market, improving its financial mechanisms, making it sustainable, assisting in private sector building with special emphasis on small and medium size firms, pinching in identifying intra regional complementarities, developing and institutionalizing them and extending its support to design income-generating projects. In sum, an arrangement with the EU is more than a Free Trade Area; it is more than trade interaction. It is an across-the-board arrangement entailing economic growth, division of labor and more efficient production.

There is an inverse correlation between integration and development level. Many low income countries are among the least integrated and some of them have become more marginalized during this period. On the other hand, there is a direct correlation between the level of liberalization and integration. Economic growth and increased integration are mutually reinforcing. Integration is likely to pay higher dividends and is necessary to avoid marginalization as opposed to non-integration. Therefore, Middle East, or MENA for that matter, cannot isolate itself from this reformation.

Granted that the economic integration is neither the necessary nor the sufficient condition, however, integration arrangements among the developing and developed countries can yield benefits by securing markets, encouraging investment, access to technology, and enhancing the discipline and credibility of reform. A very important benefit of the integration and entailing institutional reforms is the enhancement of developing country's credibility and attractiveness for investment. The degree of success depends on a country's commitment to macroeconomic discipline.

Regional multilateral economic structure should be driven by the dynamism and initiative of the private sector. Hence, stimulus is needed to encourage and create a suitable milieu for the individual enterprises. The emphasis should be on the small- and medium-sized enterprises. The governments' role should be to facilitate the efforts of the private sector by creating favorable economic, commercial, legal and fiscal conditions.